<u>SECTION A – CASE QUESTIONS</u> (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. Vincent Lee, the accounting manager of Peter Wong Equipment Group Limited (PWE). PWE is a company incorporated in Bermuda with limited liability. Its shares are listed on The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange").

The consolidated financial statements are presented in Hong Kong dollars, which is the same as the functional currency of PWE. PWE is an investment holding company and it has a number of subsidiary companies in various countries. On 1 April 2011, PWE acquired an equity interest in Sandy Jolly Limited (SJL), a company incorporated in Hong Kong. The following are the extracts of the draft consolidated financial statements of PWE for the year ended 31 March 2012 and the statement of financial position of SJL as at 1 April 2011, the date of acquisition.

Consolidated Statement of Comprehensive Income of PWE (the Group)
for the year ended 31 March 2012 (extract)

	HK$'000
Revenue	853,000
Cost of sales	(800,350)
Gross profit	52,650
Administrative expenses	(35,100)
Finance costs	(2,300)
Share of profits of associates	1,650
Profit before tax	16,900
Tax expense	(1,050)
Profit for the year (Note 1)	15,850
Other comprehensive income:	
Exchange differences on translating foreign subsidiaries *(Note 6)*	5,000
Total comprehensive income for the year	20,850
Profit for the year attributable to:	
Owners of PWE	13,950
Non-controlling interests	1,900
	15,850
Total comprehensive income for the year attributable to:	
Owners of PWE	17,950
Non-controlling interests	2,900
	20,850

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Statements of Financial Position (extract)

	PWE Consolidated 31 Mar 2012 HK$'000	PWE Consolidated 31 Mar 2011 HK$'000	SJL at acquisition HK$'000
ASSETS			
Non-current assets			
Property, plant and equipment (Note 3)	279,500	244,500	35,500
Prepaid land lease payment	21,600	22,200	--
Goodwill (Note 4)	9,000	7,500	--
Investment in associates	16,000	15,500	--
Certificate of deposit (Note 7)	7,500	--	--
Current assets			
Trade and other receivables	44,000	47,250	10,250
Cash and cash equivalents (Note 8)	1,000	9,000	1,250
Total assets	378,600	345,950	47,000
EQUITY AND LIABILITIES			
Share capital (Note 2)	13,000	10,000	3,000
Share premium (Note 2)	82,000	55,000	10,000
Retained earnings	58,900	53,200	10,500
Other reserves (Note 5)	104,000	100,000	17,000
	257,900	218,200	40,500
Non-controlling interest	27,500	18,600	--
Total equity	285,400	236,800	40,500
Current liabilities			
Trade and other payables	34,900	56,650	4,500
Interest payable	1,250	500	--
Taxation payable	7,050	7,000	2,000
Non-current liabilities			
Bank loans	50,000	45,000	--
Total equity and liabilities	378,600	345,950	47,000

Additional information

(1) Profit for the year has been arrived at after charging (crediting):

	HK$'000
Auditor's remuneration	1,000
Depreciation of property, plant and equipment	32,600
Exchange loss arising on translating the foreign currency bank deposits	500
Exchange loss arising on translating the foreign currency bank loans	1,260
Impairment loss recognised in respect of trade receivables	711
Loss on disposal of property, plant and equipment (Note 3)	2,500
Operating lease rentals	200
Release of prepaid land lease payments	600

(2) PWE issued 3,000,000 HK$1 ordinary shares at HK$10 each, which has a total fair value of HK$30,000,000 at the acquisition date, and paid cash of HK$4,000,000, in consideration for 80% of SJL's shares. At the date of acquisition, all of SJL's assets and liabilities were recorded at their fair values. The fair value of non-controlling interests of SJL was recorded as HK$8,000,000 on the acquisition date. During the year, PWE did not make any further issue of ordinary shares.

(3) An analysis of the movement on the Group's property, plant and equipment during the year showed that the property, plant and equipment with a carrying amount of HK$29,000,000 was sold for HK$26,500,000.

(4) During the year, no goodwill has suffered from any impairment and the Group has not repaid any bank loans.

(5) The increase in the other reserves is solely attributed to the controlling shareholders' share of the translation reserve arising on the translation of foreign subsidiaries.

(6) The exchange difference arising on the translation of foreign subsidiaries are summarised as below:

	HK$'000
Trade and other receivables	4,500
Trade and other payables	(1,500)
Cash and cash equivalents	2,000
	5,000

(7) The certificate of deposit is a 5-year certificate of deposit that pays 4% compounded semi-annually with a maturity date of 31 December 2016.

(8) Included in cash and cash equivalents are foreign currency demand deposits. An exchange loss of HK$500,000 arises on the translation of these foreign currency demand deposits.

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You have prepared the draft consolidated financial statements of PWE for the year ended 31 March 2012. After you sent these draft consolidated financial statements to PWE's directors for review, one of the directors, who is not a certified public accountant, sent you an e-mail as follows:

To: Vincent Lee, Accounting Manager, PWE
From: Fatima Choi (Director)
c.c.: Jason Lam, Andy Cheng, Nick Chan (Directors)
Date: 16 May 2012

Re: Consolidated financial statements of PWE as at 31 March 2012

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

(A) I find that you have deducted HK$7,500,000 from our cash and bank balances and separately included it as "certificate of deposit". The way you have done it reduces our reported cash and cash equivalents a lot. You should not do so! It is even worse that you included it as a non-current asset. The way you have done that not only significantly reduces our reported cash and cash equivalent but also results in net current liability. I don't want people to think that we have liquidity problem. I demand you to adjust the cash and cash equivalent by adding back this "certificate of deposit".

(B) You told me that various HKFRSs have been issued but we have not applied them. Why don't we apply those HKFRSs as they have been issued? Do we need to tell our shareholders on this matter?

(C) I find that PWE have acquired a new subsidiary and therefore goodwill arises. How should we disclose this acquisition of a subsidiary in our consolidated financial statements? How do you calculate the amount of goodwill?

(D) I find that it is difficult to obtain the figures in the consolidated statement of cash flows. Can you tell me more about how you arrive at each figure?

Please clarify and adjust in time for the upcoming board meeting.

Best regards,

Fatima

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

Assume that you are the accounting manager, a certified public accountant, and you are required to draft a memorandum to Fatima Choi, a Director of PWE. In your memorandum, you should:

(a) discuss the appropriate treatment of the certificate of deposit with reference to:

(i) the accounting standards; and (5 marks)

(ii) the ethical issues (6 marks)

(b) discuss the disclosure requirements relating to the fact that various new HKFRSs that have been issued but are not yet effective and are not early adopted;
(6 marks)

(c) briefly describe the presentation requirement of the cash flow effects of the acquisition of SJL. Show the calculation of goodwill and the net cash flow arising on the acquisition of SJL; and
(10 marks)

(d) prepare an annex to your memorandum showing the Consolidated Statement of Cash Flows, using the indirect method, for PWE for the year ended 31 March 2012, beginning with profit before tax. All figures should be rounded to the nearest HK$'000.
(23 marks)

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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 (6 marks – approximately 11 minutes)

"Financial statements should be prepared on a going concern basis and measured with historical cost in order to present fairly the financial position of an entity." **Comment on this statement.**

(6 marks)

Question 3 (16 marks – approximately 29 minutes)

Nero Fashion Limited (NFL) is a clothing manufacturer in mainland China and distributes its products through the following channels:

- Counter sales at department stores – walk-in customers purchase and collect the goods upon the issue of an invoice by and make cash or credit card payments to the department stores. In accordance with the consignment contract signed between the department store and NFL, the selling price is determined and inventory is managed by NFL, the sales teams are employed by NFL while the cashier service is provided by the department stores. The department stores pay 80% of the retail price of the goods sold to NFL on a monthly basis. The department stores accept their customers to return or exchange the goods sold within 7 days from the invoice date and they would return all these items to NFL and deduct the invoice amounts to be remitted to NFL.

- Distributors – NFL ships the goods to the designated location in accordance with the instructions of the distributors, including the items and quantity requested. Distributors can open their own retail store to sell the goods, but NFL will determine the retail prices for the goods, which are normally the same as the prices offered in counter sales at department stores. Goods are not returnable except for items with quality problems which can be returned within 7 days of delivery. The distributors have to sign and return an acceptable confirmation at the completion of quality inspection or 7 days of delivery, whichever is earlier. NFL will issue an invoice to the distributors at 50% of the pre-determined retailing price of items delivered on a monthly basis.

Based on the past three years historical data, less than 0.1% of sales were returned from customers of department stores within the 7-day period and around 5% of sales were returned from distributors before signing the confirmation under the above return policies.

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Required:

(a) **Discuss how NFL should account for the sales revenue through these channels, with reference to HKAS 18 "Revenue".**

(i) **Counter sales at department stores** **(7 marks)**

(ii) **Distributors** **(6 marks)**

(b) **Discuss how NFL should account for monthly revenue if it will give a 10% discount of the invoiced amount to the distributors when the respective annual quantity delivered is above 100,000 pieces.**

(3 marks)

Question 4 **(11 marks – approximately 20 minutes)**

In the preparation of the financial statements for the year ended 31 March 2012 of Star Workshop Inc. (SW), the financial controller identified the following transactions / events which happened after the end of the reporting period but before the date when the financial statements are authorised for issue:

(a) A customer informed SW on 3 April 2012 that all the goods delivered to the customer's warehouse on 25 March 2012 were not produced in accordance with the agreed specification. SW reproduced the order and shipped the replacement goods to the customer on 10 April 2012. The invoice of HK$8 million issued on 25 March 2012 has not been cancelled and the customer had settled when it confirmed the acceptance of the replacement goods.

(4 marks)

(b) The production of a plant has been suspended since 15 April 2012 due to the sudden shortage of electricity supply. Sales orders of HK$15 million received in February 2012 with a planned production and delivery in May 2012 could not be fulfilled. According to the terms of the sale contracts, SW agreed to compensate the counterparty by 20% of the contract price for breach of contract.

(4 marks)

(c) An official letter issued on 8 April 2012 by the local government regarding the approval of a subsidy of HK$5 million has been received. The subsidy was given to SW because of the employment of more than 1,000 local workers during the six months ended 31 December 2011. According to the published government notice, enterprises are encouraged to employ local workers and, subject to approval, a discretionary subsidy will be granted. SW applied for the subsidy on 8 March 2012.

(3 marks)

<u>Required:</u>

Discuss how the above transactions/events should be dealt with in the financial statements of SW for the year ended 31 March 2012.

<u>Question 5</u> (17 marks – approximately 30 minutes)

(a) On 1 January 2011, Sonna Inc. (SC) issued HK$2,000 million of three-year Hong Kong Interbank Borrowing Rate (HIBOR) plus 180 basis points variable rate bond at par value. Interest is payable annually. On the same date, SC entered into an interest rate swap with a bank by paying 2 per cent fixed interest amount and receiving HIBOR plus 180 basis points for three-year and exchange at the dates of interest payment dates. SC measures the bond at amortised cost.

<u>Required:</u>

(i) Explain the difference between the fair value interest rate risk and the cash flow interest rate risk in the context of a bank loan.

(2 marks)

(ii) Explain what a hedged item and hedging instrument are and discuss how hedge accounting affects the accounting treatment of a hedging instrument in the financial statements under cash flow hedges.

(6 marks)

(iii) Assuming hedge accounting is not adopted, explain the accounting treatment for the bond and interest rate swap if the market interest rate is increased by 0.5% on 30 September 2011, the current year end date (no quantification of the effect is required).

(5 marks)

(b) On 1 August 2011, SC entered into a non-cancellable purchase order to acquire equipment from Monta Corporation, a Japanese entity, at Yen 300 million. Payment is made upon delivery of the equipment to Hong Kong on 31 December 2011. On 30 September 2011, SC entered into a forward contract to exchange Yen 300 million at a pre-determined exchange rate between the Yen and Hong Kong dollar on 31 December 2011. The functional currency of SC is the Hong Kong dollar.

Required:

Discuss the accounting implications for the purchase contract and forward contract if fair value hedge accounting is adopted.

(4 marks)

* * * END OF EXAMINATION PAPER * * *