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

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

### CASE

Assume that you are Mr. Tommy Lau, the accounting manager of Papaya Limited (PPY). PPY is a company incorporated in Hong Kong and is principally engaged in the manufacturing of consumer products. PPY acquired 80% of the ordinary shares of Sheffield Limited (SFL) for HK$25,600,000 on 1 April 2007.

At the acquisition date, SFL reported retained earnings of HK$12,000,000 and no revaluation reserve. The carrying amount of all assets and liabilities approximated the fair value except for intangible assets. The fair and book values of the intangible assets of SFL (with a remaining life of ten years), excluding deferred tax liability on fair value adjustments, is HK$18,500,000 and HK$16,000,000 respectively at the date of acquisition.

Non-controlling interests are measured as the non-controlling interest's proportionate share of the acquiree's net identifiable assets as at acquisition date. Investment in SFL was carried at cost. Both companies did not have any reserves other than retained earnings and revaluation reserves.

On 1 April 2007, PPY commenced construction of a plant which was expected to take three years to complete. Property, plant and equipment in the course of construction for production, supply or administrative purposes, or for purposes not yet determined, are carried at cost, less any recognised impairment loss. On 1 April 2008, a two-year term loan of HK$10,000,000 was drawn down to finance the construction costs. The relevant effective interest rate was 9% per annum. On 1 April 2008 and 2009, the carrying amount of the plant under construction was HK$10,000,000 and HK$18,000,000 respectively. Construction of the plant was accelerated and it was completed four months earlier than expected. On 30 November 2009, PPY completed the plant. However, the specific borrowing for the construction of this plant could not be repaid until 31 March 2010. The relevant borrowing costs for the past years had been correctly capitalised, but the amount for the current year has not yet been capitalised in the financial statements of PPY.

On 1 April 2009, PPY held inventory purchased from SFL during the year ended 31 March 2009 for HK$1,200,000 which had been manufactured by SFL at a cost of HK$800,000. During the year ended 31 March 2010, SFL sold goods costing HK$3,200,000 to PPY for HK$4,800,000. PPY sold the inventory on hand at the beginning of the year, but continued to hold 40% of its 2009 purchases from SFL on 31 March 2010. It is the group's accounting policy to allocate to non-controlling interests the adjustments to unrealised profits from upstream transactions. The tax rate for the years of assessment from 2007 / 08 to 2009 / 10 was 16.5%.

PPY holds an investment property which was let out, charging arm's length rentals, to a senior manager of SFL. PPY acquired this property on 1 April 2009 at a price of HK$6,000,000. The estimated useful life of the property was 50 years from 1 April 2009. The fair value of the property at 31 March 2010 remains at HK$6,000,000 and the rental income to PPY for the year ended 31 March 2010 amounts to HK$300,000. This property

is included in PPY's statement of financial position at its fair value as an investment property. PPY adopts the revaluation model for property, plant and equipment, except for construction in progress, which is stated at cost. Intangible assets are carried at cost. Depreciation is provided using the straight-line method.

The draft financial data of the two companies for the year ended 31 March 2010 are shown below:

| | PPY | SFL |
|---|---|---|
| | HK$ | HK$ |
| Sales | 80,000,000 | 38,400,000 |
| Cost of sales* | (51,200,000) | (25,600,000) |
| Gross profit | 28,800,000 | 12,800,000 |
| Other income (Dividend income) | 1,280,000 | -- |
| Distribution costs | (3,000,000) | (2,300,000) |
| Administrative expenses | (5,000,000) | (2,500,000) |
| Finance costs | (5,760,000) | (1,120,000) |
| Profit before tax | 16,320,000 | 6,880,000 |
| Income tax expense | (3,520,000) | (2,080,000) |
| Profit for the year | 12,800,000 | 4,800,000 |
| Other comprehensive income: revaluation surplus | 6,000,000 | 1,200,000 |
| Total comprehensive income for the year | 18,800,000 | 6,000,000 |

| | Share capital | Retained earnings | Revaluation surplus | Total equity |
|---|---|---|---|---|
| | HK$ | HK$ | HK$ | HK$ |
| PPY | | | | |
| Balance, 1 April 2009 | 32,000,000 | 36,400,000 | 4,000,000 | 72,400,000 |
| Total comprehensive income | -- | 12,800,000 | 6,000,000 | 18,800,000 |
| Dividends | -- | (3,200,000) | -- | (3,200,000) |
| Balance, 31 March 2010 | 32,000,000 | 46,000,000 | 10,000,000 | 88,000,000 |
| | | | | |
| SFL | | | | |
| Balance, 1 April 2009 | 16,000,000 | 21,800,000 | 1,000,000 | 38,800,000 |
| Total comprehensive income | -- | 4,800,000 | 1,200,000 | 6,000,000 |
| Dividends | -- | (1,600,000) | -- | (1,600,000) |
| Balance, 31 March 2010 | 16,000,000 | 25,000,000 | 2,200,000 | 43,200,000 |

| | PPY | SFL |
|---|---|---|
| | HK$ | HK$ |
| Property, plant and equipment, net | 40,000,000 | 7,600,000 |
| Investment property | 20,800,000 | 12,000,000 |
| Investment in SFL, at cost | 25,600,000 | -- |
| Intangible assets, net | -- | 11,200,000 |
| Inventories | 51,200,000 | 21,600,000 |
| Trade and other receivables | 25,000,000 | 14,000,000 |
| Cash and cash equivalents | 23,000,000 | 10,400,000 |
| | 185,600,000 | 76,800,000 |

| | PPY | SFL |
|---|---|---|
| | HK$ | HK$ |
| Share capital | 32,000,000 | 16,000,000 |
| Retained earnings | 46,000,000 | 25,000,000 |
| Revaluation surplus | 10,000,000 | 2,200,000 |
| | 88,000,000 | 43,200,000 |
| Trade and other payables | 47,600,000 | 13,600,000 |
| Long term loan | 50,000,000 | 20,000,000 |
| | 185,600,000 | 76,800,000 |

* **Cost of sales includes the depreciation of the plant and amortisation of intangible assets**

You have prepared the draft consolidated financial statements of PPY for the year ended 31 March 2010. After you sent these draft consolidated financial statements to PPY's directors for review, one of the directors, who is not a certified public accountant, sent you an e-mail as follows:

To: Tommy Lau, Accounting Manager, PPY
From: Gabriel Wong (Director)
c.c.: Renee Ho, Chris Wong, Adrian Cheung (Directors)
Date: 8 May 2010

Consolidated financial statements of PPY as at 31 March 2010

Could you please clarify the following points relating to PPY's draft consolidated financial statements which I have just reviewed.

(A) I know that borrowing costs in relation to qualifying assets can be capitalised. Can we capitalise the borrowing costs for the current year amounting to HK$900,000?

(B) I am puzzled about the investment property. The figure that was found in the PPY's statement of financial position was not the same as that in the consolidated one.

(C) I find that it is difficult to obtain the figures in the consolidated statement of financial position. Can you tell me more about how you arrived at each figure?

I would appreciate your clarification for the upcoming board meeting.

Best regards,

Gabriel

**<u>Question 1</u>** **(50 marks – approximately 90 minutes)**

**Assume that you are Tommy Lau, the accounting manager, and you are required to draft a memorandum to Gabriel Wong, a Director of PPY. In your memorandum, you should:**

**(a)** **briefly discuss and calculate the amount of borrowing costs that should be capitalised as part of the cost of the plant for the year ended 31 March 2010;**
**(5 marks)**

**(b)** **discuss the reason for the different figures for the investment property in the consolidated financial statements and in the financial statements of PPY; and**
**(7 marks)**

**(c)** **prepare an annex to your memorandum showing worksheets for:**

**(i)** **the consolidated statement of comprehensive income, and**
**(12 marks)**

**(ii)** **the consolidated statement of financial position.**
**(26 marks)**

**(Consolidation adjustments are to be shown in the form of a worksheet. You have to show the detailed calculations of each figure though journal entries are not required.)**

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# 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 and appropriate presentation of the answers.*

### Question 2 (14 marks – approximately 25 minutes)

Modern Department Store (MDS) adopted a share option scheme which allows the board of director of the company to award share option to employees at nil consideration. On 1 April 2008, 2,000,000 share options were granted to the chief operating officer ("the COO"). Subject to the continued employment of the COO with the company, one-fourth of the awarded share options shall become vested at the end of each anniversary from the date of grant. MDS expects that all the awarded share option will vest.

On 1 April 2010, MDS entered into an agreement with the COO to cancel the unvested awarded share options at a consideration of HK$5,500,000.

Fair value of the share options of MDS (assuming same for different vesting dates):

| | |
|---|---|
| 1 April 2008 | HK$8 |
| 31 March 2009 | HK$3 |
| 31 March 2010 | HK$5 |
| 1 April 2010 | HK$5 |

**Required:**

**(a) Calculate the amount of compensation expense in relation to the share options awarded by MDS for the years ended 31 March 2009 and 31 March 2010 respectively.**

**(4 marks)**

**(b) Explain the accounting implication of and calculate the compensation expense upon the cancellation of the unvested awarded share options on 1 April 2010 to the financial statements of MDS for the year ending 31 March 2011.**

**(7 marks)**

**(c) Assuming that the share options were awarded to the director of Bargain Store (BS), a subsidiary of MDS, instead of the COO of the company, without any intra-group charge for such share-based payment arrangement, explain the accounting implication for the financial statements of BS for the year ended 31 March 2010.**

**(3 marks)**

**Question 3** **(16 marks – approximately 29 minutes)**

On 1 October 2009, Smart Computer Limited (SCL) acquired an 80% interest in Breakthrough Disc Company (BDC) at a consideration of HK$72 million. Fair value of BDC shares at that date was HK$45 each.

The carrying amount of identifiable net assets of BDC reported on its statement of financial position at the date of acquisition was HK$42 million. Other than the property, plant and equipment with carrying amount of HK$60 million and fair value of HK$76 million, there were no differences between the carrying amount and the fair value for all other reported assets and liabilities. An internally generated intangible asset with fair value of HK$8 million was identified. Both the property, plant and equipment and the intangible asset have an estimated useful life of 10 years from the date of acquisition.

On 1 April 2010, SCL distributed 300,000 shares of BDC, represented 15% interest in BDC, to its shareholders ("the Distribution"). Fair value of the BDC share at that date was HK$63 each. Post acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 2010 was HK$8 million.

SCL has four shareholders with equal ownership and adopts the accounting policy to measure any non-controlling interests in the acquiree at fair value.

**Required:**

**Assuming that BDC is not subject to income tax in any jurisdiction,**

**(a)** **calculate the amount of goodwill recognised for the acquisition.**

**(7 marks)**

**(b)** **calculate the amount of non-controlling interests in BDC as at 1 April 2010 before the Distribution to be reflected in the consolidated statement of financial position of SCL.**

**(5 marks)**

**(c)** **explain the accounting treatment and prepare the necessary consolidation adjustment journal(s) for the Distribution for the preparation of the consolidated financial statements of SCL.**

**(4 marks)**

**Question 4** **(14 marks – approximately 25 minutes)**

Anna Manufacturing Limited (AML), a company listed on the Hong Kong Stock Exchange, had a convertible bond (CB) with a principal amount of HK$800 million issued on 1 December 2008. Fixed interest at 6% per annum is payable annually in arrears. The holders are entitled to convert the CB into 50 million ordinary shares of HK$2 par value each of AML at any time before the redemption by AML at 30 November 2012 at principal amount.

On 1 April 2010, the holders of CB exercised their options to convert into shares in AML. On the same date, AML borrowed an interest-free loan of HK$500 million from its major shareholder for a term of two years.

Effective interest rate of AML's other external borrowings was 8% and 6% per annum on 1 December 2008 and 1 April 2010 respectively.

The functional currency of AML is the Hong Kong dollar.

**Required:**

**(a)** **Prepare journal entries for the issue of CB on 1 December 2008.**
**(5 marks)**

**(b)** **Prepare journal entries for the conversion of CB into shares on 1 April 2010.**
**(5 marks)**

**(c)** **Prepare journal entries for the recognition of the interest-free loan on 1 April 2010.**
**(4 marks)**

**(Note: Tax effect is ignored.)**

**Question 5** **(6 marks – approximately 11 minutes)**

Cleantech Motor Limited (CML) was an overseas company incorporated in the British Virgin Islands and registered under the Hong Kong Companies Ordinance in October 2008 with a share capital of HK$60 million contributed by two shareholders in cash. During 2009, CML incurred approximately HK$28 million for the development activities for an electrical vehicle project, out of which approximately HK$5 million is not yet paid at the end of financial period. A letter of intent has been signed with an automobile manufacturing company for licencing the technology from CML at a consideration of not less than HK$50 million if it is successfully developed. It was so far unable to complete the technical feasibility study on the computerised energy saving monitoring system and no module is available for testing. The other asset of the entity is cash kept at a bank. CML has 100 employees. The management does not have intention to raise funds publicly at this moment.

**Required:**

**You are the auditors of CML. Advise the directors of CML whether they can prepare the financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**

**(6 marks)**

* * * END OF EXAMINATION PAPER * * *