SECTION A – CASE QUESTIONS (Total: 50 marks)

To : Ms. Tess Chow, Director of MHL
From : Melody Li, Accounting Manager
Date : dd/mm/yyyy
Subject : Brand name, patent, earnings per share and the consolidated financial statements of MHL

I refer to your queries regarding the brand name, patent, earnings per share and the consolidated financial statements of MHL.

Answer 1(a)

Brand name

The brand name, Magica, is an internally generated intangible asset.

HKAS 38 establishes a much higher hurdle for the recognition of internally generated assets than purchased ones. In particular, it specifically prohibits the recognition of internally generated brands.

HKAS 38.64 states that expenditure on internally generated brands cannot be distinguished from the cost of developing the business as a whole.

Therefore, MHL should not recognise the brand name in its consolidated statement of financial position.

Patent

Since the patent is expected to expire in 20 years, it should be amortised to a nil residual value at HKD2 million / 20 years, i.e. HKD100,000 per annum.

A patent cannot be revalued under HKAS 38 because there is no active market as a patent is unique (HKAS 38.78).

HKAS 38 does not permit revaluation without an active market as the value cannot be reliably measured in the absence of a commercial transaction.

Therefore, MHL should not revalue the patent in its consolidated statement of financial position.

Answer 1(b)

Earnings per share

The basic and diluted earnings per share of MHL for the year ended 31 December 2012 are calculated as follows:

	Shares outstanding	fraction	weighted average
1 Jan to 30 Sep	23,250,000	9/12	17,437,500
Issued on 1 Oct	5,000,000		
1 Oct to 31 Dec	28,250,000	3/12	7,062,500
Weighted average number of shares			24,500,000

Basic EPS = HKD147,189,600 / 24,500,000 = HKD6.01

Considering the dilutive effects of the warrants:

The proceed raised on the exercise of the warrants is 3,000,000 x exercise price of HKD60 = HKD180,000,000

To raise the same amount, the number of shares to be issued at market value of HKD100 would be HKD180,000,000 / HKD100 = 1,800,000 shares

Thus "free shares" = 3,000,000 shares – 1,800,000 shares = 1,200,000 shares*

*(*alternatively, it can be calculated as [(100 – 60) / 100] x 3,000,000 = 1,200,000 shares)*

Considering the dilutive effects of convertible bonds:

Interest saving after tax = HKD10 million x 4% x (1-16.5%) = HKD334,000

Additional shares = HKD10 million / HKD1,000 x 20 = 200,000 shares.

The EPS of this convertible bond is therefore HKD334,000 / 200,000 shares = HKD1.67.

As this is smaller than the basic EPS (HKD6.01), the convertible bond is dilutive and should be taken into account in the calculation of the diluted EPS.

Diluted EPS with warrants and convertible bonds is HKD(147,189,600 + 334,000) / (24,500,000 + 1,200,000 + 200,000) shares = HKD147,523,600 / 25,900,000 shares = HKD5.70.

Answer 1(c)

Translation reserve for SDL

Translation reserve on goodwill

Goodwill

	AUD'000
Net assets at book value*	54,000
Add: fair value adjustment after deferred tax**	7,000
Adjusted fair value of net assets	*61,000*
NCI 20% share	12,200
Cost of acquisition (HKD427,500,000 / 7.6)	56,250
	68,450
Goodwill	***7,450

* Share capital (AUD24,000,000) + retained earnings (AUD30,000,000) = AUD54,000,000

** Fair value adjustment (AUD10,000,000) less deferred tax = AUD10,000,000 x (1-30%) = AUD7,000,000

*** Goodwill is treated as an asset of the foreign operation.

Thus Translation reserve on goodwill:

	AUD'000	Rate	HKD'000
Goodwill, 1 Jan	7,450	7.60	56,620
Goodwill, 31 Dec	7,450	8.10	60,345
Translation reserve			3,725

Translation reserve on fair value adjustment (patent)

	AUD'000	Rate	HKD'000
Fair value adjustment b/f	10,000	7.60	76,000
Amortisation for 2012	(1,000)	7.80	(7,800)
			68,200
Fair value adjustment c/f	9,000	8.10	72,900
Translation reserve			4,700
Group share 80%			3,760
NCI's share 20%			940

Translation reserve on Deferred tax on fair value adjustment

	AUD'000	Rate	HKD'000
DTL, 1 January	3,000	7.60	22,800
Change in 2012	(300)	7.80	(2,340)
			20,460
DTL, 31 January	2,700	8.10	21,870
Translation reserve			1,410
Group share 80%			1,128
NCI's share 20%			282

or Group share after tax = 3,760 – 1,128 = 2,632 (i.e. 3,760 x (1 – 30%))

NCI share after tax = 940 – 282 = 658 (i.e. 940 x (1 – 30%))

Translation reserve on net assets:

	AUD'000	Rate	HKD'000
Net assets (at book value) b/f (24,000 + 30,000)	54,000	7.60	410,400
Net profit for 2012	10,000	7.80	78,000
			488,400
Net assets (at book value) c/f	64,000	8.10	518,400
Translation reserve			*30,000
Group share 80%			24,000

Therefore, total Translation reserve for the group:	*HKD'000*
Translation reserve on goodwill	*3,725*
Translation reserve on fair value adjustment	*2,632*
Translation reserve on net assets	*24,000*
	30,357

*<u>*Alternative for calculating Translation reserve on net assets</u>*

SDL

Translated statement of retained earnings for the year ended 31 December 2012

	AUD'000	Rate	HKD'000
Profit after tax	*10,000*	*7.80*	*78,000*
Retained earnings, 1 January	*30,000*	*7.60*	*228,000*
Retained earnings, 31 December	*40,000*		*306,000*

** profit after tax is translated at average rate.*

SDL

Translated statement of financial position as at 31 December 2012

	AUD'000	Rate	HKD'000
Non-current assets	*76,000*	*8.10*	*615,600*
<u>Current assets:</u>			
Inventory	*6,000*	*8.10*	*48,600*
Accounts receivable	*12,000*	*8.10*	*97,200*
Cash	*6,600*	*8.10*	*53,460*
Total assets	*100,600*		*814,860*
Current liabilities	*4,600*	*8.10*	*37,260*
Non-current liabilities	*32,000*	*8.10*	*259,200*
Share capital	*24,000*	*7.60*	*182,400*
Retained earnings (from above)	*40,000*		*306,000*
Translation reserve *(balancing figure)*			**30,000*
	100,600		*814,860*
Group share 80%			*24,000*

Alternative for calculating total Translation reserve

		translate	year end		FCTR	
	SDL	ex-rate	ex-rate	difference	CI (80%)	NCI (20%)
Net asset at BV	54,000	7.6	8.1	27,000	21,600	5,400
FV adjustment	10,000	7.6	8.1	5,000	4,000	1,000
DTL	(3,000)	7.6	8.1	(1,500)	(1,200)	(300)
	61,000	7.6	8.1	30,500	24,400	6,100
Goodwill	7,450	7.6	8.1	3,725	3,725	-
Value at acq. date	68,450	7.6	8.1	34,225	28,125	6,100
Profit after tax	10,000	7.8	8.1	3,000	2,400	600
Amortisation of FV	(1,000)	7.8	8.1	(300)	(240)	(60)
DTL on amortisation	300	7.8	8.1	90	72	18
Total	77,750			37,015	30,357	6,658

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

Best regards,
Melody Li

Answer 1(d)

MHL – Worksheet for the Consolidated Statement of Financial Position as at 31 December 2012

	MHL	SDL				Consolidated
	HKD'000	HKD'000	HKD'000	Ref.	HKD'000	HKD'000
Non-current assets	1,170,000	615,600	76,000	1, 2	7,800	1,858,500
			4,700	4		
Investment in SDL	427,500	-		1	427,500	-
Goodwill			56,620	1		
			3,725	3		60,345
Current assets						
Inventory	225,000	48,600				273,600
Receivables	120,000	97,200				217,200
Cash	27,000	53,460				80,460
	1,969,500	814,860				2,490,105
Share capital	750,000	182,400	182,400	1		750,000
			228,000	1		
			7,800	2	2,340	
Retained earnings	784,500	306,000	14,508	5		842,532
				3	3,725	
			1,128	4	3,760	
Translation reserve		30,000	6,000	6		30,357
				1	92,720	
Non-controlling Interests			282	4	940	
				5	14,508	
				6	6,000	113,886
Current liabilities	315,000	37,260				352,260
			2,340	2,4	1,410	
DTL				1	22,800	21,870
Non-current liabilities	120,000	259,200				379,200
	1,969,500	814,860				2,490,105

Journal entries and reconciliations are <u>not</u> required

CJE 1			HKD'000	HKD'000
Dr	Share capital		182,400	
Dr	Retained earnings		228,000	
Dr	Non-current assets		76,000	
Dr	Goodwill		56,620	
	Cr	Deferred tax liability		22,800
	Cr	Investment in SDL		427,500
	Cr	NCI		92,720

CJE 2

Dr	Amortisation		7,800	
	Cr	Accumulated amortisation		7,800

[10 million ÷ 10 years x 7.80] (Amortisation on undervalued assets)

Dr	DTL	(7,800 x 30%)	2,340	
	Cr	Tax expenses		2,340

(Tax effect on amortisation expenses)

CJE 3

Dr	Goodwill		3,725	
	Cr	Translation reserve (Goodwill)		3,725

(Translation gain on goodwill)

CJE 4

Dr	Non-current assets		4,700	
	Cr	Translation reserve (FV adjustment)		3,760
	Cr	NCI		940
Dr	Translation reserve (FV adjustment)		1,128	
Dr	NCI		282	
	Cr	DTL		1,410

(Allocation of translation gain on fair value adjustment)
Or net Translation reserve 2,632, NCI 658

CJE 5

Dr	Income to NCI		14,508	
	Cr	NCI		14,508

NCI's share of net profit calculated as follows:

Net profit of SDL (in HKD000)	78,000	
Less: amortisation of FV adjustment, after tax	(5,460)	[7,800 x (1 – 30%)]
	72,540	
NCI's share @20%	14,508	

CJE 6

Dr	Translation reserve		6,000	
	Cr	NCI		6,000

(NCI's share of Translation reserve on net assets: 20% of HKD30 million)

Reconciliation of NCI:

		20% NCI
	HKD'000	HKD'000
Net assets	518,400	103,680
FV adjustment		
72,900 – 21,870	51,030	10,206
	569,430	113,886

Alternative calculation for various items in consolidated statement of financial position

	SDL AUD'000	SDL HKD'000	MHL HKD'000	Consolidated HKD'000
Note 1				
Non-current asset	76,000			
FV adjustment	10,000			
Amortisation of FV	(1,000)			
	85,000			
closing rate for B/S	8.1	688,500	1,170,000	1,858,500
Note 2				
Goodwill (1c)	7,450			
closing rate for B/S	8.1	60,345		60,345
Note 3				
Retained earnings				
current year profit	10,000			
additional amortisation	(1,000)			
tax impact (30%)	300			
	9,300			
average rate for P/l	7.8	72,540		
controlling interest		80%		
		58,032	784,500	842,532
Note 4				
Non-controlling interests				
Total adjusted net assets (1c)	77,750			
less: goodwill (only controlling interest)	(7,450)			
	70,300			
NCI portion (20%)	14,060			
closing rate for B/S item	8.1	113,886		113,886
Note 5				
Deferred tax liabilities (DTL)				
on FV adjustment (10,000 x 30%)	3,000			
on amortisation (1,000 x 30%)	(300)			
	2,700			
closing rate for B/S item	8.1			
		21,870		21,870

* * * END OF SECTION A * * *

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

Answer 2(a)

Temporary differences at 30 September 2013 = Carrying amount less tax base

Where tax base of asset = Carrying amount – taxable amount + deductible amount

Patent:

Carrying amount = HKD4.5 million x 1/5 = HKD0.9 million

Tax base = HKD(0.9 – 0.9 + 0) = 0

Temporary difference is HKD0.9 million.

Deferred tax at 30 September 2013:

Patent being a non-tax deductible expenditure and the initial recognition is not part of a business combination and does not affect either accounting profit or taxable profit, therefore no deferred tax liability should be recognised.

Software licence:

Carrying amount = HKD2.4 million x 1/5 = HKD0.48 million

Tax base = HKD(0.48 – 0.48 + 0) = 0

Temporary difference is HKD0.48 million.

Deferred tax at 30 September 2013:

Deferred tax liability: HKD0.48 million x 30% = HKD144,000

Answer 2(b)

Directors have statutory duties laid down in the Companies Ordinance, common law duties of reasonable care and skill, fiduciary duties in equity, and must act honestly and in good faith for the benefit of the company.

Directors must act for a proper purpose.

Directors are responsible for the preparation of financial statements in accordance with the financial reporting framework required by the law or jurisdiction, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

It is improper to state all the cost of acquisition of the patent as a software licence in the financial statements in order to mislead the tax authority for the calculation of the tax deductible expenditure.

The creation of fictitious agreements or invoices for recording assets is improper/ a fraud.

To make any false statement in connection with a claim for any deduction for tax purposes, or to prepare or maintain or authorise the preparation or maintenance of any false books of account or other records, or/and make use of any fraud for tax purposes may constitute an offence under the relevant tax law.

Answer 3(a)

Tower A is reclassified from an investment property under HKAS 40 to an owner-occupied property under HKAS16 upon commencement of occupation for own use at end of March 2013 (or since April 2013).

Tower B is treated as an investment property continuously, but transferred from under construction to completed property upon completion of the construction by end of May 2013(or since June 2013).

Tower C is reclassified from owner-occupied property to investment property upon the end of the owner-occupation from 1 April 2013.

Tower D is derecognised as an asset from 1 May 2013 under the sales and operating lease back arrangement.

Answer 3(b)

Carrying amount at 30 June 2013:

Tower A – Owner-occupied property stated at cost model

Deemed cost at 31 March 2013: fair value of HKD26.4 million

Depreciation for 3 months ended 30 June 2013:
HKD 26.4 million x (0.25 year / 47.25 years) = HKD 0.14 million

Cost less accumulated depreciation:
HKD26.4 million – 0.14 million = HKD26.26 million

Tower B – investment property stated at fair value of HKD19.2 million

Tower C – investment property stated at fair value of HKD40.0 million

Answer 3(c)

Amounts recognised in the income statement for the six months ended 30 June 2013:

Fair value gain on investment properties = HKD2 million
Tower A: HKD26.4 million – 25.8 million = HKD0.6 million
Tower B: HKD19.2 million – (14.2 million + 3.8 million) = HKD1.2 million
Tower C: HKD40.0 million – (38.0 million + 1.8 million) = HKD0.2 million

Depreciation of owner-occupied properties = HKD0.41 million
Tower A: HKD0.14 million
Tower C: HKD30 million x (0.25/50) or (3mths/ 600mths)= HKD0.15 million
Tower D: HKD18 million / 50 x 4/12 or HKD18 million / 600 mths x 4mths = HKD0.12 million

Gain on disposal of owner-occupied property = HKD13.02 million
Tower D: HKD30 million – (17.1 million - 0.12 million) = HKD13.02 million

Operating lease expense of Tower D = HKD0.16 million (HKD0.08 million x 2)

Amount recognised in the other comprehensive income for the six months ended 30 June 2013:

Revaluation gain on reclassification of owner-occupied property to investment property
Tower C: HKD38.0 million – (28.5 million - 0.15 million) = HKD9.65 million

Answer 4(a)

A provision should be recognised when and only when:

- An entity has a present obligation (legal or constructive) as a result of a 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.

Provision for discount coupon

XP had the obligation to give the discount upon issue of the letter and before the expiry date.

As XP is still able to make a profit, after the deduction of HKD500, for the sales of the new printer, there are no outflow of resources nor transfer of economic benefits.

It may be possible for XP to make an estimate of number of new sales with the usage of the discount coupon should there have been a similar scheme in the past.

Conclusion:

A provision should only be recognised when all the conditions under HKAS 37.14 are met. No provision should be recognised at 31 March 2013. Accordingly, the provision for the discount coupon of HKD750,000 should be reversed.

Warranty provision

XP has a contractual obligation to provide the free of charge repair service.

XP needs to incur and has incurred the cost for labour and parts replacement for the repair service, there will be a transfer of economic benefits

It is presumed that XP can make an estimate of the amount to be incurred for the provision of the repair service in respect of the product sales made in the year based on the historical performance.

Conclusion:

A provision should be recognised at 31 March 2013.

The amount recognised should be the best estimate of the expenditure recognised to settle the present obligation at the end of the reporting period.

With the presumption that the ratio of expenditure incurred to the sales of the past five years is a reliable estimate of the amount to be incurred for repair services, XP should adjust downward the provision to an amount ranging from HKD2.80 million (HKD437 million x 0.64%) to HKD4.37 million (HKD437 million x 1%).
OR
Assuming 0.8% of the sales is considered to be the best estimate of the amount to be incurred for the repair service, XP can adjust downward to approximately HKD3.5 million (437 million x 0.8%).

Litigation provision

XP is considered to have an obligation to compensate the plaintiff that arises from a past sales transaction.

The compensation of cash payment represents a transfer of economic benefits for XP.

It is presumed that XP could make an estimate of the compensation amount taking into consideration the offer given by XP and counter-offer from the plaintiff approved by the Board.

The payment made in April is an adjusting event after the reporting period.

Conclusion:
The provision should be adjusted downward to HKD5,650,000, i.e. HKD5 million compensation to plaintiff and HKD650,000 legal fee for provided services.

Answer 4(b)

Disagree with the comment.

No provision should be recognised at 31 March 2013 for the cost of television advertising to be launched after the end of the reporting period because:

- The agreement is executory and XP had no present obligation (or XP had future obligation only) for the future services to be received from the counter-party.

- HKAS 37 does not allow artificial ‘smoothing” of results by early recognition in the profit or loss before the costs are actually incurred.

* * * END OF EXAMINATION PAPER * * *