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

Answer 1

To : Mr Sunny Chan, Chief Operating Officer
From : Agnes Cheng, Accounting Manager
Date : dd/mm/yyyy
Subject : Accounting treatment for RPE

I refer to your query regarding the accounting treatment for RPE

RPE is a joint arrangement between PPL and TLL. To determine how RPE should be accounted for in PPL's financial statements, it is necessary to consider whether RPE is a joint venture or a joint operation, according to HKFRS 11 *Joint Arrangements*.

Joint operation vs joint venture

HKFRS 11 classifies joint arrangements into two types – joint operations and joint ventures.

- A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement (i.e. joint operators) have rights to the assets, and obligations for the liabilities, relating to the arrangement.

- A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement (i.e. joint venturers) have rights to the net assets of the arrangement.

PPL should determine the type of joint arrangement in which it is involved by considering its rights and obligations. PPL should assess its rights and obligations by considering the structure and legal form of the arrangement, the contractual terms agreed by the parties to the arrangement and, when relevant, other facts and circumstances.

Where a joint arrangement is not structured through a separate entity, it is always a joint operation. However, since RPE is a separate entity, it could be a joint operation or joint venture, so the terms of the contractual arrangement must be considered to determine which form of joint arrangement it is.

As the contractual arrangement does not give PPL and TLL rights to the assets and obligations for the liabilities of RPE, this is a joint venture, not a joint operation.

Accounting treatment for joint venture

HKFRS 11 requires PPL, as a joint venturer, to recognise its interest in a joint venture as an investment and account for that investment using the equity method in accordance with HKAS 28 (2011) *Investments in Associates and Joint Ventures*.

In its separate financial statements, PPL as a joint venturer, shall account for its interest in RPE in accordance with HKAS 27 (2011) *Separate Financial Statements*. Thus, when PPL prepares separate financial statements, PPL can account for investments in joint ventures either at cost, in accordance with HKFRS 9 *Financial Instruments*, or using the equity method.

Therefore, we can keep the investment in RPE at cost in the separate financial statements of PPL.

However, we must account for the investment using the equity method in the consolidated financial statements in accordance with HKAS 28 (2011) *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method as specified in HKAS 28 (2011).

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

Best Regards,
Agnes Cheng

Answer 2

Gain on disposal to be recorded in separate financial statements of PPL

The disposal has not been recorded by PPL. The relevant journal entry is:

Dr	Cash	HK$110 million	
	Cr Investment (HK$120m / 2)		HK$60 million
	Cr Gain on disposal		HK$50 million

To recognise the disposal in PPL's separate financial statements (A2)

Gain on disposal to be recorded in consolidated financial statements of PPL

The group's gain on disposal should be calculated as:

	HK$m	HK$m
Fair value of consideration received		110
Fair value of 35% investment retained		126
Less: share of carrying amount when control lost		
Net assets (190 – (20 x 6 / 12))	180	
Goodwill#	43	
Less: non-controlling interests at date of disposal*	(54)	
		(169)
Group's gain on disposal		67

Goodwill on acquisition of LKL

	HK$m
Consideration transferred	120
Non-controlling interest (HK$110 m x 30%)	33
Less: fair value of net assets at acquisition date	(110)
Goodwill on acquisition of LKL#	43

		HK$m
Non-controlling interests at acquisition (HK$110 m x 30%)		33
NCI share of post-acquisition retained reserves		
Retained reserves at date of disposal (HK$90m - HK$20m x 6 / 12)	80	
Retained reserves at acquisition date	(10)	
	70 x 30% =	21
non-controlling interests at date of disposal*		54

Answer 3

Worksheet for the Consolidated Statement of Financial Position of PPL as at 31 March 2016:

	PPL	SAL				Consolidated
	HK$m	HK$m	HK$m	Ref	HK$m	HK$m
Property, plant and equipment	890	276	16	3	22	1,161.80
			1.8	4		
Investment in SAL	190	-		1	190	-
Investment in LKL	120	-	66	E1		129.50
				A2	60	
			3.5	E3		
Investment in RPE	7		3	V1		10.00
Goodwill			50	1		50.00
Current assets	193	52	110	A2		353.00
				5	2	
	1,400	328				1,704.30
Share capital	500	45	45	1		500.00
Retained reserves	400	195	155	1		546.16
			12	2		
			4.2	3		
				4	1.26	
			1.4	5		
				E1	66	
				A2	50	
			17	E2	17	
				E3	3.5	
				V1	3	
Non-controlling interests				1	60	70.14
				2	12	
			1.8	3		
				4	0.54	
			0.6	5		
Non-current liabilities	400	68				468.00
Current liabilities	100	20				120.00
	1,400	328	487.3		487.3	1,704.30

Workings (For reference only):

Reconciliation of NCI

		HK$m
Book Value of net assets of SAL (HK$45m + HK$195m) x 30%	=	72.00
Unrealised profit on machine (HK$6m x 7 / 10) = HK$4.2m x 30%	=	(1.26)
Unrealised profit on inventory (HK$2m x 30%)	=	(0.60)
		70.14

Reconciliation of investment in associate

		HK$m
Book Value of net assets of LKL (HK$190m) x 35%	=	66.5
Implicit goodwill (HK$126 – HK$180 x 35%)	=	63.0
		129.5

Consolidation journal entries (All figures in HK$million)

J1	Elimination of investment in SAL			
Dr	Share capital		45	
Dr	Retained reserves		155	
Dr	Goodwill		50	
	Cr	Investment in SAL		190
	Cr	Non-controlling interests ((HK$45m + HK$155m) x 30%)		60
J2	NCI share of post-acquisition retained reserves of SAL			
Dr	Retained reserves (30% x (HK$195m - HK$155m)		12	
	Cr	Non-controlling interests		12
J3	Eliminate gain on machine sold by SAL to PPL			
Dr	Property, plant and equipment (HK$26m → HK$42m)		16.0	
Dr	Retained earnings (HK$6m x 70%)		4.2	
Dr	Non-controlling interests (HK$6m x 30%)		1.8	
	Cr	Accumulated depreciation (HK$42m – HK$20m)		22.0
J4	Depreciation adjustment for the machine sold by SAL to PPL			
Dr	Accumulated depreciation (HK$6m x 3 / 10)		1.8	
	Cr	Retained earnings 70%		1.26
	Cr	Non-controlling interests 30%		0.54
J5	Elimination of intragroup sales and unrealised profit for the inventory sold by SAL to PPL			
Dr	Retained earnings 70%		1.4	
Dr	Non-controlling interest 30%		0.6	
	Cr	Inventory (HK$60m - HK$50m) x 20%		2

Calculation of goodwill for the acquisition of SAL

		HK$m
Consideration transferred	=	190
NCI (HK$200m x 30%)	=	60
Less: Fair value of net assets of SAL	=	(200)
Goodwill on acquisition of SAL		50

		Dr	Cr
E1	Recognise retained 35% in LKL as an associate		
Dr	Investment in associate (LKL) (HK$126m – HK$120m / 2)	66	
	Cr Retained earnings		66
E2	Adjust to group gain on partial disposal of interest in LKL (HK$67m)		
Dr	Retained earnings (HK$67m - HK$50m)	17	
	Cr Gain on disposal		17
E3	Share of current year reserves of LKL		
Dr	Investment in LKL (HK$20m x 6 / 12 x 35%)	3.5	
	Cr Share of profits and OCI of associate		3.5
V1	Share of current year reserves of RPE		
Dr	Investment in RPE (HK$6m x 50%)	3	
	Cr Share of profits and OCI of joint venture		3

Answer 4(a)

Disclosure requirement for JADE as a company listed on GEM

The disclosure requirements of routine financial information for companies listed on GEM are principally set out in Chapter 18 Financial Information of the GEM Rules.

While a company listed on the Main Board needs to issue an interim report for the first six months of a financial year and this report must be published not later than two months after the end of that interim period, companies listed on GEM are subject to tighter reporting requirements in terms of interim reporting.

JADE, as a company listed on GEM, is required to publish half-yearly reports and quarterly reports within 45 days after the end of each relevant financial period.

Since JADE needs to prepare the quarterly reports, not only half-yearly reports, JADE has to prepare for this quarterly report and cannot wait. As it is already three months of the reporting year end, JADE has to publish this quarterly report within 45 days.

Answer 4(b)

Cost of a planned major overhaul

HKAS 34 specifies that the cost of a planned major periodic maintenance or overhaul or other seasonal expenditure that is expected to occur later in the year should not be anticipated for interim reporting purposes unless an event has caused the entity to have a legal or constructive obligation.

The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

Therefore, this planned major overhaul, which has not yet caused JADE to have any obligation, should not be anticipated and the cost should not be recognised in this quarter's interim report.

* * * END OF SECTION A * * *

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

Answer 5(a)

For event (i), these grants are related to income. The grant of HK$1,500,000, for the new model which AML has launched in 2014, is recognised in profit or loss during the year ended 31 December 2015 when it is a compensation for expenses already incurred in a previous accounting period.

The other grant of HK$400,000, to compensate for the research and development cost incurred by AML in the year of 2015, is recognised in profit or loss for the year ended 31 December 2015 in which AML recognises these research and development costs as expenses for which the grants are intended to compensate.

Under HKAS 20.29, two methods of presentation are permitted in the financial statements. Accordingly, in the financial statements for the year ended 31 December 2015, AML can present the government incentives of HK$1,900,000 as part of the profit or loss, either separately or under a general heading such as “other income”; or present a net expense of HK$100,000 when the incentives were deducted from the research and development expense of HK$2,000,000.

For event (ii), according to HKAS 20.7, AML should not recognise the grant until there is reasonable assurance that it will comply with the conditions attached to them and the grant is received.

The relevant grants are related to depreciable assets. If there is reasonable assurance that AML will comply with the conditions, the grants are recognised in profit or loss over the periods in which depreciation expense on those assets is recognised, corresponding to the useful lives of the assets.

HKAS 20.24 permits two methods of presentation in the financial statements. Accordingly, AML can recognise the grant of HK$10,000,000 as deferred income, which is recognised in profit or loss over the useful lives of the plant and equipment of five years (i.e. HK$2,000,000 each year); or deduct the grant in calculating the carrying amount of the plant and equipment, in which case the grant is recognised in profit or loss over the life of such plant and equipment by way of a reduced depreciation expense.

Answer 5(b)(i)

When AML failed to meet the production targets, the government grants received in the prior year would become repayable immediately. HKAS 20 requires that a government grant that becomes repayable should be accounted for as a change in accounting estimate in accordance with HKAS 8.

Repayment of a grant related to an asset is recognised by increasing the carrying amount of the relevant plant and equipment or reducing the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised in profit or loss to date in the absence of the grant is recognised immediately in profit or loss.

On the ground that the condition of production targets has failed, AML should consider if there is possible impairment for the new carrying amount of the relevant plant and equipment.

Answer 5(b)(ii)

Given the grant is related to depreciable assets, such a grant should be recognised in profit or loss over the periods in which depreciation expense on those assets is recognised, corresponding to the useful lives of the assets. Accordingly, if AML recognised the entire government grant for the year ended 31 December 2013, it is considered to be an error.

Under HKAS 8.42, AML shall correct the material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- restating the comparative amounts for the prior period presented i.e. the statement of financial position as at 31 December 2014 and the statement of profit or loss and other comprehensive income for the year ended 31 December 2014 if the error has occurred during the year ended 31 December 2014; or

- for the errors occurred before the earliest prior period presented, i.e.1 January 2014, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

AML shall present a third statement of financial position as at the beginning of the preceding period when the retrospective restatement has a material effect on the information in the statement of financial position at the beginning of the preceding period.

Accordingly, the financial statements of AML for the year ended 31 December 2015 include three statements of financial position as at 1 January 2014, 31 December 2014 and 31 December 2015.

AML should also disclose the information required by HKAS 1.41 to HKAS 1.44 and HKAS 8. However, the related notes for the opening statement of financial position as at 1 January 2014 are not required.

Answer 6(a)

With a view to making short-term profits, the investment in shares of a listed company is classified as held for trading and carried at fair value through profit or loss. The decline in the fair value of the shares subsequent to 31 March 2016 is a non-adjusting event and the shares should be stated at fair value (i.e. HK$30,000,000) as at 31 March 2016 in the financial statements for the year ended 31 March 2016. If the impact is significant, NEC may disclose the decline in fair value between 31 March 2016 and the date when the financial statements are authorised for issue.

As NEC intended to avoid the fluctuation in its financial performance, it would choose to recognise the fair value change of the investments in the private entity in other comprehensive income.

Even if the completion date of the disposal was on 31 May 2016, the disposal consideration as stated in the agreement signed on 30 March 2016 provided the best available evidence of the fair value of the investment at 31 March 2016. Thus, the fair value change of HK$3,000,000 between the cost of HK$12,000,000 and the disposal consideration of HK$9,000,000 should be recognised in the other comprehensive income for the year ended 31 March 2016.

Answer 6(b)

Deposits are monetary items when the units of currency held and assets to be received are in a fixed or determinable number of units of currency. Since the functional currency of NEC is HKD, the currency of Country X is considered as foreign currency and the related deposit should be initially recognised using the exchange rate at the date of transaction (i.e. 12 HKD vs 1 Country X's currency).

For the purpose of the year-end financial statements, the deposits should be retranslated using the closing rate (i.e. 14 HKD vs 1 Country X's currency) at the end of the reporting period (i.e.31 March 2016) with the exchange difference recognised in profit or loss. So the devaluation of the exchange rate after 31 March 2016 is a non-adjusting event and should not be reflected in the financial statements for the year ended 31 March 2016. If the effect of the exchange rate movement between 31 March 2016 and the date when the financial statements are authorised for issue is significant, NEC may make relevant disclosures.

Answer 6(c)

Plant and equipment, stated at cost less accumulative depreciation and impairment, is a non-monetary item as it does not have a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. It is measured in terms of historical cost in a foreign currency and should be translated using the spot exchange rate of 8.83 at the date of the transaction (i.e. NEC received and initially recognised the plant and equipment). Its carrying amount remained at the initial recognised amount and was not retranslated at 31 March 2016.

Payables are monetary items and should be initially recognised using the exchange rate at the date of transaction (i.e. 28 February 2016). For the purpose of the year-end financial statement, payables should be retranslated using the closing rate at the end of the reporting period (i.e. 31 March 2016). The exchange difference arising from the settlement of payables on 30 June 2016 is a non-adjusting event. The effect of the exchange rate movement between 31 March 2016 and 30 June 2016, is recognised in profit or loss at the time of settlement.

Answer 7(a)

Journal entries for the initial recognition of the financial guarantee provided for the bank borrowing of a related company on 1 July 2015:

Dr	Equity	HK$180,000	
	Cr. Financial guarantee liability		HK$180,000

Journal entries for amortising the financial guarantee liability initially recognised for the period from 1 July 2015 to 31 December 2015:

Amortisation for 2015 = HK$180,000 / 3 years / 12 months x 6 months = HK$30,000

Dr	Financial guarantee liability	HK$30,000	
	Cr. Profit or loss		HK$30,000

Answer 7(b)

The bank loan should be originally classified as a non-current liability when it is due to be settled after twelve months from 31 December 2015.

However, as GHL has breached the bank covenant (i.e. the gearing ratio) of a long-term loan arrangement at 31 December 2015, it does not have an unconditional right to defer its settlement for at least twelve months after 31 December 2015. With the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the issuance of financial statements, not to demand payment as a consequence of the breach.

GHL may continue to classify the liability as non-current if the bank agreed by 31 December 2015 to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

If GHL classifies the bank loan as a current liability, it shall disclose in the financial statements for the year ended 31 December 2015 in respect of the rectification of a breach of a long-term loan arrangement and the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period, if these events occur between 1 January 2016 and the date the financial statements are authorised for issue.

* * * END OF EXAMINATION PAPER * * *