SECTION A – CASE QUESTIONS (Total: 50 marks)

To : Ms. Agnes Cheng, Director

From : Sarah Lam, Accounting Manager

Date : dd/mm/yyyy

Subject : Appropriate accounting treatment for the new plant

I refer to your query regarding the accounting treatment for the new plant.

Answer 1

New plant

HKAS 37 Provisions, Contingent liabilities and Contingent assets states that a provision should be recognised if:

- There is a present obligation as a result of the past event;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

In this case, the obligating event is the construction of the new plant. The operating licence has created a legal obligation to incur the cost of removal. The expenditure is probable and a reasonable estimate of the amount can be made.

Since PHL cannot operate the plant without incurring an obligation to pay for the removal, this expenditure is required in order to enable PHL to acquire economic benefits through the income generated from the product manufactured. Therefore, PHL should recognise an asset as well as a provision, and depreciate this asset over its useful life of 50 years.

HKAS 16 Property, Plant and Equipment specifies that the cost of an item of property, plant and equipment includes the costs of its dismantlement, removal or restoration, the obligation for which an entity incurs as a consequence of installing the item.

A provision should be recognised for the best estimate of the eventual costs that relate to the removal of the plant. These costs (HK$30 million, at net present value as at 1 January 2016) should be included as part of the cost of the new plant.

The costs that arise through the contamination resulting from the production of the cosmetic products for the current year (HK$600,000) are recognised as a liability when the cosmetic products are produced and hence contamination is made. The cost relating to the production contamination should be estimated over time based on the actual contamination, and it should be recognised as an expense for the period.

Therefore, the property, plant and equipment as at 31 December 2016 would show:

	HK$'000
Cost of the new plant	200,000
Dismantle and removal costs (NPV at 1 January 2016)	30,000
Total cost for the new plant	230,000
Accumulated depreciation ($230m / 50 years)	(4,600)
Net book value as at 31 December 2016	225,400

The provisions as at 31 December 2016 would show:

	HK$'000
Provision for dismantlement and removal at 1 January 2016	30,000
Unwinding of discount ($30m x 6%)	1,800
Provision for dismantle and removal at 31 December 2016	31,800
Provision for restoration cost relating to contamination of the land	600
	32,400

The income statement for the year ended 31 December 2016 would show:

	HK$'000
Depreciation for the year	4,600
Unwinding of discount (finance cost)	1,800
Restoration cost due to contamination of the land	600

I hope the above explanation has answered your question. Please feel free to contact me if you have further queries.

Best Regards,
Sarah Lam

Answer 2

Functional currency of BSC

HKAS 21 defines functional currency as the currency of the primary economic environment in which the entity operates.

HKAS 21 specifies primary indicators (para 9) and secondary indicators (para 10) that have to be considered by all entities for determining the functional currency. In addition, for a foreign operation such as in this case, four additional factors (para 11) should also be considered.

The relative importance of the various indicators varies from entity to entity. The primary and secondary indicators should be looked at as a hierarchy. If all the primary indicators considered together identify a particular currency as the functional currency, there is no need to consider the secondary indicators.

After considering all the factors, if the functional currency is still not obvious, the management should use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions (para 12).

HKAS 21 (para 9) requires an entity to consider the following factors (primary indicators) in determining its functional currency:

(a) the currency:

- that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

- of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Applying indicator (a) above, the indicator suggests that BSC's functional currency is GBP as that is the currency in which sales prices are denominated and settled. Furthermore, sales prices do not respond on a short-term basis to changes in exchange rates, but are determined primarily by local competition in Britain. This is a strong indicator that the functional currency is GBP.

However, applying indicator (b) above provides a mixed response. The cost of sales is primarily denominated and settled in HK$, whereas local expenses, including selling and operating expenses, are denominated and settled in GBP. Given that a significant part of the costs and expenses are settled in HK$, this indicator does not provide conclusive evidence that GBP is the functional currency.

The two primary indicators produce a mixed response, though overall they favour GBP as the functional currency. Therefore, it is necessary to look at the secondary indicators.

The following factors (secondary indicators, HKAS 21.10) may also provide evidence of an entity's functional currency:

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and

(b) the currency in which receipts from operating activities are usually retained.

Applying the secondary indicators also provides mixed responses on the functional currency of BSC. Although BSC will finance part of its operations through a HK$10 million loan from PHL, BSC is allowed to arrange long term loans from the bank in Britain locally and thus the HK$ is not necessarily the currency in which funds from financing activities are obtained.

In addition, BSC's management will have a considerable degree of autonomy in carrying out the operations of BSC and the distribution of profits will only be made in the form of dividends, it is expected that BSC can retain its receipts from operating activities in GBP.

Given that BSC's operations were carried out with a significant degree of autonomy, its functional currency would be determined independently from the parent (PHL).

Since the above indicators are mixed and the functional currency is not obvious, we need to use our judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, we should give priority to the primary indicators before considering the secondary indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

Based on the above analysis, it is concluded that the functional currency of BSC is GBP as the primary indicators are overall in favour of GBP.

Answer 3(a)

Worksheet for the consolidated statement of profit or loss of PHL for the year ended 31 December 2014.

	PHL	QBL				Consolidated
	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
Sales	900,000	400,000				1,300,000
Cost of sales	600,000	250,000	2,000	3,5	600	851,100
				6	300	
Expenses	288,100	142,800				430,900
Share of profits of			501	E1		
associate				E3	1,200	699
Profit for the year	11,900	7,200				18,699
Tax	1,900	1,200	99	5,3	330	
			49.5	6		2,918.5
Profit after tax	*10,000*	*6,000*				*15,780.5*
Profit attributable to NCI			1,106	7		1,106
Profit attributable to owners of parent						*14,674.5*
Opening retained	137,000	124,000	120,000	1		
earnings			800	2		
			3,200	3	528	
			2,400	4	396	
			79.2	5	480	
			300	6	49.5	
			400.8	E1		
				E2	1,440	136,713.5
Closing retained earnings	*147,000*	*130,000*				*151,388*

Answer 3(b)

Worksheet for the consolidated statement of Financial Position of PHL as at 31 December 2014:

	PHL	QBL				Consolidated
	HK$'000	HK$'000	HK$'000	Ref	HK$'000	HK$'000
Non-current assets	501,000	259,200	20,000	1		772,400
				3	6,000	
			11,000	4	14,000	
			1,200	5		
Investment in QBL	240,000	-		1	240,000	-
Investment in RSL		60,000		E1	1,002	61,998
			1,800	E2		
			1,200	E3		
Goodwill			26,640	1		26,640
Deferred tax assets			495	4,5	198	297
Inventory	116,000	35,000				151,000
Accounts Receivables	62,000	15,000				77,000
Cash	1,000	800				1,800
	920,000	*370,000*				*1,091,135*
Share capital	331,000	50,000	50,000	1		331,000
Retained earnings	147,000	130,000				151,388
Other comprehensive income	200,000	80,000	80,000	1		200,000
Non-controlling interests				1	53,340	54,437
				2	800	
			800	3	132	
			600	4	99	
			19.8	5	120	
			100.2	E1		
				E2	360	
				7	1,106	
Non-current liabilities	153,000	100,000				253,000
Current liabilities	89,000	10,000				99,000
Deferred tax liabilities			990	3,1	3,300	2,310
	920,000	*370,000*				*1,091,135*

Reconciliation of NCI:

		HK'$000
Book Value of net assets of QBL (50 + 130 + 80) x 20%	=	52,000
Unrealised profit (HK$3m x (1-16.5%) x 3/5) = $1,503k x 20%	=	(300.6)
Fair Value adj (HK$20m x (1-16.5%) x 7/10) = $11,690k x 20%	=	2,338
Share of post-acquisition increase in net assets of RSL [(HK$60m - HK$50m) x 30%] x 20%	=	600
Share of amortization of Fair Value adjustment of RSL (HK$1,002k x 20%)	=	(200.4)
		54,437

Reconciliation of investment in associate:

		HK'$000
Book Value of net assets of RSL (66+60+50) x 30%	=	52,800
Fair Value adj (HK$10m x (1-16.5%) x 3/5) = $5,010k x 30%	=	1,503
Implicit goodwill for investment in RSL		*7,695*
		61,998

Calculation of goodwill for the acquisition of RSL:

		$'000
Book (Fair) value of net assets of RSL = HK$66m + HK$50m + HK$50m	=	166,000
Fair value increment, after tax = HK$10m x (1-16.5%)	=	8,350
Fair value of identifiable net assets of RSL	=	174,350
x 30%		52,305
Consideration transferred	=	60,000
Implicit goodwill for investment in RSL		7,695

Answer 3

Consolidation journal entries (All figures in HK$'000):

J1	Elimination of investment in QBL		
Dr	Share capital	50,000	
Dr	Retained earnings	120,000	
Dr	Other comprehensive income	80,000	
Dr	Goodwill	26,640	
Dr	Plant and equipment	20,000	
	Cr Deferred tax liabilities		3,300
	Cr Investment in QBL		240,000
	Cr Non-controlling interests 20%		53,340
J2	NCI share of post-acquisition retained earnings of QBL up to the beginning of the current year		
Dr	Retained earnings (20% x ($124m - $120m)	800	
	Cr Non-controlling interests		800
J3	Additional depreciation for fair value adj in QBL		
Dr	Depreciation of plant and equipment (COS) (HK$20m / 10 years)	2,000	
Dr	Retained earnings (HK$20m x 2/10) x 80%	3,200	
Dr	NCI 20%	800	
	Cr Accumulated depreciation		6,000
Dr	Deferred tax liabilities (HK$6m x 16.5%)	990	
	Cr Tax expense (HK$2m x 16.5%)		330
	Cr Retained earnings		528
	Cr NCI 20%		132
	(if current year figures HK$(2,000 – 330) are shared to NCI HK$(400 – 66): *J3a: Dr Profit attributable to NCI HK$334; Cr NCI HK$334)*		
J4	Eliminate gain on machine sold by QBL to PHL		
Dr	Machine (HK$15m → HK$26m)	11,000	
Dr	Retained earnings (HK$3m x 80%)	2,400	
Dr	Non-controlling interests (HK$3m x 20%)	600	
	Cr Accumulated depreciation		14,000
Dr	Deferred tax asset (HK$3m x 16.5%)	495	
	Cr Retained earnings		396
	Cr Non-controlling interests		99

J5	Depreciation adjustment for the machine sold by QBL to PHL			
Dr	Accumulated depreciation (HK$3m x 2 / 5)	1,200		
	Cr Depreciation of machine (COS) (HK$3m / 5)			600
	Cr Retained earnings 80%			480
	Cr Non-controlling interests 20%			120
Dr	Tax expense (HK$600k x 16.5%)	99		
Dr	Retained earnings 80% (HK$480k x 16.5%)	79.2		
Dr	Non-controlling interests 20%	19.8		
	Cr Deferred tax asset (HK$1,200k x 16.5%)			198
	(if current year figures HK$(600 – 99) are shared to NCI HK$(120 –19.8): *J5a: Dr NCI HK$100.2; Cr Profit attributable to NCI HK$100.2)*			
J6	Eliminate gain on inventory sold by PHL to QBL			
Dr	Retained earnings (HK$1,800k - HK$1,500k)	300		
	Cr Cost of sales			300
Dr	Tax expense (HK$300k x 16.5%)	49.5		
	Cr Retained earnings			49.5
E1	Amortisation of fair value adjustment in RSL			
Dr	Retained earnings (HK$10m / 5 years) x (1-16.5%) x 30% associate x 80%	400.8		
Dr	Non-controlling interests 20%	100.2		
Dr	Share of profits of associate	501		
	Cr Investment in RSL (HK$10m x 2/5 years) x (1-16.5%) x 30% associate			1,002
	(if current year figures HK$(501) are shared to NCI HK$(100.2): E1a: Dr Profit attributable to NCI HK$100.2; Cr NCI HK$100.2)			
E2	Share of post-acquisition retained earnings of RSL up to the beginning of the current year			
Dr	Investment in RSL (30% x (HK$56m - HK$50m)	1,800		
	Cr Retained earnings			1,440
	Cr Non-controlling interests 20%			360

E3 Share of current year profits of RSL

Dr	Investment in RSL (30% x HK$4m)	1,200		
	Cr Share of profits of associate		1,200	

(if current year figures HK$(1,200) are shared to NCI HK$(240): E3a: Dr Profit attributable to NCI HK$240; Cr NCI 240)

J7 NCI share of post-acquisition profit of QBL

Dr	Profit attributable to NCI of QBL		1,106		
	Cr Non-controlling interests			1,106	
				20% NCI	
		Reported profit of QBL	6,000	1,200	J7a
	J3	Additional depreciation for fair value adj, after tax (HK$2m – tax HK$330k)	(1,670)	(334)	J3a
	J5	Depreciation adjustment on intragroup sales of machine, after tax (HK$600k – tax 99k)	501	100.2	J5a
	E1	Amortisation of fair value adjustment of RSL (HK$10m/5 x (1-16.5%) x 30% associate)	(501)	(100.2)	E1a
	E3	Share of profits of associate (RSL)	1,200	240	E3a
			5,530		
			X 20%	1,106	

(if current year figures are shared in individual journal entry, J7a would share the unadjusted profit: J7a: Dr Profit attributable to NCI HK$1,200; Cr NCI HK$1,200)

Calculation of goodwill for the acquisition of QBL:

		HK$'000
Book value of net assets of QBL = HK$50m + HK$120m + HK$80m	=	250,000
Fair value increment, after tax = HK$20m x (1-16.5%)	=	16,700
Fair value of identifiable net assets of QBL	=	266,700
Consideration transferred	=	240,000
NCI (HK$266,700 x 20%)	=	53,340
	=	293,340
Goodwill on acquisition of QBL		26,640

* * * END OF SECTION A * * *

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

Answer 4(a)

Contingent consideration is recognised as part of the consideration transferred for a business combination, measured at fair value at the date of acquisition.

As the number of shares that will ultimately be delivered by ACL does not vary (i.e. the only outcomes are nil or 4 million shares to be issued depending on the profit of JML), the contingent consideration meets the definition of equity instrument under HKAS 32 and would be classified as equity upon initial recognition.

As at 31 December 2015, if JML fails the profit target, no remeasurement is required and there will not be any impact on profit or loss. If JML fulfills the profit target, 4 million shares will be issued to the vendor which will be dealt within the equity.

Answer 4(b)

The consideration transferred in a business combination is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the asset transferred, liabilities incurred and the equity interest issued by ACL according to paragraph 37 of HKFRS 3.

The acquisition date is defined as the date on which ACL obtains control over JML, i.e. 15 August 2014 on which all the conditions to obtain control were satisfied.

Thus, the consideration transferred by ACL is the aggregate value of cash of HK$10 million, the fair value of its shares and the fair value of the contingent consideration at the date of acquisition, i.e. 15 August 2014.

Consideration transferred

= HK$10 million + [20 million x HK$1.40] + HK$1.8 million

= HK$39.8 million

Answer 4(c)

ACL should not recognise those potential contracts from prospective new customers of JML separately from goodwill as the goodwill for the acquisition of JML would subsume the value attributed to those potential contracts when they are not themselves assets at the acquisition date. Accordingly, even those contracts which are concluded subsequently after the acquisition, ACL should not reclassify the value of those contracts from goodwill for the events that occur after the acquisition date pursuant to HKFRS 3.B38. However, ACL should assess the facts and circumstances surrounding an event occurring shortly after the acquisition to determine whether a separately recognisable intangible asset existed at the acquisition date.

ACL should recognise the acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received.

When the fair value of the property, plant and equipment at the date of acquisition is higher than its carrying amount in JML's financial statements with the tax bases of these assets and liabilities being unchanged, a taxable temporary difference arises as a result of the acquisition. A deferred tax liability arising from this taxable temporary difference is recognised in the consolidated financial statements.

The existing customers' relationship is identified as an intangible asset at the acquisition date which is not previously recognised in JML's financial statements. The newly recognised assets would create additional taxable temporary difference and thus the relevant deferred tax liabilities.

The deferred tax impact of the temporary difference under initial recognition exemption in JML's financial statements is recognised in the consolidated financial statements.

Answer 5(a)

The classification of joint arrangements required by HKFRS 11 depends upon the parties' rights and obligations arising from the arrangement in the normal course of business.

As stated in HKFRS 11.B14, the classification of joint arrangements requires the parties to assess their rights and obligations arising from the arrangement. When making that assessment, an entity shall consider the following:

(a) the structure of the joint arrangement; and
(b) when the joint arrangement is structured through a separate vehicle:
    (i) the legal form of the separate vehicle;
    (ii) the terms of the contractual arrangement; and
    (iii) when relevant, other facts and circumstances.

The "other facts and circumstances" may include the activities of an arrangement which are primarily designed for the provision of output to the parties (HKFRS 11.B31) and the effect of an arrangement with such a design and purpose is that the liabilities incurred by the arrangement are, in substance, satisfied by the cash flows received from the parties through their purchases of the output (HKFRS 11.B32).

Joint Arrangement A:

The legal form of the separate vehicle does not give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement.

There is no contractual arrangement that specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement. In view of the form of ABC Limited, the liability borne by JEL and Party A would be limited to the share capital of ABC Limited. The provision of financial guarantees by itself does not result in rights to the assets and obligations for the liabilities.

ABC Limited is not designed with the aim to provide JEL and Party A with an output. ABC Limited would generate its own cash flows to settle the liabilities relating to its operation.

To conclude, Joint Arrangement A is a joint venture for JEL.

Joint Arrangement B:

The legal form of the separate vehicle does not give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement.

There is no contractual arrangement that specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement. In view of the form of XYZ Limited, the liability borne by JEL and Party B would be limited to the share capital of XYZ Limited.

XYZ Limited is designed with the aim to provide JEL and Party B with an output as there is an agreement that JEL and Party B would purchase all the outputs from XYZ Limited. As all the outputs are purchased by JEL and Party B and there is no mark up of the price of output, XYZ Limited relies on the cash received from JEL and Party B on a continuous basis for settling the liabilities relating to its operation. In particular, JEL and Party B will provide funding when XYZ Limited has a cash shortage.

To conclude, Joint Arrangement B is likely to be a joint operation for JEL.

Answer 5(b)

HKAS 24.9 defined a related party transaction as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

(i) JEL's purchase of products from JAS Limited should be disclosed in the financial statement of both JEL and JAS Limited as JAS Limited is an associate of JEL and it is considered to be a related party under HKAS 24.9(b)(ii).

(ii) JAS Limited's renting of property from ABC Limited is not required to be disclosed in the financial statement of JEL as it is a transaction between JAS Limited and ABC Limited but it is not a transaction with JEL as the reporting entity as set out in HKAS24.9(b).

However, as ABC Limited is a joint venture of JEL, ABC Limited is considered as the related party of JAS Limited under HKAS24.9(b)(IV). Accordingly, the transaction should be disclosed in the financial statement of JAS Limited.

(iii) JEL providing guarantees to the bank for ABC Limited should be disclosed in the financial statement of JEL as ABC Limited is a joint venture of JEL and it is considered as a related party under HKAS 24.9(b)(ii).

(iv) A shareholder of JEL settling the payable on behalf of JEL if the shareholder has control, joint control or significant influence over JEL should be disclosed. Otherwise, the shareholder is not considered to be a person related to JEL.

(v) A shareholder of JEL providing a loan to ABC Limited is not required to be disclosed as it is a transaction between the shareholder of JEL and ABC Limited. It is not a transaction between JEL as the reporting entity with any entity considered as related as set out in HKAS24.9(b).

Answer 6(a)

(i) The loan shall be recognised and measured initially at fair value less direct transaction costs in accordance with HKFRS 9 and subsequently carried at amortised cost. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with HKFRS 9 and the proceeds received. As this is a benefit from the shareholder, it shall be recognised in equity as capital contribution.

(ii) Investment in the shares of SUN Limited shall be measured initially and subsequently at fair value in accordance with HKFRS 9 as they are not a financial asset with contractual terms which give rise on specific dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. The gain or loss arising from the fair value change shall be recognised in profit or loss. When the investment in shares of SUN Limited is not held for trading (i.e. long term strategic purpose) and HIL would avoid volatility in profit or loss, HIL should elect to present gains or losses on that investment in other comprehensive income.

(iii) The deposit shall be measured initially and subsequently at fair value in accordance with HKFRS 9 as it is not a financial asset with contractual terms which gives rise on specific dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. The gain or loss arising from the fair value change shall be recognised in profit or loss.

Answer 6(b)

(i) Loan from a shareholder

Initial carrying value of the shareholder's loan:

[HK$15 million+(HK$15 million*2%*5)]/(1.05)^5
= HK$12.9 million

Journal entries for initial recognition of loan on 1 March 2014:

Dr	Cash		HK$15 million	
	Cr	Shareholder's loan – liability		HK$12.9 million
	Cr	Capital contribution – equity		HK$2.1 million

Journal entries for effective interest expense for the period from 1 March 2014 to 31 December 2014:

Dr	Interest expense (HK$12.9 million*5%/12*10)		HK$0.54 million	
	Cr	Shareholder's loan – liability		HK$0.54 million

(ii) Investment in shares of SUN Limited

Journal entries for initial recognition of investment on 30 April 2014:

Dr	Equity investment		HK$8 million	
	Cr	Cash		HK$8 million

Journal entries for fair value change for the year ended 31 December 2014:

Dr	Equity investment (HK$5*2 million - HK$8 million)		HK$2 million	
	Cr	Other comprehensive income		HK$2 million

(iii) Deposit with a bank

Journal entries for initial recognition of deposit on 1 July 2014:

Dr	Deposit		HK$3 million	
	Cr	Cash		HK$3 million

Journal entries for fair value change for the year ended 31 December 2014:

Dr	Deposit (HK$3.5 million – HK$3 million)		HK$0.5 million	
	Cr	Profit or loss		HK$0.5 million

* * * END OF EXAMINATION PAPER * * *