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

To : Ms. Pindy Lee, Director of APE
From : Charmaine Yuen, Accounting Manager
Date : dd/mm/yyyy
Subject : Various investments, bankrupt customer and consolidated financial statements of APE

I refer to your queries regarding the various investments and the bankrupt customer and their impact on the consolidated financial statements of APE.

Answer 1(a)

Applicable financial reporting standard

The arrangement for the investment in DPE has three parties: APE has 60% of the voting rights in DPE, BPE has 20% and CPE has 20%. The contractual arrangement among APE, BPE and CPE specifies that at least 90% of the voting rights are required to make decisions about the relevant activities of DPE. Even though APE can block any decision, APE **cannot control** DPE because it needs the agreement of both BPE and CPE.

Since we cannot control DPE, it is **not a subsidiary** of APE.

The terms of the contractual arrangement requiring at least 90% of the voting rights to make decisions about the relevant activities imply that APE, BPE and CPE have **joint control** of DPE because decisions about the relevant activities of DPE cannot be made without APE, BPE and CPE agreeing. Thus it has implicitly specified that APE, BPE and CPE are required to **agree unanimously** to decisions about the relevant activities of the arrangement.

HKFRS 11 defines joint control as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities (i.e. activities that significantly affect the returns of the arrangement) require the unanimous consent of the parties sharing control.

In this case, DPE shall be considered as a joint arrangement as it is an arrangement of which two or more parties have joint control. The agreement sets up the terms under which APE, BPE and CPE conduct the manufacturing and distribution of HDPE. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of HDPE.

Therefore, HKFRS 11 *Joint Arrangements* is to be applied by all entities (APE, BPE and CPE) that are a party to this joint arrangement.

General principles

HKFRS 11 requires a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations arising from the arrangement.

HKFRS 11 classifies joint arrangements into two types - joint operations and joint ventures. APE should determine the type of joint arrangement in which it is involved by considering its rights and obligations.

Diadema Polyethylene (DPE)

APE, BPE and CPE carry out the manufacturing and distribution activities through DPE, whose legal form confers separation between the parties and the entity.

In addition, the contractual arrangement dealing with the manufacturing and distribution activity did not specify that the parties have rights to the assets, and obligations for the liabilities, relating to DPE.

There are no contractual arrangements and no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to DPE or that the parties have an obligation for the liabilities relating to that arrangement. DPE is a **joint venture**.

A joint venture is defined in HKFRS 11 as a joint arrangement whereby the parties that have joint control of the arrangement (i.e. APE, BPE and CPE as joint venturers) have rights to the **net assets** of the arrangement.

HKFRS 11 requires a joint venturer to recognise an investment and to account for that investment using the equity method in accordance with HKAS 28 Investments in Associates and Joint Ventures, unless the entity is exempted from applying the equity method as specified in that standard.

Therefore, the parties (APE, BPE and CPE) should recognise their rights to the **net assets** of DPE as investments in Joint Ventures and account for them using the equity method.

Answer 1(b)

Bankrupt customer

HKAS 10 *Events after the Reporting Period* defines events after the reporting period as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

- those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

- those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

HKAS 10 specifies that the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period is an adjusting event after the reporting period that requires an entity to adjust the amounts recognised in its financial statements.

The bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on an accounts receivable and therefore APE needs to adjust the carrying amount of the accounts receivable. Therefore, it is an adjusting event.

On the basis of this objective evidence about the existence of impairment in the account receivable, APE should recognise the impairment (bad debt) losses for the year ended 31 March 2012.

Dr Other expenses (impairment)	HK$650,000	
Cr Receivables		HK$650,000

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

Best regards,
Charmaine Yuen

Answer 1(c)(i)

APE – Worksheet for the Consolidated Statement of Comprehensive Income for the year ended 31 March 2012

	APE	EPE	Dr	Ref	Cr	Consolidated
	HK$'000	HK$'000	HK$'000		HK$'000	HK$'000
Sales	80,000	35,750	9,000	6		106,750
Cost of sales	(55,000)	(24,500)		5	900	(70,650)
				6	7,950	
Other income (including gain on disposal and EPE's dividend)	3,700	--	1,000	3		2,100
			600	E2		
Depreciation expense	(8,000)	(1,700)	500	2		(10,200)
Interest expense	(5,900)	(1,600)				(7,500)
Other expenses	(3,800)	(4,200)	650	1(c)		(8,650)
Share of profits of FPE				E1	660	780
				E2	120	
Profit for the year	*11,000*	*3,750*				*12,630*
Profit attributable to:						
Owners of the parent						*12,010*
Non-controlling interests			620	7		620
						12,630

Answer 1(c)(ii)

APE – Worksheet for the Consolidated Statement of Financial Position as at 31 March 2012

	APE	EPE	Dr	Ref	Cr	Consolidated
	HK$'000	HK$'000	HK$'000		HK$'000	HK$'000
Plant and equipment, net	43,000	19,000	2,500	1,2	1,500	63,000
Investment in EPE, cost	26,550	--		1	26,550	--
Investment in FPE	7,450	--	660	E1, E2	480	**7,630**
Goodwill	--	--	2,800	1		2,800
Other investments	20,750	1,250				22,000
Inventory	41,250	20,000		6	1,050	60,200
Receivables	10,000	11,000		1(c)	650	20,350
Cash and cash equivalents	7,500	8,750				16,250
	156,500	60,000				192,230
Share capital	30,000	15,000	15,000	1		30,000
Retained earnings	51,500	25,000				**59,190**
Non-controlling interests	--	--				**8,040**
Payables	75,000	20,000				95,000
	156,500	60,000				192,230

Answer 1(c)(iii)

APE – Worksheet for the Consolidated Statement of Changes in Equity for the year ended 31 March 2012

	Share capital	Retained earnings	*Total*	*Non-controlling interest*	*Total Equity*
Balance at 1 April 2011	30,000	50,680*	80,680	7,670**	88,350
Changes in equity					
Dividends		(3,500)	(3,500)		(3,500)
Dividend paid to NCI				(250)	(250)
Total comprehensive income for the year		12,010	12,010	620	12,630
Balance at 31 March 2012	*30,000*	***59,190***	89,190	**8,040**	97,230

Working:

W1

Retained earnings, 1 April 2011	44,000	22,500	12,250	1		50,680*
			800	2		
			2,050	4		
			720	5		

W2

Non-controlling interests, 1 April 2011	200	2, 1	6,000	**7,670****
	-	4	2,050	
	180	5		

*<u>Journal entries and reconciliations are **not** required</u>*

			HK$'000	HK$'000
CJE 1 Elimination of investment in EPE				
Dr	Share capital		15,000	
Dr	Retained earnings		12,250	
Dr	Goodwill		2,800	
Dr	Plant and equipment		2,500	
	Cr	Investment in EPE		26,550
	Cr	Non-controlling interests (BS)		6,000
CJE 2 Past and current depreciation on undervalued plant and equipment				
Dr	Opening retained earnings =2,500k/5*2*80%		800	
Dr	Non-controlling interests (BS) = 2,500k/5*2*20%NCI		200	
Dr	Depreciation=2,500/5 years		500	
	Cr	Accumulated depreciation		1,500
CJE 3 Eliminate dividend income				
Dr	Dividend income (1,250k x 80%)		1,000	
Dr	Non-controlling interests (BS) (1,250k x 20% NCI)		250	
	Cr	Dividends declared		1,250
CJE 4 Assign post-acquisition RE to NCI				
Dr	Opening retained earnings (1/4/2009 to 31/3/2011)		2,050	
	Cr	Non-controlling interests (BS)		2,050
Assign post-acquisition RE to NCI 20%*(RE 31/3/2011 22,500k – pre-acq 12,250k)				
CJE 5 Realisation of opening unrealised profit in inventory				
Dr	Opening retained earnings	80%	720	
Dr	Non-controlling interests (BS)	20% NCI	180	
	Cr Cost of sales	(2,500k – 1,600k)		900
CJE 6 Elimination of intercompany sale of inventory				
Dr	Sales		9,000	
	Cr	Cost of sales		7,950
	Cr	Inventory 35% unsold x (9,000k – 6,000k)		1,050
CJE 7 Allocate current profit for the year to non-controlling interests				
Dr	Non-controlling interests (PL)		620	
	Cr	Non-controlling interests (BS)		620

	HK$'000	**20%**
Profit for the year before adjustment	3,750	**750**
Less: depreciation on undervalued plant and equipment CJE 2	(500)	**(100)**
Add: previous year's unrealised profit now realised CJE 5 (2,500k-1,600k)	900	**180**
Less: current year's unrealised profit CJE 6 [35%*(9,000k-6,000k)]	(1,050)	**(210)**
Adjusted profit	*3,100*	
NCI's share 20%	**620**	**620**

NCI = 6,000k – 200k – 250k + 2,050k – 180k + 620k = 8,040k

EA1 Share of FPE's current year post-acquisition profits

			Dr	Cr
Dr	Investment in FPE (2,200k x 30%)		660	
	Cr	Share of profits of FPE		660

EA2 Elimination of intercompany sales of PPE (10,000k–8,000k) x **4 years / 5 years** unrealised x 30% Asso

			Dr	Cr
Dr	Gain on disposal*		600	
	Cr	Investment in FPE		480
	Cr	Share of profits of associates		120

Reconciliation of NCI as at 31 March 2012

	HK$'000
NCI's share of EPE's net assets at book value (15,000k + 25,000k) x 20%	8,000
NCI's share of EPE's FV adjustment (unamortized) (2,500k x 2/5) x 20%	200
NCI's share of implicit goodwill (6,000k – 20% x 29,750k)	50
Less: NCI's share of unrealised profit of upstream sale (9,000k – 6,000k) x 35% unsold x 20% NCI	(210)
	8,040

Reconciliation of Investment in FPE as at 31 March 2012

	HK$'000
Share of FPE's net assets at book value (7,500k + 13,450k) x 30%	6,285
Share of implicit goodwill (7,450k – 30% x (7,500k+11,250k)	1,825
Less: unrealised profit on intercompany sales of PPE	(480)
	7,630

*Alternatively, share of profits of associates may be debited instead of gain on disposal, i.e. EA2 Elimination of intercompany sales of PPE (10,000k–8,000k) x 4 years / 5 years unrealised x 30% Asso

Dr	Share of profits of FPE*	480	
Cr	Investment in FPE		480

*APE – Worksheet for the Consolidated Statement of Comprehensive Income for the year ended 31March 2012

	APE	EPE	Dr	Ref	**Cr**	Consolidated
	HK$'000	HK$'000	HK$'000		**HK$'000**	HK$'000
Sales	80,000	35,750	9,000	6		106,750
Cost of sales	(55,000)	(24,500)		5	**900**	**(70,650)**
				6	**7,950**	
Other income (including gain on disposal and EPE's dividend)	3,700	--	1,000	3		**2,700**
Depreciation expense	(8,000)	(1,700)	500	2		**(10,200)**
Interest expense	(5,900)	(1,600)				**(7,500)**
Other expenses	(3,800)	(4,200)	650	1(c)		**(8,650)**
Share of profits of FPE			480	E2,1	660	180
Profit for the year	*11,000*	*3,750*				*12,630*

* * * END OF SECTION A * * *

Answer 2(a)

On 1 July 2011

DEBIT Staff expense	HK$960,000	
CREDIT Equity – share-based payment		HK$960,000
{240 x 8,000 x HK$(8-7.50)}		

On 30 April 2012

DEBIT Equity – Share-based payment	HK$40,000	
DEBIT Cash	HK$600,000	
CREDIT Capital/Equity		HK$640,000
(10 x 8,000 x HK$0.5) and (10 x 8,000 x HK$7.5)		

On 30 June 2012

DEBIT Staff expense	HK$1,836,000	
CREDIT Equity – share-based payment		HK$1,836,000
(240 x 85% x 12,000 x HK$1.5 / 2)		

Answer 2(b)

Managerial staff who leave during the two-year period will forfeit their rights to the share options. Accordingly, those staff who left during the vesting period will not be entitled to any share-based benefit.

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 estimate to equal the number of equity instruments that actually vest.

Answer 3(a)

Current tax computation

Current tax for the year:
HK$43,122,000 x 18%
= HK$7,761,960

Current tax payable at 30 September 2012:
HK$7,761,960 - HK$4,600,000
= HK$3,161,960

Answer 3(b)

Deferred tax computation

Deferred tax charge for the year:

Temporary difference on plant and equipment:
Carrying amount
= HK$94,334,000 – HK$15,933,000
= HK$78,401,000

Tax base
= HK$(94,334,000 – 4,388,000 – 38,500,000) + (HK$4,388,000 x (1-10%))
= HK$51,446,000 + HK$3,949,200
= HK$55,395,200

Taxable temporary difference
= HK$78,401,000 – 55,395,200
= HK$23,005,800

Alternative method for calculation of temporary difference:

Deprecation allowance of HK$38,500,000
Less: Deprecation charged to P/L of HK$15,933,000
Add: Depreciation charged to P/L attributable to non-deductible item of HK$438,800 (HK$4,388,000 x 10%)
= HK$23,005,800

Deductible temporary difference on government grant:
HK$9,600,000 – HK$1,200,000
= HK$8,400,000

Deductible temporary difference on warranty provision:
HK$4,200,000 – HK$1,248,000
= HK$2,952,000

Net taxable temporary difference:
HK$23,005,800 – HK$8,400,000 – HK$2,952,000
= HK$11,653,800

Deferred tax charge and liabilities recognised
= HK$11,653,800 x 20%
= HK$2,330,760

<u>Answer 3(c)</u>

Tax reconciliation for the year ended 30 September 2012:

	Reconciliation at 18%	Reconciliation at 20%
Profit before tax	HK$54,018,000	HK$54,018,000
	============	============
Tax thereon	HK$9,723,240	HK$10,803,600
Tax effect on non-taxable income [HK$1,039,000]	(187,020)	(207,800)
Tax effect on non-deductible expense [HK$1,358,000 + (HK$4,388,000 x 10%)	323,424	359,360
Tax effect on 2% tax rate deduction [HK$43,122,000 x 2%]	N/A	(862,440)
Deferred tax recognised at different tax rate [HK$11,653,800 x 2%]	233,076	N/A
Tax charge for the year (HK$7,761,960 + 2,330,760)	HK$10,092,720	HK$10,092,720

Answer 4(a)

Pursuant to paragraph 21 of the SME-FRF, when an entity has previously qualified for reporting under the SME-FRF in terms of paragraph 17 of the SME-FRF, the entity will no longer qualify for reporting under the SME-FRF in terms of paragraph 17(b) of the SME-FRF until the entity is no longer an SME for two consecutive reporting periods.

STL has previously qualified for reporting under the SME-FRF since its establishment and up to the year ended 31 December 2009,

Although STL failed to meet two out of three of the size test for the year ended 31 December 2010, as the total annual revenue is greater than HK$50 million and STL has over 50 employees, it still qualified for reporting under SME-FRF for the year.

Also, STL met two out of three of the size test for the year ended 31 December 2011, i.e. both total annual revenue and total asset are less than 50 millions, and so it still qualified for reporting under SME-FRF for the year.

Answer 4(b)

STL is eligible to prepare its financial statements under HKFRS for Private Entities as it does not have public accountability and publishes general purpose financial statements for external users.

Answer 4(c)

The statement is partially correct / incorrect.

Pursuant to section 17.15 of HKFRS for Private Entities, an entity shall measure all items of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated impairment losses. Therefore, accounting for impairment is appropriate.

Only the cost model is allowed. The revaluation model is not an option for the subsequent measurement of property, plant and equipment.

Answer 4(d)

Pursuant to paragraph 22 of the SME-FRF, or Section 1.3 of HKFRS for Private Entities, an entity has public accountability for the purposes of the SME-FRF or HKFRS for Private Entities if it is in the process of issuing publicly traded equity or debt securities.

Accordingly, for the purpose of incorporation of the historical financial information of STL in its prospectus, STL is not qualified for reporting under either the SME-FRF or HKFRS for Private Entities.

Answer 5(a)

For the year ending 31 December 2013:

HK$40 million x 10/12 x 6.5%	HK$2,166,667
HK$40 million x 6/12 x 6.5%	1,300,000
HK$40 million x 2/12 x 6.5%	433,333
Total borrowing cost capitalised	HK$3,900,000

For the year ending 31 December 2014:

HK$120 million x 6/12 x 6.5%	HK$3,900,000
HK$40 million x 4/12 x 6.5%	866,667
Total borrowing cost capitalised	HK$4,766,667

Answer 5(b)

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. In order to comply with the requirements of HKAS 16 relating to deprecation, it is necessary to identify:

- The parts (components) of each item of property, plant and equipment that are to be deprecated separately, such as the structure of the hotel building, furniture and fixtures and equipment that can be considered as significantly different components.

- The cost of each separately depreciable component.

- The amount eligible for capitalisation.

- The estimated residual value of each separately depreciable component, which is likely to be immaterial in most instances.

- The length of time during which the component will be commercially useful to the entity taking into consideration the expected physical wear and tear, obsolescence, and legal or other limits on the use of the assets, for example the length of the operating lease term.

- The time when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management, and therefore deprecation of an asset begins. For the hotel property of RHE, it should start for depreciation at the date of the pre-opening activities start, i.e. 1 July 2014.

- The most appropriate deprecation method, which reflects the pattern in which the assets' future economic benefits are expected to be consumed by the entity, for each separately depreciable component.

Answer 5(c)

The equipment and furniture in the hotel rooms at a cost of HK$40 million and the corresponding borrowing cost capitalized are considered as separately depreciable components with a useful life of 5 years.

The remaining cost of the hotel construction of HK$160 million and the corresponding borrowing cost capitalised are depreciated over 30 years.

Total borrowing costs capitalised : HK$8,666,667 (HK$3,900,000 + HK$4,766,667)

Allocated to equipment and furniture: HK$1,733,333 (40/200 x HK$8,666,667)

Allocated to hotel building structure: HK$6,933,334 (160/200 x HK$8,666,667)

Depreciation for 6 months from 1 July to 31 December 2014:
[(HK$40,000,000 + HK$1,733,333) / 5 x 6/12] + [(HK$160,000,000 + HK$6,933,334) / 30 x 6/12]
= HK$4,173,333 + HK$2,782,222
= HK$6,955,555

* * * END OF EXAMINATION PAPER * * *