SECTION A – CASE QUESTIONS (Total: 50 marks)

To : Mr. Kim Chong, Director
From : Ivy Lee, Accounting Manager
Date : dd/mm/yyyy
Subject : Appropriate accounting treatment of useful life of machine, repair and maintenance and bankruptcy of MYL

I refer to your queries regarding the accounting treatments for the useful life of machine, repair and maintenance and bankruptcy of MYL.

Answer 1(a)

Useful life of machine

HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines a change in accounting estimate as an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

In this case, revision of the useful life of a machine is a change in accounting estimate. The effect of this change in an accounting estimate should be recognised prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or
(b) the period of the change and future periods, if the change affects both.

Since the revision of estimate of the useful life is made at the review of the financial statements for the year ended 31 March 2015, the effect of this change in accounting estimate should be recognised prospectively by including it in profit or loss in the year ended 31 March 2015. Being a prospective adjustment, there should not be any impact on the profit or loss for the year ended 31 March 2014.

For the year ended 31 March 2015, the current annual depreciation charge is HK$6 million / 5 years = HK$1,200,000. The machine was purchased on 1 April 2013 and depreciated for one year up to 31 March 2014. The revised annual depreciation charge should be [HK$6 million – (HK$1,200,000 x 1 year)] / (7 – 1) years = HK$800,000.

Therefore profits for the year ended 31 March 2015 should be increased by HK$1,200,000 - HK$800,000 = HK$400,000.

Answer 1(b)

Repair and maintenance

Since the expenditure of HK$2 million on 1 April 2013 was wrongly recorded as a repair expense in the year ended 31 March 2014 while it should have been capitalised as building, it should be considered as a correction of error.

A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

HKAS 1 (Revised) *Presentation of Financial Statements* requires an entity to present a statement of financial position as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies an accounting policy retrospectively or makes a retrospective restatement, as defined in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, or when the entity reclassifies items in the financial statements.

The correction of a prior period error should therefore be excluded from profit or loss for the period in which the error is discovered. Any information presented about prior periods, including any historical summaries of financial data, is restated as far back as is practicable.

Therefore, for the year ended 31 March 2014, HHL should reverse the repair expense of HK$2 million.

The HK$2 million should be capitalised as building with an annual depreciation of HK$2 million / 40 years = HK$50,000 per year.

Thus the net increase to the profit of HHL for the year ended 31 March 2014 is HK$2 million - HK$50,000 = HK$1,950,000.

For the year ended 31 March 2015, the depreciation of HK$50,000 should be charged. Thus profit for the year ended 31 March 2015 should be reduced by HK$50,000.

Answer 1(c)

Bankruptcy of MYL

HKAS 10 *Events after the Reporting Period* requires an entity to adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

According to HKAS 10.9(b)(i), 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 a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable.

Therefore, it is an adjusting event after the reporting period and HHL should adjust the carrying amount of the trade receivable from MYL as at 31 March 2015.

Since only 20% of the amount due from MYL is expected to be collected, 80% of the HK$600,000 should be adjusted and the profits for the year ended 31 March 2015 should be reduced by HK$480,000.

There should be no impact on the profits for the year ended 31 March 2014.

For the additional sales of HK$140,000 subsequent to 31 March 2015 to MYL, there is no impact on the profits for the year ended 31 March 2015, though it will affect the profits for the year ending 31 March 2016.

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,
Ivy Lee

Answer 2(a)

Goodwill at the date of acquisition

		1 January 2010		30 November 2014
		AEL		BPL
		HK$'000		HK$'000
Fair value of identifiable net assets				
Net book value at acquisition date		(400,000)		(335,000)
Fair value adjustment		--		(15,000)
		(400,000)		(350,000)
Consideration transferred		500,000		260,000
Non-controlling interests as proportion of fair value of identifiable net assets	400,000 x 20%	80,000	350,000 x 35%	122,500
		580,000		382,500
Less: Fair value of identifiable net assets (above)		(400,000)		(350,000)
Goodwill recognised at acquisition date		180,000		32,500

Answer 2(b)

Impairment loss of goodwill

Since HHL measures non-controlling interests as its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to non-controlling interests is included in the recoverable amount of the related cash-generating unit (BPL's recoverable amount) but is not recognised in the parent's consolidated financial statements (C4 of Appendix C of HKAS 36).

Therefore, HHL should gross up the carrying amount of goodwill allocated to AEL and BPL to include the goodwill attributable to the non-controlling interests. This adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.

Impairment loss of goodwill as at 31 March 2015

	AEL HK$ million	BPL HK$ million
Goodwill recognised at acquisition date	180	32.5
Relevant assets at 31 March 2015	450	300
Carrying amount	630	332.5
Unrecognized NCI (goodwill of NCI)		
(HK$180m x 20%/80%)	45	
(HK$32.5m x 35%/65%)		17.5
Adjusted carrying amount	675	350
Compare with recoverable amount	700	330
Impairment loss	N/A	20
Impairment loss of goodwill to be recognised (65%)		13

Answer 3(a)

Worksheet for the consolidated statement of profit or loss for the year ended 31 March 2015:

	HHL	AEL	BPL	Dr.		Cr.	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
			4 months				
Sales	600,000	400,000	127,000				1,127,000
Cost of sales	(400,000)	(330,000)	(124,000)	(500)	4		(854,500)
Administrative expenses	(100,000)	(50,000)	(5,000)		6	125	(167,875)
				(13,000)	9		
Other income and gains	23,000	--	--	(8,000)	5		7,800
				(3,200)	7		
				(4,000)	8		
Finance costs	--	(5,000)	(7,000)		7	3,200	(8,800)
Profit/(loss) for the year	123,000	15,000	(9,000)				103,625
(Profit)/loss attributable to NCI				(1,425)	10		1,900
					11	3,325	
Profit attributable to owners of parent							*105,525*

Answer 3(b)

Reconciliation of opening and closing consolidated retained earnings of HHL for the year ended 31 March 2015:

	HHL	AEL	BPL	Dr.		Cr.	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
			4 months				
Opening retained earnings	137,000	277,000	50,000	(250,000)	1		158,600
				(50,000)	2		
				(5,400)	3		
Profit attributable to owners of parent							*105,525*
Dividends	(20,000)	(5,000)	--		8	5,000	(20,000)
Closing retained earnings	*240,000*	*287,000*	*41,000*				*244,125*

Answer 3(c)

Worksheet for the Consolidated Statement of Financial Position of HHL as at 31 March 2015:

	HHL	AEL	BPL	Dr.		Cr.	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
Other non-current assets	492,000	372,200	400,100	15,000	2,4	(500)	1,150,925
				14,000	5,5	(18,000)	
					5	(4,000)	
				125	6		
					7	(120,000)	
Investment in AEL/BPL	760,000	-	-		1	(500,000)	--
					2	(260,000)	
Goodwill				180,000	1		199,500
				32,500	2,9	(13,000)	
Inventory	116,000	85,000	27,000				228,000
Trade and other receivables	62,000	65,000	33,000		7	(4,800)	155,200
Cash	10,000	800	900				11,700
	1,440,000	*523,000*	*461,000*				*1,745,325*
Share capital	(958,000)	(150,000)	(285,000)	150,000	1		(958,000)
				285,000	2		
Retained earnings	(240,000)	(287,000)	(41,000)				(244,125)
Non-controlling interests					1	(80,000)	(205,000)
					2	(122,500)	
					3	(5,400)	
				1,000	8,10	(1,425)	
				3,325	11		
Non-current liabilities	(153,000)	(76,000)	(120,000)	120,000	7		(229,000)
Current liabilities	(89,000)	(10,000)	(15,000)	4,800	7		(109,200)
	(1,440,000)	*(523,000)*	*(461,000)*				*(1,745,325)*

Reconciliation of NCI
(not required by the question):

		HK$'$000	20% NCI HK$'$000
Book Value of net assets of AEL			
(HK$150m + HK$287m)	=	437,000	87,400
Unrealised profit of freehold land (HK$4m)	=	(4,000)	(800)
Unrealised profit of building (HK$4m x 31/32)	=	(3,875)	(775)
NCI of AEL		429,125	85,825

			35% NCI HK'$000
Book Value of net assets of BPL			
(HK$285m + HK$41m)	=	326,000	114,100
Fair Value adjustment of plant and equipment			
(HK$15m x 116/120)	=	14,500	5,075
NCI of BPL		340,500	119,175
Total NCI			205,000

Answer 3

Consolidation journal entries (All figures in HK$'000) *(not required by the question)*

J1 Elimination of investment in AEL

Dr	Share capital	150,000	
Dr	Retained earnings	250,000	
Dr	Goodwill	180,000	
	Cr Investment in AEL		500,000
	Cr Non-controlling interests 20%		80,000

J2 Elimination of investment in BPL

Dr	Share capital	285,000	
Dr	Retained earnings	50,000	
Dr	Plant and equipment	15,000	
Dr	Goodwill	32,500	
	Cr Investment in BPL		260,000
	Cr Non-controlling interests 35%		122,500

J3 NCI share of post-acquisition retained earnings of AEL up to the beginning of the current year

Dr	Retained earnings (20% x ($277m - $250m)	5,400	
	Cr Non-controlling interests		5,400

J4 Additional depreciation for fair value adjustment in BPL

Dr	Depreciation of plant and equipment (COS) ($15m / 10 x 4/12) 30/11/14 – 31/3/15	500	
	Cr Accumulated depreciation		500

J5 Eliminate gain on freehold property sold by AEL to HHL (1/4/14)

Dr	Building ($76m → $90m)	14,000	
Dr	Other income or gains - gain on disposal	8,000	
	Cr Land ($24m → $20m)		4,000
	Cr Accumulated depreciation $90m x 8/40		18,000

	Proceeds	NBV	Gain/(Loss)
Land:	$24m	$20m	$4m
Building:	$76m	$90m x 32/40 = $72m	$4m
	$100m		$8m

J6 Depreciation adjustment for the building sold by AEL to HHL at a profit (1/4/14 – 31/3/15)

Dr	Accumulated depreciation ($4m x 1/32)	125	
	Cr Depreciation of building (Administrative expense)		125

(if current year figures $125 are shared to NCI $25:
J6a: Dr Profit attributable to NCI $25; Cr NCI $25)

J7 Eliminate interest income/payable on loan from HHL to BPL on 1 April 2014

Dr	Other income and gains – Interest income ($120m x 8% x 4/12)	3,200	
	Cr Finance costs (30/11/14 – 31/3/15)		3,200
Dr	Interest payable ($120m x 8% x 6/12)	4,800	
	Cr Interest receivable		4,800
Dr	Non-current liabilities (loan payable)	120,000	
	Cr Other non-current assets (loan receivable)		120,000

J8 Eliminate dividend income from AEL

Dr	Other income and gains ($5m x 80%)	4,000	
Dr	NCI ($5m x 20%)	1,000	
	Cr Dividends		5,000

J9 Goodwill impairment for BPL

Dr	Impairment loss	13,000	
	Cr Goodwill		13,000

J10 NCI share of current year profit of AEL

Dr	Profit attributable to NCI of AEL	1,425	
	Cr Non-controlling interests		1,425
	Reconciliation		*20% NCI*
	Reported profit of AEL	15,000	3,000
	J5 Eliminate gain on freehold property sold by AEL to HHL (1 Apr 2014)	(8,000)	(1,600)
	J6 Depreciation adjustment for the building sold by AEL to HHL at a profit	125	25
		7,125	
		x 20%	1,425

J11 NCI share of post-acquisition current year profit/(loss) of BPL

Dr	Non-controlling interests	3,325	
	Cr Loss attributable to NCI of BPL		3,325
	Reconciliation		35% NCI
	4 months post-acquisition profits of BPL	(9,000)	(3,150)
	J4 Depreciation of fair value adjustment on plant and equipment (COS) (HK$15m / 10 x 4/12)	(500)	(175)
		(9,500)	
		x 35%	(3,325)

* * * END OF SECTION A * * *

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

Answer 4(a)

HKAS 38 distinguishes between two phases in the generation of an intangible asset internally – the research phase and the development phase. Costs incurred during the research phase are required to be expensed in accordance with HKAS 38.54.

Pursuant to HKAS 38.57, specifically, an intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an entity can demonstrate all of the following:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the entity can 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;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure the expenditure attributable to the intangible asset during the development phase.

The cost to carry out a search for the evaluation of the alternatives of the system is a research cost and incurred with the intent of gaining new knowledge rather than creating a practical application from which future economic benefits will flow. Therefore, research costs do not meet the criteria for recognition of an internally generated asset. This cost should be expensed in profit or loss.

The technicians' salaries to build up the system can be capitalised as a development cost given that the salaries are directly incurred for the application of the research findings to build up the innovative system and PCL has demonstrated all the above criteria are fulfilled.

Answer 4(b)

The commencement of the amortisation period should be from the date the system is available for use. i.e. by the end of 2015.

The intangible assets shall be amortised over its useful life. The estimated useful life of the intangible assets is the shorter of the period of the legal rights and the period over which economic benefits are expected to be generated.

For the legal rights of the patent, HKAS 38.94 stated that the useful life of an intangible asset should include the renewal period only if there is evidence to support renewal by the entity without significant cost.

Existence of some factors to support renewal without significant cost include:

- evidence that possibly based on experience the contractual or other legal rights will be renewed;

- evidence that any conditions necessary to obtain renewal will be satisfied; and

- evidence that the cost of renewal is not significant when compared with the future economic benefits arising from the renewal.

So the useful life as determined by the legal rights is 10 years.

However, the new system can generate economic benefits for 8 years only for the period it is not obsolete. The amortisation period is the shorter of these two, i.e. 8 years.

Answer 4(c)

Yes, PCL is required to conduct an impairment assessment of the innovative system.

As the costs incurred for building up the innovative system are intangible assets not yet available for use, even if there is no indicator of impairment, impairment should be tested annually in accordance with HKAS 36.10(a).

This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. However, since such intangible assets were initially recognised by PCL during the year ended 31 December 2014, they shall be tested for impairment on or before 31 December 2014.

The recoverable amount is defined as the higher of an asset's or cash-generating unit's fair value less the costs of disposal and its value in use in accordance with HKAS 36.6.

In determining the cash flows projection, PCL should consider the following in relation to the cash flows derived from the intangible assets:

- the future income stream from sales of the product generated from the innovative system;
- the expenditures in constructing the production facilities;
- discount rate;
- growth rate of the industry; or

The cash flows projection should be limited to the useful life of the system, i.e. 8 years.

Answer 5(a)(i)

Under the current scenario, the conversion feature does not meet the definition of equity as the conversion results in the delivery of a variable number of shares, instead of a fixed number of shares.

Accordingly, under SCL's accounting policies, the debt component of the CB is carried at amortised cost and the conversion option is accounted for as a derivative with fair value through profit or loss.

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

Answer 5(a)(ii)

For the issue of CB on 1 April 2014:

Dr	Cash/Bank		HK$200 million	
	Cr	Convertible Bond – liability		HK$160 million
	Cr	Derivative – conversion option		HK$40 million

For the partial conversion of CB on 30 June 2014:

Carrying amount of the debt component of the CB to be converted at 30 June 2014:
HK$(160 million) x [1 + (6.1% x 3/12)] x HK$ (40/200) million
= HK$32.49 million

Carrying amount of derivative component of the CB to be converted at 30 June 2014:
HK$50 million x HK$ (40/200) million
= HK$10 million

Dr	Convertible Bond – liability		HK$32.49 million	
Dr	Derivative – conversion option		HK$10 million	
	Cr	Equity		HK$42.49 million

Answer 5(b)

Effective interest expense of the debt component of the CB for the year ended 31 December 2014:

HK$160 million x (6.1%*9/12)
= HK$7.32 million

Fair value change of derivative component of the CB for the year ended 31 December 2014:

Initial fair value (HK$40 million) – year-end fair value (HK$65 million)
= fair value loss of HK$25 million

Journal entries for the year ended 31 December 2014:

Dr	Finance cost – effective interest expense	HK$7.32 million	
Dr	Fair value change – profit or loss	HK$25 million	
	Cr Convertible Bond – liability		HK$7.32 million
	Cr Derivative – conversion option		HK$25 million

Answer 5(c)

If the conversion price is fixed and other terms remained constant, the conversion feature would meet the definition of equity as the conversion results in the delivery of a fixed number of shares.

Accordingly, under SCL's accounting policies, 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 the carrying amount 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 6(a)

The closure of the manufacturing plant is one of the events under the definition of restructuring. For the recognition of a provision for a restructuring, two principal requirements to be met are that the entity has a detailed formal plan; and has raised a valid expectation in those affected that the plan will be carried out by starting to implement that plan or by announcing its main features to those affected by it under HKAS 37.72.

Despite the fact that FEL has decided on the closure of one of the manufacturing plants, without a public announcement to all its employees, there is no detailed plan with sufficient details to give rise to valid expectations in other parties that the entity will carry out the restructuring. The management decision to restructure taken on 1 December 2014 is not relevant as FEL has not started to implement the restructuring plan or announced the main features of the restructuring plan to those affected with sufficient detail. Accordingly, FEL should not make any provision as at 31 December 2014 in respect of the restructuring plan.

The operational costs are not liabilities for restructuring at 31 December 2014 as these expenditures are associated with the future conduct of the business. These should be recognised on the same basis as if they arose independently of a restructuring.

A restructuring provision does not include the cost of relocating continuing staff pursuant to HKAS 37.81.

Dismantling plant is a restructuring liability as it is necessarily entailed by the restructuring; and not associated with the ongoing activities of FEL pursuant to HKAS 37.80.

In addition, the decision on the closure of the manufacturing plants is an impairment indicator. The company should perform an impairment test and any impairment loss should be recognised in profit or loss for the year ended 31 December 2014.

Answer 6(b)

An onerous contract is defined as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

As the manufacturing cost per Product X (HK$22) is higher than the revenue per Product X (HK$20), the supply contract is considered to be onerous and a provision should be recognised. FEL should recognise a provision for the onerous contract equal to the expected loss, i.e. HK$2 x 250,000 units of Product X (remaining quantities to be delivered: (100,000 x 3) – 50,000) = HK$500,000.

When FEL has notified the landlord about the early termination of the lease, FEL has established a constructive obligation. FEL should recognise a provision for the onerous contract equal to the non-cancellable lease payment, i.e. HK$80,000 x 36 months = HK$2,880,000.

Answer 6(c)

A provision should be recognised by FEL for the warranty given to customers as past experience shows that it is probable that certain claims would be paid by FEL. The provision should be measured based on the estimation as at 31 December 2014, i.e. HK$10 x 80,000 units of Product Y = HK$800,000.

When there are actual claims from the customers, the payment is recognised as an utilisation of the provision on 15 January 2015.

FEL should not recognise the contingent asset on the reimbursement from the insurance company as at 31 December 2014 as this may result in the recognition of income that may never be realised.

Instead, FEL should recognise the reimbursement income from the insurance company on 15 January 2015 at the amount of HK$10 x 10,000 units of Product Y = HK$100,000 when the realisation of income is virtually certain.

* * * END OF EXAMINATION PAPER * * *