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

To : Ms. Choi, Director of PWE
From : Vincent Lee, Accounting Manager, PWE
c.c. : Jason Lam, Andy Cheng, Nick Chan (Directors)
Date : dd/mm/yyyy
Subject : Consolidated financial statements of PWE as at 31 March 2012

I refer to your e-mail dated 16 May 2012 regarding your queries about the draft consolidated financial statements of PWE as at 31 March 2012.

Answer 1(a)(i)

Certificate of deposit

Paragraph 54 of HKAS 1 (Revised) *Presentation of Financial Statements* requires cash and cash equivalents to be presented as a line item in the statement of financial position.

Cash is defined by HKAS 7 *Statement of Cash Flows* as cash on hand and demand deposits while cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Since the certificate of deposit (HK$7,500,000) has a maturity more than three months from the date of acquisition, it cannot meet the definition of cash and cash equivalents.

Therefore, we cannot include the certificate of deposit amounting to HK$7,500,000 (2010: nil) in the cash and cash equivalents.

Classified as non-current

HKAS 1 (Revised) *Presentation of Financial Statements* specifies the classification of an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent (as defined in HKAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

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All other assets should be classified as non-current. Since the certificate of deposit of HK$7,500,000 (2011: nil) is not expected to be realised within twelve months after the reporting period, it cannot be classified as current and therefore it should be classified as a non-current asset.

Answer 1(a)(ii)

Ethical issues

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. In acting in the public interest, a professional accountant shall observe and comply with the Code of Ethics for Professional Accountants.

With all the relevant facts discussed above, clearly we are not allowed to include the certificate of deposit into the cash and cash equivalents and it would violate fundamental principles such as integrity, objectivity, professional competence and due care as well as professional behaviour:

- Integrity - A professional accountant should be straightforward and honest in all professional and business relationships. It would not be honest if I misrepresent the certificate of deposit as cash and cash equivalents when in fact it is not.

- Objectivity - A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments. It would not be objective if I included the certificate of deposit as cash and cash equivalents with the mere intention to present a better financial position.

- Professional Competence and Due Care - A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services. I must act diligently in accordance with the accounting standards and thus I cannot allow the inclusion of the certificate of deposit as cash equivalents.

- Professional Behaviour - A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession. I cannot compromise with an action that discredits our profession. Thus I cannot include the certificate of deposit as cash equivalents.

Therefore, in this case, if the intention is merely for the purpose of increasing the amount of cash and cash equivalents to be presented in the statement of financial position, it would not be ethical and it would not be acceptable under the code of ethics for professional accountants.

Having considered all these issues, I would suggest, as an alternative course of action, that we may provide a disclosure note to show the total amount of cash and bank deposits and highlight the fact that the total amount of cash and bank deposits actually did not drop significantly (2012: HK$8,500,000, 2011: HK$9,000,000).

Answer 1(b)

Disclosure requirement as various HKFRSs are not early adopted

According to paragraph 30 of HKAS 8 *"Accounting Policies, Changes in Accounting Estimates and Errors"*, when an entity has not applied a new HKFRS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact (i.e. PWE has not applied the new HKFRSs because it has been issued but is not yet effective); and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new HKFRS will have on the entity's financial statements in the period of initial application.

Therefore, PWE has to disclose:

(a) the title of the new HKFRS;

(b) the nature of the impending change or changes in accounting policy (e.g. HKFRS 9 *Financial Instruments (as issued in November 2009)* introduces new requirements for the classification and measurement of financial assets. HKFRS 9 *Financial Instruments (as revised in November 2010)* adds requirements for financial liabilities and for derecognition);

(c) the date by which application of the HKFRS is required (e.g. HKFRS 9 Financial Instruments is effective for annual periods beginning on or after 1 January 2013, with earlier application permitted);

(d) the date at which it plans to apply the HKFRS initially; and

(e) either:

  (i) a discussion of the impact that the initial application of the HKFRS is expected to have on the entity's financial statements; or

  (ii) if that impact is not known or reasonably estimable, a statement to that effect.

Answer 1(c)

Cash flow effects of the acquisition of SIL

According to paragraph 39 of HKAS 7 *"Statement of Cash Flows"*, the aggregate cash flows arising from obtaining control of subsidiaries shall be presented separately and classified as investing activities.

In particular, PWE should disclose, in aggregate, in respect of obtaining control of SIL during the period each of the following:

(a) the total consideration paid (HK$34,000,000);

(b) the portion of the consideration consisting of cash and cash equivalents (HK$4,000,000);

(c) the amount of cash and cash equivalents in the subsidiary over which control is obtained (HK$1,250,000); and

(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiary over which control is obtained, summarised by each major category.

The net cash outflow arising on the acquisition and the fair value of the assets acquired and liabilities assumed were as follows:

	HK$'000	HK$'000
Total consideration paid		34,000
Fair value of non-controlling interests (20%)		8,000
		42,000
Property, plant and equipment	35,500	
Trade and other receivables	10,250	
Cash and cash equivalents	1,250	
Trade and other payables	(4,500)	
Taxation payable	(2,000)	
Less: Fair value of identifiable net assets		*40,500*
Goodwill		1,500
Total consideration paid		34,000
Non-cash consideration – fair value of shares issued		(30,000)
Cash consideration paid		4,000
Less: Cash and cash equivalent of SJL		(1,250)
Cash outflow on acquisition, net of cash acquired		2,750

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

Best regards,
Vincent Lee

Answer 1(d)

Consolidated Statement of Cash Flows of PWE for the year ended 31 March 2012

	HK$'000	HK$'000
Operating activities		
Profit before tax	16,900	
Adjustments for:		
Depreciation	32,600	
Impairment loss recognised in respect of trade receivables	711	
Loss on disposal of property, plant and equipment	2,500	
Release of prepaid land lease payments	600	
Finance costs	2,300	
Exchange loss arising on translating foreign currency bank loans	1,260	
Exchange loss arising on translating foreign currency bank deposits	500	
Share of profits of associate	(1,650)	
Operating profits before working capital changes	*55,721*	
Decrease in trade and other receivables (44,000 – (47,250 – impairment 711) – exchange 4,500 – new 10,250)	17,289	
Decrease in trade and other payables (34,900 – 56,650 – exchange 1,500 – new 4,500)	(27,750)	
Cash generated from operations	*45,260*	
Interest paid (500 + I/S 2,300 – 1,250)	(1,550)	
Tax paid (7,000 + I/S 1,050 + new 2,000 – 7,050)	(3,000)	
Net cash from operating activities		40,710
Investing activities		
Acquisition of subsidiary, net of cash acquired (1(c)) (4,000 – 1,250)	(2,750)	
Increase in certificate of deposit	(7,500)	
Dividend received from associate (W1)	1,150	
Purchase of property, plant and equipment (W2)	(61,100)	
Proceeds from disposal of property, plant and equipment	26,500	
Net cash used in investing activities		(43,700)

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<u>Financing activities</u>		
New bank loans raised (W3)	3,740	
Dividend paid to non-controlling interest (W4)	(2,000)	
Dividend paid (W5)	(8,250)	
Net cash from financing activities		(6,510)
Net decrease in cash and cash equivalents		(9,500)
Cash and cash equivalents at beginning of period		9,000
Effect of exchange rate changes on cash and cash equivalents (exchange gain on translation of foreign subsidiaries 2,000 – exchanges loss on foreign currency bank deposits 500)		1,500
Cash and cash equivalents at end of period		1,000

Workings: (All figures in HK$'000)

W1 Opening investment in associates 15,500 + I/S 1,650 – dividend = closing 16,000, thus dividend received from associates = 1,150

W2 Opening PPE 244,500 + addition – depreciation 32,600 – disposal 29,000 + new 35,500 = closing 279,500, thus addition = 61,100

W3 Opening bank loans 45,000 + new bank loans raised + translation loss 1,260 = closing bank loans 50,000, thus new bank loans raised = 3,740

W4 Opening NCI 18,600 + new 8,000 + SCI 2,900 –dividend to NCI = closing 27,500, thus dividend to NCI = 2,000

W5 Opening retained earnings and other reserves (53,200+100,000) + SCI 17,950 – dividend = closing (58,900+104,000), thus dividend paid = 8,250

* * * END OF SECTION A * * *

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

Answer 2

The statement is incorrect.

HKAS 1.15 states that financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity. True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework for Financial Reporting (the "Framework"). The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a true and fair view.

S.4.1 of the Framework states that the financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

If such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used should be disclosed.

HKAS 1.25 states that an entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so.

HKAS 10.14 states that an entity shall not prepare its financial statements on a going concern basis if management determine after the reporting period either that it intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

Under historical cost basis, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Under the current financial reporting standards, elements of financial statements can be / are required to be measured at a base other than historical cost. Fair value measurement is allowed/required for certain assets and liabilities, which may be above or below the value measured on historical cost basis. Furthermore, inventories should be measured at the lower of cost and net realisable value in according to HKAS 2. And net realisable value is the estimated selling price of an item of inventory less estimated costs to complete and sell it.

For an entity which does not prepare financial statements on a going concern basis, assets and liabilities which are originally measured at historical cost may need to be measured on realizable (settlement) value.

When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

Answer 3(a)(i)

Counter sales at department stores:

NFL has the primary responsibility for providing the goods to the customers of department stores with its sales team.

NFL has inventory risk as the ownership of the goods has not been transferred to department stores.

NFL has latitude in establishing prices while the department stores will only share 20% of the invoice amounts for the service provided.

Customers' credit risk is borne by the department stores but it is considered as a weak indicator for department store operation.

Taking into consideration the above features as a whole, it is considered that NFL acts as a principal because it has exposure to the significant risks and rewards associated with the sale of goods while the department stores act as an agent and service provider instead of the customers of NFL.

The buyers, being the customers of the department stores, will have transferred to them the significant risks and rewards of the ownership of the goods upon the passing of possession of the goods and issue of invoices by the department store.

The return or exchange offered to the customers is considered to retain only an insignificant risk of ownership as past history demonstrates that the return rate is insignificant.

Revenue is recognised at the time of sale made through the department stores to the customers.

The amount recognised as revenue of NFL is the gross selling price charged to the customers.

The 20 per cent of the retail prices retained by the department stores are considered as the selling and distribution expenses of NFL and not to offset against the revenue.

Answer 3(a)(ii)

Distributors:

NFL has no primary responsibility for providing the goods to their retail store customers.

NFL did not bear the inventory risk after delivering the goods shipped to distributors as the goods are non-returnable except for quality problems.

Although NFL has latitude in establishing price charges for the goods to be sold by the distributors at their own retail store but it is the distributors to bear their customers' credit risk.

Taking into consideration the above features as a whole, the distributors are acting as a principal instead of an agent of NFL as they have exposure to the significant risks and rewards associated with the sales of goods at their own retail store. The distributors are considered as the customers of NFL.

Revenue is recognised by NFL when the goods are delivered and accepted by the distributors either after their quality inspection or the lapse of the 7 days returned period.

The amount recognised as the revenue of NFL is the invoice price, i.e. 50% of the pre-determined retail price of the items delivered and accepted by the distributors.

Answer 3(b)

HKAS 18.10 states that the amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

NFL should estimate the distributors to whom the company is likely to give the volume discount, i.e. annual quantity delivery will be above 100,000 pieces, at the time of sale on a monthly basis, and recognise revenue net of the amount of volume discount.

The final discount will be true up to the end of the year for the actual amount of discount given. The discount should be presented as a reduction in revenue

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Answer 4(a)

This is an adjusting event under HKAS 10. SW should reverse the recognition of the HK$8 million sales during the year ended 31 March 2012 and record the inventory as the lower of cost and net realisable value after considering the rework cost because:

- The notice from the customer on 3 April 2012 has indicated that the goods received on 25 March 2012 were not accepted, being an event after the reporting period that provided evidence of conditions [of goods] that existed at the end of reporting period.

  SW accepted the complaint of the customer and has replaced the goods shipped after the reporting period.

- The customer confirmed only the acceptance of the replaced goods, which was after the reporting period.

Answer 4(b)

This is a non-adjusting event under HKAS 10. SW should recognise the HK$3 million (20% of HK$15 million) compensation for the breach of contract in the period subsequent to 31 March 2012 because

- The sales orders were received and the sales contracts were signed before the end of the reporting period.

- There was no indication that SW would fail to fulfil the sales orders at the end of the reporting period. The failure in the production and delivery of orders was due to the suspension of production from 15 April 2012, not a condition that existed at 31 March 2012.

If this event is considered to be material, SW should disclose the nature of the event and its financial effect in the notes to the financial statements.

Answer 4(c)

This is a non-adjusting event under HKAS 10. SW should not recognise the HK$5 million subsidy as government grant in the year ended 31 March 2012 OR SW should recognise the subsidy as government grant in the period subsequent to 31 March 2012 because:

- Although it is possible to argue that there is reasonable assurance that SW would comply with the conditions attached (HKAS 20.7 (a)), i.e. the relevant employment period of local workers was the six months ended 31 December 2011 and the application for the subsidy was on 8 March 2012, which is during the year ended 31 March 2012.

- There was no reasonable assurance that the subsidy will be received (HKAS20.7 (b)) at 31 March 2012, i.e. the subsidy is discretionary and subject to approval by the local government which was obtained on 8 April 2012.

If this event is considered to be material, SW should disclose the nature of the event and its financial effect in the notes to the financial statements.

Answer 5(a)(i)

A fixed rate bank loan exposes the borrower to fair value interest rate risk, i.e. the change in market interest rate will affect the fair value of the bank loan.

A variable rate bank loan exposes the borrower to cash flow interest rate risk, i.e. the change in market interest rate will affect the cash flow of the bank loan with an increase or decrease in payment of loan interest.

Answer 5(a)(ii)

A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A hedged item is a recognised asset, liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Hedge accounting recognises the offsetting effect on profit or loss of changes in the fair values of the hedging instrument and the hedged item. The objective is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period when the item that is being hedged affects profit or loss.

Without adopting the hedge accounting, the hedging instrument, if it is a derivative, will normally be measured at fair value through profit or loss. The hedged item may adopt a different accounting treatment under HKFRS which results in a mis-match of the effects of changes in the fair value.

If a cash flow hedge meets the conditions for hedge accounting during the period, it shall be accounted for as follows:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income and

(b) The ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, the amount that had been recognised in other comprehensive income shall be:

(a) reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged forecast cash flows affect profit or loss or

(b) includes them in the initial cost or other carrying amount of the asset or liability.

Answer 5(a)(iii)

The variable rate bond of SC has a cash flow exposure to changes in the market rate of interest.

An increase in the market interest rate, assuming other variables affecting the valuation of the bond are unchanged, theoretically, the fair value of a variable rate bond will not change while a fixed rate bond will decrease.

Since SC measures the bond at amortised cost, the increase in the market interest rate of 0.5% will not result in any adjustment to the carrying amount of the bond.

The interest rate swap, as a derivative, is measured at fair value through profit or loss, if hedge accounting is not adopted.

An increase in the market interest rate of 0.5 per cent will result in SC receiving more under the variable rate interest amount in exchange for paying 2 per cent fixed interest amount.

Theoretically, the fair value of the interest rate swap should be increased and a gain will be recognised in the income statement.

Answer 5(b)

If SC designates the hedge as a fair value hedge, the non-cancellable purchase order in Yen is considered as a firm commitment to be hedged (hedged item) in connection with the spot foreign currency risk.

The Yen forward contract is considered to be as the hedging instrument.

As a financial derivative, the Yen forward contract will have been reported at fair value on each reporting date, with gains or losses reported in profit or loss.

Under fair value hedge, the change in fair value of the firm commitment related to the hedged risk will also recognised in profit or loss and shall adjust the carrying amount of the hedged item. This applies if the hedged item is otherwise measured at cost for SC's hedged item which is an unrecognised firm commitment, its cumulative change in the fair value attributable to the hedged risk is recognised as an asset or liability.

* * * END OF EXAMINATION PAPER * * *

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