Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Hong Kong's
CPA Qualification
香港會計師專業資格

Qualification Programme

Module 11
Financial Reporting

Pilot Examination Paper

Time Allowed	3 hours
Examination Assessment Allocation	
Section A – Case Questions	50 Marks All FOUR questions are compulsory
Section B – Essay / Short Questions	50 Marks All THREE questions are compulsory

Published in March 2021

Module 11 – Financial Reporting

This examination is divided into TWO sections.

- Section A (50%). This consists of FOUR compulsory case questions. You should allocate approximately 1 hour and 30 minutes in total for Section A.
- Section B (50%). This consists of THREE compulsory essay / short questions. You should allocate approximately 1 hour and 30 minutes in total for Section B.

Suggested time allocation (by marks):

Marks	Approximate time in minutes
1	2
2	3
3	5
4	7
5	9
6	11
7	12
8	14
9	16
10	18
11	20
12	21
13	23
14	26
15	27
16	29
17	30
18	32
19	34
20	36

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

CASE

Prosperity Holdings Limited (the "Company") is one of Hong Kong's leading property development companies. The Company's shares have been listed on the Main Board of the Hong Kong Stock Exchange since March 2007. The principal activities of the Company and its subsidiaries (the "Group") include property development and investment, hotel operations, property leasing and trading of building materials as well as furniture. The Company prepares its financial statements by 30 September each year.

Assume today is 1 December 2018 and you are the Finance Manager of the Company overseeing the accounting-related matters of the Group.

Residential Development Project Paraìso

Currently, the Group has a number of property development projects. One of these is a residential development project in Shatin named project Paraìso. Project Paraìso includes the construction of five multi-storey residential buildings with multiple units in its first phase. The project obtained approval of its General Building Plan by the Building Authority [1] in December 2016. Foundation works were completed by mid 2017 and superstructure works commenced in late 2017. By June 2018, the construction was in-progress, and the Group started selling the apartments in the mass retail market before construction was completed. Such pre-sale complies with the presale period set by the Hong Kong SAR Government. Upon completion of the construction, the Group needs to obtain a Certificate of Compliance issued by the Lands Department[2]. This is expected to occur on 31 August 2019 while the expected date of passing the keys of the apartments to customers will be 30 September 2019.

The directors would like to know the accounting impact of HKFRS 15 *Revenue from Contracts with Customers* to the Group, particularly when revenue from the pre-sale of apartments can be recognised. The directors selected one of the pre-sale transactions of the project Paraìso and asked for the advice. The transaction is detailed as follows:

On 1 July 2018, Mr Jeff Chan decided to buy an apartment (Unit C, 5/F of Block 1) of Paraìso and entered into a preliminary agreement for sale and purchase, which is legally enforceable, with the Group. Jeff immediately paid a deposit equal to 5% of the list price of the apartment, HK$20 million. On 4 July 2018, Jeff entered into a formal agreement for sale and purchase superseding the preliminary agreement. On the same day, Jeff paid another 5% of the list price as deposit. The 10% initial deposit has to be paid regardless of which payment plan customers chose as the deposit is used to protect the property developer from customers who fail to complete their obligations under the contract. The deposit is considered to be solely for the above purpose.

Note 1: A building development project involves submission of different types of prescribed plans, such as the General Building Plan, Foundation Plan and Drainage Plan. Consent to commence building works is required from the Building Authority before the construction works start.

Note 2: Lands Department of the Hong Kong SAR Government is in charge of all land matters in Hong Kong. A Certificate of Compliance is issued when the development is complete and in compliance with all the positive obligations.

The Group offered Jeff a payment plan where if Jeff paid the remaining amount in full within 90 days after the preliminary agreement for sale and purchase, he would receive a 20% discount on the list price. On 1 August 2018, Jeff paid the remaining balance of the list price after discount. The payment was then placed in a stakeholder account in accordance with the Consent Scheme of the Lands Department of Hong Kong[3]. The Group could withdraw money from the stakeholder account to pay for the construction costs of the project which would effectively reduce the financing needs of the project.

The Group estimated, at the inception of the contract, that the cash selling price of this type of apartment unit after considering different alternative payment options was HK$19,244,580. A comparison of the payment terms between different payment options indicated a total cumulative interest of HK$3,244,580 and an implied interest rate of 18% per annum (equivalent to 1.5% per month). After taking into consideration the relevant principles in HKFRS 15, the Group concluded that this arrangement with Jeff contained a significant financing component. Interest, if necessary, is calculated monthly in the computations.

<u>Acquisition of Hotel S</u>

The hospitality arm of the Group completed an acquisition deal to acquire a hotel in Seoul, South Korea ("Hotel S") in July 2018. This was the first time for the Group to acquire a hotel outside Hong Kong. The Group has not decided under which mode of operation will Hotel S be managed. In other words, Hotel S may be owner-managed, or the Group may act as a passive investor.

You are the Finance Manager of the Group. You received the following email from one of the directors, Tom Chan:

To: Chris Wong, Finance Manager
From: Tom Chan, Director
Date: 1 December 2018
Subject: Acquisition of Hotel S

Hi,

I understood our Group has acquired Hotel S recently. If the Group were to own a hotel property, it should simply be classified as an investment property as it would fulfil the definition of investment property in accordance with the respective accounting standard. Please let me know if my understanding is correct.

Regards,
Tom

Note 3: Consent Scheme of the Lands Department was designed to regulate the sale of uncompleted flats and to give some protection to purchasers. Under this scheme, the developer has to demonstrate that it has adequate financial ability to complete the development. The scheme also requires purchase monies to be put in a stakeholder's account and will be released for meeting the construction cost of the development. The interests of flat purchasers are therefore protected.

Acquisition of Design Beta Limited

On 1 October 2017, True Prosperity Limited ("True Prosperity"), one of the wholly-owned subsidiaries of the Group, completed the acquisition of 80% equity interest in Design Beta Limited ("Design Beta"). Design Beta is a private company engaging in designing and manufacturing modern furniture under its own-developed brand name "SimHome". It has been the intention of the Group to equip its apartments and hotels with furniture designed and manufactured by Design Beta. The Group determined that the acquisition date for this business combination was 1 October 2017.

On 1 October 2017, True Prosperity paid cash of HK$126.8 million to the ex-owners of Design Beta. True Prosperity agreed to pay an additional HK$29 million in cash to the ex-owners of Design Beta if Design Beta could meet the annual profits target of an average of HK$20 million over a two-year period, starting from 1 October 2017. Any additional consideration would be paid on 1 January 2020. The fair value of such potential payment of consideration was determined to be HK$25 million on 1 October 2017. The time value of money for such potential payment was considered immaterial.

The purchase price allocation exercise revealed that the fair value of the "*recorded*" net identifiable assets of Design Beta was close to the book value, which was HK$158 million, as at the acquisition date. The exercise further revealed that the following two items were not recognised by Design Beta and the Group is uncertain if these items can be separately recognised in the business combination:

The brand name "SimHome" had a fair value of HK$8 million as at 1 October 2017. The brand was assessed to have an indefinite useful life in accordance with HKAS 38 *Intangible Assets*. The Group impaired "SimHome" by HK$1 million during the year ended 30 September 2018.

Design Beta has a team of specialised staff for designing its furniture. This collection of employees was valued to be worth HK$4 million as at 1 October 2017.

The Group chose to measure the non-controlling interest in this acquisition at their proportionate share of fair value of net identifiable asset at the acquisition date.

On 30 September 2018, True Prosperity acquired an additional 5% ordinary shares of Design Beta from an existing shareholder by paying HK$10 million cash. Design Beta reported a profit of HK$25 million for the year ended 30 September 2018. The fair value of net identifiable assets of Design Beta as at 30 September 2018 was assessed to be HK$158.71 million. The Group is subject to Hong Kong profits tax at 16.5%.

Integrated Reporting

In a recent Board of Directors' meeting, some directors questioned the possibility of publishing an integrated report. Yet some opposed this as they argued that the Group has already integrated all the financial information in the annual report and there is no need to pursue such reporting.

<u>Question 1</u> **(19 marks – approximately 34 minutes)**

(a) Analyse and advise as to when the Group can recognise revenue arising from the pre-sale of Unit C, 5/F of Block 1 of Paraìso.

(9 marks)

(b) Explain, with appropriate calculations and journal entries, how the payment made by Mr Jeff Chan prior to the completion of the construction should be dealt with in accordance with relevant accounting standard(s) in the Group's consolidated financial statements for the year ended 30 September 2018 and for the year ended 30 September 2019.

(10 marks)

<u>Question 2</u> **(9 marks – approximately 17 minutes)**

Prepare an email to the director, Tom Chan, and justify whether you agree the statement made by him regarding Hotel S. State clearly what additional piece(s) of information regarding the mode of operation of Hotel S you need to gather before reaching a conclusion. Explain how such additional information may affect your classification of Hotel S in the Group's consolidated financial statements.

Note: A maximum of 2 marks for communication skill and 2 marks for analytical skill will be awarded.

(9 marks)

<u>Question 3</u> **(19 marks – approximately 34 minutes)**

Explain the accounting impacts to the Group's consolidated financial statements arising from the acquisition of Design Beta Limited during the year ended 30 September 2018. You are expected to discuss but are not limited to the following:

- **The consideration of this acquisition at 1 October 2017;**
- **The fair value of net identifiable assets of Design Beta in this business combination at 1 October 2017, based on the information provided in the scenario; and**
- **The accounting impact of the further acquisition of 5% ordinary shares of Design Beta on 30 September 2018.**

(19 marks)

<u>Question 4</u> **(3 marks – approximately 5 minutes)**

Explain what integrated reporting is and state the objectives of such reporting.

(3 marks)

* * * 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/ calculation and appropriate presentation of answers.

Question 5 (18 marks – approximately 32 minutes)

Every Success Limited ("ESL") and Party A established Harvest Well Limited ("HWL"), an incorporated limited liability company with shareholding of 60% as to ESL and 40% as to Party A. The principal activity of HWL is holding a property. The board of directors of HWL is comprised of five directors. The critical rights and terms agreed among those parties are as follows:

- ESL and Party A are entitled to appoint three directors and two directors respectively.
- Dissolution of HWL and issue of additional shares of HWL will be subject to unanimous consent from ESL and Party A at a shareholders' meeting.
- All decisions over HWL are approved by a simple majority of the board of directors except for the operating and capital decisions of HWL, including sales plan and annual budget, which require approval by all directors.
- The appointment and removal of directors require the approval of all shareholders of HWL.
- Bank B offers the mortgage loan to HWL. It is agreed with Bank B that HWL is required to obtain approval from Bank B if HWL changes its principal activities.
- Each shareholder provides guarantees to the bank in proportion to their ownership interests in HWL (i.e. the bank can request the shareholders to settle if HWL fails to make payment).
- All shareholders can pledge their shares in HWL to other parties as they wish.

Required:

Advise on how the investment in HWL shall be classified in the financial statements of ESL based on each of the rights and terms above.

(15 marks)

List THREE disclosure requirements for reflecting the financial effects of and risks associated with the investment in HWL in the financial statements of ESL.

(3 marks)

Question 6 **(14 marks – approximately 26 minutes)**

On 1 October 2016, Good Result Limited ("GRL"), with 30 June as its financial year-end, approved a plan that granted 120,000 share options to its top management which were immediately vested and 180,000 share options to its administrative staff which will be vested after a service period of three years. 10% of the administrative staff is expected to leave during the three-year period and therefore forfeit their rights to the share options. For certain sales executives, GRL granted 50,000 share options with a condition of meeting specific sales targets for the year ended 30 June 2017 when they are under GRL's employment. It is certain that half of these sales executives can meet their sales targets. All vesting of shares is same as the original expectations. The market price of GRL's shares at 1 October 2016 was HK$5. GRL estimated that the fair value of each type of share option above is valued at the same value of HK$1.6 at grant date.

Mr Tam, one of the sales executives of GRL, and Mr Yeung, the chief financial officer of GRL, have been very good friends for many years. To be entitled to the relevant share options by achieving the specific sales target, Mr Tam has requested Mr Yeung to recognise the sales Mr Tam made in July 2017 earlier in the year ended 30 June 2017, then he will share the proceeds with Mr Yeung from selling the shares of GRL after exercising the share options. Mr Yeung is a member of the Hong Kong Institute of Certified Public Accountants.

Required:

(a) **Prepare the journal entries for the share options issued by GRL during the year ended 30 June 2017.**

(4 marks)

(b) **Explain how the departures of top management, sales executives and staff before the exercise of their options (i) during the year ended 30 June 2017, and (ii) after 30 June 2017 but within the aforesaid service period of three years, will affect the accounting for the share-based payment.**

(4 marks)

(c) **Advise as to the ethical issues involved in this case in accordance with the Code of Ethics for Professional Accountants.**

(6 marks)

<u>Question 7</u> (18 marks – approximately 32 minutes)

On 1 April 2017, Power Save Limited ("PSL"), a Hong Kong company, issued an HK$800 million convertible bond (CB) at coupon interest of 2% per annum which is payable annually in arrears. PSL uses December as its financial year-end. The CB will mature on 31 March 2022. The holders are entitled to redeem at par together with any accrued interest on 31 December 2017 or upon maturity. The CB holders are entitled to convert the CB into 400 million ordinary shares of PSL on or before maturity.

On 1 October 2017, certain holders exercised their options to convert into shares in PSL for a principal amount of HK$200 million.

The prevailing market interest rate of a similar type of instrument without a conversion option is 6%. Both the functional currency and presentation currency of PSL is HK dollar (HK$). PSL prefers applying the fair value option to any hybrid instrument issued by PSL. The fair value of the conversion option is categorised within Level 3 of the fair value hierarchy.

The fair value of each component at the respective date is as follows:

	Liability component HK$'million	Conversion option HK$'million
1 April 2017	665	110
1 October 2017	660	130
31 December 2017	680	100

<u>Required:</u>

(a) (i) Explain how the CB will be accounted for under the above scenario.
(2 marks)

(ii) Prepare the journal entries with detailed calculations for the issue of the CB on 1 April 2017 and the partial conversion of the CB on 1 October 2017.
(6 marks)

(b) Assuming the functional currency of PSL is Renminbi (RMB):

(i) Explain how the CB will be accounted for under this scenario.
(4 marks)

(ii) Describe the disclosures as required by HKFRS 7 *Financial Instruments: Disclosures* and HKFRS 13 *Fair Value Measurement* for the CB in respect of liquidity risk, market risk and fair value measurement in the preparation of the financial statements of PSL for the year ended 31 December 2017.
(6 marks)

* * * END OF EXAMINATION PAPER * * *

Module 11
Financial Reporting

Answers

The suggested answers are longer than what candidates are expected to give in the examination. The purpose of the suggested answers is meant to help candidates in their revision and learning. The suggested answers may not contain all the correct points and candidates should note that credit will be awarded for valid answers which may not fully covered in the suggested answers.

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

General principles for recognising revenue under HKFRS 15

Under HKFRS 15, an entity only recognises revenue when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is generally considered to be transferred when the customer obtains control. HKFRS 15 states that control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control also means the ability to prevent others from directing the use of, and receiving the benefit from, a good or service.

A critical question, at the contract inception, is to determine whether the Group will transfer control of the apartment over time. If that is the case, the Group can recognise revenue over time, specifically in this case, when the construction is still in progress. Otherwise, the Group satisfies the performance obligation at a point in time and therefore recognises revenue only at a point in time.

Assessment of whether control transfers over time

In order to assess whether control transfers over time rather than at a point in time, HKFRS 15 states that an entity has to fulfil one of the following criteria:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

(c) (i) the entity's performance does not create an asset with an alternative use to the entity and
(ii) the entity has an enforceable right to payment for performance completed to date.

Criterion (a) typically refers to pure service contracts in which an entity transfers services over time (such as routine or recurring cleaning services). This criterion is less likely to be relevant to pre-completion sale of real estate.

The essence of criterion (b) is whether the customer has already obtained control (or ownership) of the land at the start of the construction. In the context of a multi-unit apartment, this is less evident as a particular customer will only obtain physical possession of the particular unit he or she has purchased until the completion of the construction of the whole building. Criterion (b) is therefore less likely to be applicable in this situation.

Criterion (c) is analysed in two perspectives. In order to rely on criterion (c) for recognising revenue over time, it is crucial to first ensure that the performance of the property developer does not create an asset (in this case, the apartment) with an alternative use. HKFRS 15 states that an asset created by an entity's performance does not have an alternative use to an entity if it fulfils one of the following two criteria:

- the entity is restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset; or

- the entity is limited practically from readily directing the asset in its completed state for another use.

This assessment should be made at the inception of the contract.

In this context, the Group entered into the preliminary agreement for sales and purchase, which is a legally enforceable contract to transfer a specific apartment (Unit C, 5/F of Block 1 of Paraìso) to an individual customer (in this case, Mr Jeff Chan). The Group is therefore restricted contractually from re-selling the specific apartment to another customer. It is therefore quite apparent that the specific apartment that the property developer creates has no alternative use once the agreement is signed (criterion c(i) is met).

The analysis then goes on to evaluate whether the Group has an enforceable right to payment for performance completed to date (i.e. criterion c(ii) above). HKFRS 15 requires that, for this condition to be fulfilled, an entity *at any time* during the contract term (i.e. all times throughout the contract starting from the date of contract inception) must be entitled to an amount that at least compensates the entity for performance completed to date, even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised.

The agreed payment schedule set out in the contract with Mr Chan does not provide the Group with an enforceable right to payment for performance completed to date at all times throughout the contract. The Group had already been in the middle of its construction activity when Mr Chan entered into the preliminary sale and purchase agreement. Only 10% deposit had been paid by Mr Chan on 1 July 2018 while the remaining balance was paid in one month's time. Yet, the construction has always exceeded 10% of the project. The amount paid (i.e. the 10% initial deposit) is not commensurable to the stage of completion of the apartment.

Further, the assessment of whether an entity has an enforceable right to payment for performance completed to date requires the entity to consider the rights and obligations created by the contract, taking into account the legal environment within which the contract is enforceable. This is of particular importance when the contract was terminated before completion for reasons other than the property developer's failure to perform as promised. Under the common law system, there is high uncertainty in granting of the equitable relief of specific performance in favour of the property developers.

Based on the above assessments, it is therefore concluded that the property developer does not have an enforceable right to payment for performance completed to date (criterion c(ii) is not met).

As none of the three criteria above are satisfied, the Group needs to recognise the revenue generated from the pre-completion sales of the apartment at a point in time. The next question is at which point in time should such revenue be recognised.

Application of when the customer obtains control of the apartment

As discussed above, revenue should be recognised when a customer obtains control over the asset. HKFRS 15 then provides a list of indicators that helps determine the point in time when a customer obtains control of a particular good or service:

(i) the entity has a present right to payment for the asset;
(ii) the customer has legal title to the asset;
(iii) the entity has transferred physical possession of the asset;
(iv) the customer has significant risks and rewards of ownership of the asset; and
(v) the customer has accepted the asset.

In the context of pre-completion sale, this is the point when the agreement for sale and purchase is completed and the keys are passed to the customer. From the customer's perspective, this is the point in time when he or she could, for example, occupy the apartment or prevent others from entering the apartment without their consent. This demonstrates the transfer of legal title to the apartment and the physical possession of the apartment. Control has therefore been transferred to the customer and revenue can then be recognised at this point (which is expected to be 30 September 2019).

Answer 1(b)

As the arrangement with Jeff is concluded to contain a significant financing component, the fundamental issue is to determine the transaction price of this contract in the context of HKFRS 15.

To estimate the transaction price in a contract, an entity adjusts the promised amount of consideration for the time value of money if that contract contains a significant financing component. The objective for this is to recognise revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid cash at the time as control of that good or service transferred to the customer.

In this case, the difference between the amount of promised consideration (HK$16,000,000, which is equal to 80% of the list price HK$20,000,000 (i.e. after 20% discount)) and the cash selling price (HK$19,244,580) is HK$3,244,580.

The Group only obtained significant benefit of financing once the Group received the remaining from Mr Jeff Chan.

In accordance with HKFRS 15.62, if the difference between the promised consideration and the cash selling price arises for reasons other than the provision of finance to the developer (or customer) and the difference between those amounts is proportional to the reason for the difference, that amount does not represent financing.

Such principle is then applied to the 10% initial deposit in this case. The 10% initial deposit has to be paid under any of the alternative payment plans and therefore arises for reasons other than financing. The purpose of the 10% initial deposit is to protect the developer from customers who fail to complete their obligations under the contract. The amount of such deposit is also concluded to be proportionate to the intended reasons.

The period of the significant benefit of financing, in this case, was then approximately 14 months long (from 1 August 2018 to 30 September 2019).

HKFRS 15 provides a practical expedient that an entity needs not adjust the transaction price in a contract for the effects of a significant financing component if it expects to receive payment within 12 months of transferring the promised goods or services. Such a practical expedient is not applicable in this situation.

To deal with the accounting treatment of such a significant financing component, the 10% deposit (HK$2,000,000) has to be deducted from both the cash selling price (HK$19,244,580) and the promised consideration (HK$16,000,000) as the initial deposit was not considered as providing the benefit of financing to the Group. The difference in the adjusted balances of HK$17,244,580 and HK$14,000,000 were then used for calculating the interest expense under the effective interest method:

(Note: The following table is for reference only. Candidates are expected to calculate the interest expense for the two months ended 30 September 2018.)

Month ended	Contract liability (beginning)	Monthly rate 18% / 12	Interest expense	Contract liability (ending)
31 Aug 2018	14,000,000	1.5%	210,000	14,210,000
30 Sep 2018	14,210,000	1.5%	213,150	14,423,150
31 Oct 2018	14,423,150	1.5%	216,347	14,639,497
30 Nov 2018	14,639,497	1.5%	219,592	14,859,090
31 Dec 2018	14,859,090	1.5%	222,886	15,081,976
31 Jan 2018	15,081,976	1.5%	226,230	15,308,206
28 Feb 2018	15,308,206	1.5%	229,623	15,537,829
31 Mar 2018	15,537,829	1.5%	233,067	15,770,896
30 Apr 2018	15,770,896	1.5%	236,563	16,007,460
31 May 2018	16,007,460	1.5%	240,112	16,247,572
30 Jun 2018	16,247,572	1.5%	243,714	16,491,285
31 July 2018	16,491,285	1.5%	247,369	16,738,654
31 Aug 2018	16,738,654	1.5%	251,080	16,989,734
30 Sep 2019	16,989,734	1.5%	254,846	17,244,580
			3,244,580	

On 1 July 2018:		
Dr. Cash	HK$1,000,000	
Cr. Contract liability		HK$1,000,000
(HK$20,000,000 x 5%)		
On 4 July 2018:		
Dr. Cash	HK$1,000,000	
Cr. Contract liability		HK$1,000,000
On 1 August 2018:		
Dr. Cash	HK$14,000,000	
Cr. Contract liability		HK$14,000,000
(HK$20,000,000 x (1 - 20%) - HK$2,000,000)		
For the year ended 30 September 2018:		
Dr. Interest expense	HK$423,150	
Cr. Contract liability		HK$423,150
(HK$210,000 + HK$213,150)		
For the year ended 30 September 2019:		
Dr. Interest expense	HK$2,821,430	
Cr. Contract liability		HK$2,821,430
(HK$3,244,580 - HK$423,150)		
On 30 September 2019:		
Dr. Contract liability	HK$19,244,580	
Cr. Sales revenue		HK$19,244,580
(HK$16,000,000 + HK$3,244,580)		

The Group may need to further consider whether the interest expense during the two years ended 31 December 2019 is eligible for capitalisation under HKAS 23 (Revised) *Borrowing Costs*.

Answer 2

To: Tom Chan, Director
From: Chris Wong, Finance Manager
Date: 2 December 2018

Subject: Acquisition of Hotel S

Dear Tom,

Regarding to the classification for the newly acquired hotel in Seoul, I would like to provide the following conditions with reference to the relevant accounting standards for your consideration.

HKAS 40 *Investment Property* defines an investment property to be a property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes or sale in the ordinary course of business.

What primarily distinguishes investment property from other types of property interest is that its cash flows, from rental or sale, are largely independent of those from other assets held by the entity. By contrast, owner-occupied property used by an entity for administrative purposes or for the production or supply of goods or services do not generate cash flows themselves but do so only in conjunction with other assets.

Based on the above general principles, a hotel owner may classify a property as either an investment property under HKAS 40 or owner-occupied property under HKAS 16. The key issue is the extent to which the owner retains significant exposure to variation in cash flows generated by the operations of the hotel.

Whether Hotel S is owner-managed

In accordance with HKAS 40, if the owner provides ancillary services to the user of the investment property, the property will not be qualified as an investment property unless these services are insignificant to the arrangement as a whole. HKAS 40 describes security and maintenance services as being insignificant. Supply of ancillary services is however significant in the situation if the hotel is owner-managed. The hotel property is being used to a significant extent for the supply of goods and services such as reception, food and beverages and housekeeping services. As these services are considered as a significant component of the commercial arrangements, the hotel property will be precluded from being an investment property and will then be classified as owner-occupied property. It is therefore crucial to see whether Hotel S will be managed by the Group itself.

Whether the Group is a passive investor and whether the Group retains significant exposure to variation in the cash flows generated by the operations of Hotel S

There may be circumstances where the management function and provision of services is carried out not by the owner but outsourced to a third party to whom the owner has transferred those responsibilities under a management contract. Under the above circumstance, the owner's position may be, in substance, that of a passive investor.

This may be the situation when the hotel property is leased on arm's length terms to hotel operators, especially when the payments under the lease are not significantly determined by the results of the hotel operator (i.e. the payments under the lease reflect the market rates for such property) and the nature of the owner's rights in the arrangement with the hotel operator is not divergent from those usually expected under a property lease. In this case, Hotel S would be classified as investment property.

Yet, if the owner has outsourced day-to-day functions to a hotel operator while retaining significant exposure to variation in the cash flows generated by the operations of the hotel, it should rather be treated as owner-occupied property.

The Group may therefore need to consider whether (i) the management responsibilities of Hotel S will be transferred to an external hotel operator through a management contract and whether (ii) the Group will retain significant exposure to variation in the cash flows generated by the operations of the hotel before it classifies Hotel S as an investment property.

I hope the above comments are helpful. If you wish to discuss further, please let me know. Thank you.

Best regards,

Chris
Finance Manager

Answer 3

Consideration transferred

In accordance with HKFRS 3 (Revised) *Business Combinations*, the consideration transferred should be measured at fair value, which should be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer.

Contingent consideration usually refers to an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. In this case, the potential payment should the profits target be met is considered as the contingent consideration.

Based on the discussion above, the total consideration for this business combination was:

	HK$'000
Cash consideration	126,800
Contingent consideration	25,000
Total consideration	151,800

In accordance with HKFRS 3 (Revised), during the measurement period (which should not exceed one year from the acquisition date), the acquirer recognises additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date, if known, that would have resulted in the recognition of those assets and liabilities as of that date.

Yet, whether the condition for the contingent consideration is met or not does not qualify as a measurement period adjustment as meeting the profits target is not a piece of information about facts and circumstances that existed as of the acquisition date. No retrospective adjustment to the total consideration will therefore be necessary in the subsequent periods.

Fair value of net identifiable assets of Design Beta

As the fair value of the recorded net identifiable assets of Design Beta was close to its book value (HK$158 million) as at the acquisition date, the critical question is to determine whether the two items in question should be separately recognised in the business combination.

The first item is related to an internally generated brand name "SimHome". HKAS 38 *Intangible Assets* provides a restriction in an entity's separate financial statements from capitalising internally generated intangible assets such as brands, mastheads, publishing titles, customer lists and items similar in substance.

In a business combination, an acquirer recognises an acquiree's intangible assets at the acquisition date if they are identifiable. An asset is identifiable if it is either separable or arises from contractual or other legal rights.

An asset is separable if it is capable of being separated or divided from the entity and sold, transferred, licenced, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so. In other words, exchange transactions evidence separability.

If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights (i.e. satisfying either of the above criterion), there is a presumption that sufficient information exists to measure reliably the fair value of the asset, and the intangible asset shall be recognised separately from goodwill.

Applying the above principles to the case, "SimHome" is separable as brand names could be sold or exchanged in the market (i.e. evidenced with exchange transactions), and therefore it is identifiable. True Prosperity recognised this brand as a separate identifiable asset at a fair value of HK$8 million at the acquisition date.

The recognition of such a brand name brought another issue under HKAS 12 *Income Taxes* for discussion. HKAS 12 requires the tax effects of the differences between fair values and book values to be accounted for as deferred tax liabilities or deferred tax assets if the basis for taxation does not change with the business combination.

As the carrying amount in the business combination refers to the fair value as at the date of acquisition while the tax base refers to such in the entity's separate financial statements, temporary difference arises when there is fair value adjustment in a business combination. Deferred tax assets or liabilities created will then be included as part of the fair value of net identifiable assets acquired.

In this case, the upward fair value adjustments of HK$8 million relating to the recognition of the brand name would generate a deferred tax liability of HK$1.32 million (HK$8 million x 16.5%) at the acquisition date, which was recognised as part of the net identifiable assets acquired in the business combination.

The second item is related to assembled workforce. In order to recognise an intangible asset, an entity needs to demonstrate control over the item. Control exists when an entity has the power to obtain future economic benefits from an underlying resource and to restrict the access of others to those benefits.

It is uncommon for an entity to exercise sufficient control over the expected future economic benefits over its workforce for the workforce to be recognised as an intangible asset. Design Beta has therefore not recognised the workforce as an intangible asset in its separate financial statements and would not recognise such item in the business combination. In other words, it remained subsumed in goodwill in the business combination.

(Note: Candidates may further argue, based on HKFRS 3 (Revised) B37, that the assembled workforce represents the value that allows the acquirer to operate the acquired business from the date it has been acquired. HKFRS 3 (Revised) then considers that assembled workforce does not represent the intellectual capital of the skilled workforce which refers to the (often specialised) knowledge and experience that employees of an acquiree bring to their jobs. It is not identifiable, being neither separable from the business (due to its firm-specific nature) nor contractual in nature. It is therefore not recognised separately from the goodwill. Credits will be further awarded for such additional elaborations, although the concepts of "control" demonstrated above should be sufficient to conclude that the assembled workforce would not be separately recognised in the business combination.)

The fair value of net identifiable assets of Design Beta in this business combination at the acquisition date was HK$164.68 million (HK$158 million + HK$8 million brand name – HK$1.32 million deferred tax liability).

<u>Non-controlling interest</u>

As the Group measured the non-controlling interest in this acquisition at the proportionate share of fair value of net identifiable assets at the acquisition date, the non-controlling interest was measured at HK$32,936,000 (HK$164,680,000 x 20%).

<u>Goodwill</u>

The Group calculated the goodwill as at the acquisition date as follows:

	HK$'000
Consideration	151,800
Non-controlling interest	32,936
Total	184,736
Less: Fair value of net identifiable asset	(164,680)
Goodwill	20,056

The goodwill would be presented as an intangible asset in the consolidated statement of financial position of the Group.

Further acquisition of 5% ordinary shares

There has been no change in the subsidiary status in this further acquisition of 5% ordinary shares of Design Beta. Under such circumstance, HKFRS 10 *Consolidated Financial Statements* requires the acquirer to account for any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid directly in equity but not in profit or loss as it should be treated as an equity transaction between the acquirer and the non-controlling interest.

In order to account for such additional purchase of shares, the Group has to determine the balance of non-controlling interest prior to the further acquisition. Taking into consideration the sharing of profits earned by the subsidiary for the year ended 30 September 2018, the impairment loss of brand name and its deferred tax implications, the balance of non-controlling interest as at 30 September 2018 would be HK$37,769,000, which could be reconciled as follows:

(W1: Non-controlling interest as at 30 September 2018)

	HK$'000
Profit of Design Beta for the year	25,000
Less: impairment loss of brand name	(1,000)
Add: Deferred tax movement	165
Adjusted profit for the year	24,165
	x 20%
Share to non-controlling interest	4,833
Add: Non-controlling interest at acquisition	32,936
Non-controlling interest as at 30 September 2018	37,769

With a change of the non-controlling interest from 20% to 15%, the balance of non-controlling interest, due to this further acquisition, would be decreased by HK$9,442,250 (HK$37,769,000 (W1) x 5 / 20). Comparing to the consideration HK$10,000,000, the difference of HK$557,750 (HK$10,000,000 – HK$9,442,250) was taken directly to equity to controlling interest (negative) as other reserve. It should be noted that the goodwill would not be changed due to this further acquisition.

Answer 4

Integrated reporting is defined by the International Integrated Reporting Council as a "concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term".

Integrated reporting aims to improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital. At the same time, it promotes a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organisation to create value over time. Integrated reporting focuses on the so-called "six capitals" (financial, manufactured, intellectual, human, social and relationship, and natural) and enhances accountability and stewardship for the broad base of these capitals which further promotes understanding of their interdependencies. It also supports integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

* * * END OF SECTION A * * *

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

Answer 5(a)

Investment in HWL

ESL has the rights to appoint three directors out of five directors to the board of directors of HWL which empowers ESL to make all decisions over HWL through a simple majority of votes in board meetings except for the dissolution of HWL, issue of additional shares of HWL, decisions of and establishing operating and capital decision of the investee including budgets and appointment and removal of directors of HWL.

The dissolution of HWL and the issue of additional shares of HWL requiring all shareholders' approval and the consent from Bank B when changing the activities of HWL are considered as protective rights for all shareholders since this relates to fundamental changes to the activities of the investee in an exceptional circumstance.

However, relevant activities are defined as "activities of the investee that significantly affect the investee's returns while establishing operating and capital decision of the investee, including budgets, and appointment and removal of directors are considered decisions of relevant activities".

Accordingly, ESL does not have power over HWL as it does not have existing rights that give it the current ability to unilaterally direct the relevant activities.

In other words, the decisions over the relevant activities of HWL require the approval of all directors who are representatives from both ESL and Party A, which means it requires unanimous consent of all the shareholders of HWL. Each shareholder contractually agrees sharing of control and as such this arrangement is a joint arrangement.

The classification of joint arrangements required by HKFRS 11 depends upon the parties' rights and obligations arising from the arrangement in the normal course of business.

The legal form of the separate vehicle does not give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement.

Since HWL is incorporated as a limited company, the liability borne by HWL and the other shareholders would be limited to the share capital of HWL. The provision of financial guarantees from shareholders by itself does not result in rights to the assets and obligations for the liabilities.

HWL is not designed with the aim to provide its shareholders with an output. HWL would generate its own cash flows to settle the liabilities relating to its operation.

The right to pledge the shares in HWL by those shareholders is not relevant to the assessment.

To conclude, ESL shall account for the investment in HWL as a joint venture.

Answer 5(b)

Financial effects of the investment in HWL

- summarised financial information about HWL.

- Whether the investment in HWL is measured using the equity method or at fair value.

Risks associated with the investment in HWL

- Contingent liabilities arising from the financial guarantees provided by ESL and Party A in favour of Bank B who offers the mortgage loan to HWL in proportion to their ownership interests in HWL.

Answer 6(a)

Journal entries for share options issued during the year ended 30 June 2017:

Share-based payment expense for top management:
= 120,000 x HK$1.6
= HK$192,000

Share-based payment expense for staff:
= (180,000 x HK$1.6) x 90% x 9 months / 36 months
= HK$64,800

Share-based payment expense for sales executives:
= (50,000 x HK$1.6) x 50%
= HK$40,000

Dr. Staff expense	HK$296,800	
Cr. Share option reserve - equity		HK$296,800

Answer 6(b)

For the departure of top management, as all their share options have been vested immediately, their departure after the grant date would not affect the accounting.

Sales executives who leave before meeting the sales targets before 30 June 2017 will forfeit their rights to the share options and they will not be entitled to any share-based benefit.

Staff who leave during the year ended 30 June 2017 will forfeit their rights to the share options and they will not be entitled to any share-based benefit. No share-based payment expense for these staff is recognised in the year ended 30 June 2017.

For staff who leave after 30 June 2017 but within the aforesaid service period of three years, the share-based expense previously recognized will be reversed through profit or loss.

Under HKFRS 2, the share-based payment expense recognised in each year of the vesting period should be based on the best available estimate of the number of equity instruments expected to vest.

The estimate should be revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

On the vesting date, the entity should revise the estimates to the number of equity instruments that actually vested.

Answer 6(c)

As a professional accountant, Mr Yeung has to comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as set out in s.100.5 of the Code of Ethics for Professional Accountants (the "Code").

When a professional accountant holds a senior position within an organisation, a professional accountant in business is expected to encourage an ethics-based culture in the employing organization that emphasizes the importance that senior management places on ethical behaviour (300.5 of the Code).

A professional accountant in business 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 (300.6 of the Code).

Self-interest threat may be created as Mr Tam participates in the incentive compensation arrangements offered by GRL and Mr Yeung can share the proceeds from Mr Tam when Mr Tam exercises the share options and sells the shares if he co-operates with Mr Tam (300.8 of the Code).

Familiarity threat may be also created when Mr Yeung has a long association with Mr Tam (300.11 of the Code).

Safeguards shall be applied to eliminate threats, such as ethics and conduct programmes, policies and procedures to empower and encourage employees to communicate with senior management within the entity, the audit committee or those charged with governance of the organisation or consultation with another appropriate professional accountant (300.14 of the Code).

In circumstances where Mr Yeung believes that unethical behaviour or actions by Mr Tam will continue to occur within the company, he may consider obtaining legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, Mr Yeung shall refuse to be or remain associated with information he determines is misleading and may conclude that it is appropriate to resign from the company (300.15 of the Code).

Answer 7(a)(i)

Given the conversion results in the delivery of a fixed number of shares, the conversion feature would meet the definition of equity instrument.

This is a compound instrument with the debt component initially measured at fair value and subsequently carried at amortised cost and the conversion option, being an equity component with a carrying amount that is determined by deducting the fair value of the debt component from the fair value of the component instrument as a whole, is not remeasured.

Answer 7(a)(ii)

Journal entries for the issue of CB on 1 April 2017:

Dr. Cash/ Bank	HK$800 million	
Cr. Convertible Bond – liability		HK$665 million
Cr. Equity component		HK$135 million

Journal entries for the partial conversion of the CB on 1 October 2017:

Carrying amount of the debt component of the CB to be converted at 1 October 2017:
HK$(665 million) x [1 + (6% x 6 / 12)] x HK$ (200 / 800) million
= HK$171.24 million

Dr. Convertible Bond – liability	HK$171.24 million	
Dr. Equity component	HK$33.75 million	
(HK$135 million x HK$(200 / 800) million)		
Cr. Share capital		HK$204.99 million

Answer 7(b)(i)

As the functional currency of PSL is Renminbi while the settlement of the CB is HK$, it does not fulfil the definition of equity instrument, that is, to be settled by exchanging a fixed amount of cash for a fixed number of its own equity instruments. Accordingly, the CB consists of debt component and an embedded derivative in respect of the conversion option.

When PSL applies fair value option to CB, both debt component and the conversion option are carried at fair value initially and subsequently through profit or loss except that changes in the fair value of the debt component that are attributable to changes in the credit risk of PSL are recognised in other comprehensive income.

In accordance with HKFRS9 B4.3.3, when the CB is a hybrid instrument, that is, the embedded conversion option is classified as a derivative and is the host instrument, the initial carrying amount of the host instrument is the residual amount after separating out the embedded derivative.

Answer 7(b)(ii)

In accordance with para. 39(a) and (c) of HKFRS 7, PSL shall disclose a maturity analysis of the CB based on the earliest possible date that the borrower could be required to repay and describe how it manages the liquidity risk inherent in this contractual maturity analysis.

For the market risk disclosures of the CB under HKFRS 7, it shall be described in the financial statements that the CB is exposed to other price risk and a sensitivity to show the effect on profit or loss of reasonably possible changes in the forward exchange rate of the RMB against the HK$ and any significant inputs to the valuation of the CB together with the methods and assumptions used in preparing such a sensitivity analysis should be disclosed.

As the CB is designated at fair value through profit or loss which is measured at fair value on a recurring basis in the financial statements after initial recognition, the following should be disclosed under HKFRS 13:

- the level of the fair value hierarchy within which the fair value measurement is categorised in its entirety (Level 1, 2 or 3); and

- a description of the valuation techniques and inputs used to develop those measurements.

- any valid point under para. 39, 40, 41 and 42 of HKFRS 7 and para. 91 and 93 of HKFRS 12.

* * * END OF EXAMINATION PAPER * * *