

SECTION A – CASE QUESTIONS (Total: 75 marks)

Answer 1(a)

Under the residual (or fair value) method, the revenue allocated to the loyalty points is based on the fair value of the loyalty points granted, with the residual consideration being allocated to the sale of the treatments.

Total consideration received = HK\$20 million

Fair value of the loyalty points granted = HK\$0.8 x 2 million = HK\$1.6 million

Residual consideration allocated to the initial sales of body massage, body trimming & shaping and facial beauty services
= HK\$20 million - HK\$1.6 million
= HK\$18.4 million

Revenue arising from loyalty points redeemed during the year:
= 1 million points / 1.6 million points x HK\$1.6 million
= HK\$1 million

Under the residual method, the accounting entries would be as follows:

Upon initial sales,

Dr	Cash	HK\$20 million	
	Cr	Deferred revenue	HK\$1.6 million
	Cr	Revenue	HK\$18.4 million

For the year ended 30 June 2013,

Dr	Cash	HK\$20 million	
	Cr	Deferred revenue	HK\$1.6 million
	Cr	Revenue	HK\$18.4 million

Based on the information as provided, under the residual method, sales revenue recognised from body massage, body trimming & shaping and facial beauty services for the year ended 30 June 2013 would be HK\$19.4 million (i.e. HK\$18.4 million + HK\$1 million).

Answer 1(b)

Under the relative fair value method, revenue is allocated to each component of a transaction on a relative fair value basis.

Total consideration received = HK\$20 million

Fair value of the body massage, body trimming & shaping and facial beauty services provided = HK\$20 million

Fair value of the loyalty points granted = HK\$0.8 x 2 million = HK\$1.6 million

Revenue allocated to the sales of body massage, body trimming & shaping and facial beauty services:

= HK\$20 million / (HK\$20 million + HK\$1.6 million) x 20 million

= HK\$18.52 million

Revenue allocated to the loyalty points granted:

= HK\$1.6 million / (HK\$20 million + HK\$1.6 million) x HK\$20 million

= HK\$1.48 million

Revenue arising from loyalty points redeemed during the year:

= 1 million points / 1.6 million points x HK\$1.48 million

= HK\$0.925 million

Under the relative fair value method, the accounting entries would be as follows:

Upon initial sales,

Dr	Cash	HK\$20 million	
	Cr	Deferred revenue	HK\$1.48 million
	Cr	Revenue	HK\$18.52 million

For the year ended 30 June 2013,

Dr	Deferred revenue	HK\$0.925 million	
	Cr	Revenue	HK\$0.925 million

Based on the information as provided, under the relative fair value method, sales revenue recognised from body massage, body trimming & shaping and facial beauty services for the year ended 30 June 2013 would be HK\$19.445 million (i.e. HK\$18.52 million + HK\$0.925 million).

Answer 2(a)

HK(IFRIC)-Int 4 specifies that an arrangement that meets the following criteria is, or contains, a lease that should be accounted for in accordance with HKAS 17 *Leases*:

- (a) fulfillment of the arrangement is dependent on the use of a specific asset; and
- (b) the arrangement conveys a right to use the underlying asset.

In this case, although ABC Limited's GMP certified production plant is explicitly identified in the arrangement, the outsourcing arrangement entered into between BB HK and ABC Limited does not contain a lease within the scope of HKAS 17.

BB HK has not obtained the right to use the production plant because:

- ABC Limited has the right to contract with any other customers to sell products produced by its GMP certified production plant which works at full capacity at all times. This means that BB HK does not have the ability or right to operate or direct others to operate the production plant or control physical access to the production plant;
- given that the production plant works at full capacity at all times and only 55% of the output from by the production plant is sold to BB HK, this means that 45% (which is more than an insignificant amount) of the output produced by the production plant is sold to other customers of ABC Limited; and
- the price that BB HK pays is fixed per unit of output taken and indicates that the payment is made for the actual use or output of the production plant rather than for the time that the underlying production plant is made available for use.

Answer 2(b)

Under HKFRS 5, a non-current asset or disposal group is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

For this to be the case:

- (a) the asset must be available for immediate sale in its present condition; and
- (b) its sale must be highly probable (i.e. significantly more likely than merely probable).

Based on the information provided in this case, the board of directors of BB HK committed to and agreed a plan to sell the factory and staff quarters on “as is” basis and signed a memorandum of understanding with a third party buyer for the sale. This could be an indicator that the factory and staff quarters are available for immediate sale in their present condition.

For the purpose of BB Group’s consolidated financial statements for the year ended 30 June 2013, the consideration is as follows:

- if the regulatory approval is viewed as a formality which does not prevent the sale from being highly probable, the factory and staff quarters could be classified as held for sale under HKFRS 5; however,
- if the regulatory approval is substantive in nature by which the local government can make a discretion as to the sale, the sale of factory and staff quarters would not be considered highly probable as of the reporting period end (i.e. 30 June 2013) and thus the factory and staff quarters could not be reclassified as held for sale under HKFRS 5.

If the regulatory approval is obtainable after 30 June 2013, but before the authorisation of BB Group's consolidated financial statements for the year ended 30 June 2013 for issue, BB Group should provide the following information for a held for sale classification under HKFRS 5:

- a description of the non-current asset;
- a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
- if applicable, the reportable segment in which the non-current asset is presented in accordance with HKFRS 8, *Operating segments*.

Answer 3(a)

The recall happened on 3 July 2013 and was evidence of conditions that existed at the end of the reporting period (i.e. 30 June 2013) and therefore it was an adjusting event under HKAS 10 because BB HK ordered the raw ingredients of the slimming product before production and did not register *Trim Up Easy* as required under the Hong Kong Pharmacy and Poisons Ordinance before they were sold in the market during the year.

Factors to be considered by BB HK to recognise a provision for the recall:

- BB HK has a present obligation as a result of a past event of selling unregistered pharmaceutical products to customers during the year;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, for example, penalty, expenditures required to handle the recall of the slimming product; and
- a reliable estimate can be made of the amount of the obligation, since production and inventory records should provide a reasonable basis for the estimation.

Answer 3(b)

To mitigate the risks from selling unregistered pharmaceutical products, BB Group may consider the following corporate governance measures for improvements:

- Set up a committee which comprises qualified and registered Western medicine practitioners, Chinese medicine practitioners, pharmacists or other health care professionals to oversee the safety and quality of health care products, to monitor the compliance with legal requirements for the handling pharmaceutical and health care products and to deal with crisis management relating to health care products.
- The ingredients of each health care product should be reviewed by a qualified and registered health care professional to determine whether or not it needs to be registered before sales and to deal with compliance-related matters.

- Segregation of duties: Duties relating to the researching and development of health care products, quality control of health care products and compliance with legal requirements relating to health care products should be divided among different divisions and handled by qualified and registered health care professionals.
- Each health care product should be approved by the board of directors before going on sale in BB shops.

Answer 4(a)

The advantages of acquiring existing facilities include:

- it is a quicker way of implementing a business plan
- intangible assets such as brand recognition, reputation, know-how, may also be acquired.
- if the acquirer wants to enter into an overseas market, acquiring a firm with operations or sales in that market may be a shortcut.
- less strain on financial resources if all or part of the acquisition cost can be settled in considerations shares.

The disadvantages of acquiring existing facilities include:

- the company may be subject to financial risk as there may be hidden liabilities not discovered during the due diligence process
- the company may need to pay a premium over the target's present market value
- possible integration problems due to different corporate cultures or ways of operation.
- the management of the acquiring firm may not have the ability or experience to manage the acquired firm, especially if the acquired firm is in a different line of business or a larger scale of operation.

Answer 4(b)

The possible reasons for the failure of enhancing shareholders' value of the acquiring firm:

- the interest of the management may not be aligned with that of the shareholders of the acquiring firm. For example, the management may recommend the acquisition of an asset simply because it would increase the company's dependence on management.
- as it is a complicated exercise to value the acquired firm, the acquiring firm itself as well as the synergy to be created, the management of the acquiring firm may make an error in valuing the acquired firm.
- the motivation of an acquisition may be mainly due to taking advantage of an irrational market (i.e. overvalued stock prices) in a share exchanged acquisition instead of value creation.

- (iv) the acquiring firm may pay a high price, even at the cost of value destruction, for the acquired firm just to pre-empt its rivals from competing for the acquired firm, especially when the acquiring firm fears that its rivals will gain synergy or leading market position from the acquisition.
- (v) the motivation of an acquisition may be window dressing (i.e. presenting a better financial picture of the acquiring firm in the short run) instead of value creation.
- (vi) the acquiring firm may fail to integrate the acquired business with its own and fail to materialise the synergy as planned.

Answer 4(c)

The company can consider the following options to finance the proposed acquisition:

- (i) issue of consideration shares to the sellers of the target or issue of new shares in the market. This would not impose pressure on cash flow but would result in immediate shareholding dilution and impact on earnings per share ("EPS").
- (ii) medium to long term bank loan as it is financing a long term investment. However, as the BB Group already has a long term bank loan of HK\$50 million, the appropriate gearing level should be taken into account in deciding on the financing option.
- (iii) issue of convertible bonds, so that there will be no immediate impact on shareholding. Should the convertible bond holders choose to exercise the conversion right, no cash flow is required for the repayment.

Answer 4(d)(i)

In deciding which offer to accept, BB Group should consider a number of factors such as:

- (a) maturity of the facilities
The bank loan, which has a maturity of 5 years, appears to be more appropriate to finance the acquisition of XYZ Limited (a long term investment)
- (b) borrowing cost
The bank loan has an interest rate of 6% p.a., which is lower than its current borrowing cost of 8% p.a. and appears to be acceptable.

The convertible bond carries a coupon rate of 2% p.a. It appears to be more favourable than that of the bank loan. However, one should also consider the value or cost of the conversion right to the issuer under the convertible bond.

- (c) dilution in shareholding and EPS
A bank loan would not have any dilution effect on shareholding and EPS, while a convertible bond will have dilution effect on shareholding and EPS upon conversion.

- (d) restrictive covenants in existing loan agreement

Under the convertible bond offer, the number of conversion shares is 4,000,000

$$\text{shares} \left(\frac{\$20,000,000}{\$5} \right)$$

The shareholding of Mrs. Lee would be diluted to 40.4%

$$\left(\frac{42,000,000}{100,000,000 + 4,000,000} \right)$$

As the shareholding of Mrs. Lee would drop below 41% upon full conversion of the convertible bond, the convertible bond offer may not be acceptable to BB Group.

- (e) The expected gearing level of BB Group as a result of the two options of financing.
- (f) The liquidity position of BB Group, i.e. whether it is able to service the interest payment and repayment of the principal of the facilities.

Answer 4(d)(ii)

Takeovers Code

Public companies in Hong Kong and companies with a primary listing in Hong Kong are required to comply with the Takeovers Code. In general, it is the nature of the offeree company (or the target company) that determines whether the Takeovers Code applies. As XYZ Limited is a public company in Hong Kong (it has more than 50 shareholders), the proposed acquisition will be subject to the Takeovers Code.

Answer 5

Identification of the relevant systems and processes

The data sources for booking and sales information come from either the online booking system or the manned customer service hotlines. The booking system is also integrated with the service database where records of sales of prepaid packages and the remaining balances are stored. The finance team extracts relevant information from these systems and generates journals to record sales in the accounting system.

Information technology general controls (ITGC)

As the online booking system and the service database are a computerised environment, it is expected that there are sufficient information technology general controls (ITGC) to ensure their effective and efficient day-to-day operation of these computer facilities.

Program development – There should be a minimum standard for system design, programming and documentation. Sufficient segregation of duties is also expected between those responsible for design and those responsible for testing.

Program change – There should be sufficient restriction on who is able to make changes to the program itself. Maintenance of program logs can also keep track of what changes are being made and allow for regular independent reviews on the appropriateness of the changes.

Computer operations – A listing of users with access rights to the systems is generated, reviewed and approved quarterly with records being documented and retained. Back-ups are prepared on a regular basis. One of the key elements here includes also the proper segregation of duties for potentially conflicting roles.

Access to program and data – All administrators have unique access IDs and passwords. New access rights or changes to existing access must be reviewed by appropriate management with approval being documented and retained. Furthermore, this system shall be set behind firewalls to prevent unauthorised access. There shall also be proper physical security of the system server.

Information technology application control

At each month end, revenue from each customer will be calculated automatically based on the service record in the service database. At each month end, revenue will also be calculated automatically on expiry of the prepaid package.

Whenever the prepaid balances become zero, appointments can only be made with approval from supervisors. The system will only process the update by the beauty consultants for the completion of service when the service is paid for or when the prepaid package balance is deducted.

All entries once inputted into the system are not able to be deleted; a rectification of error can only be made by a separate contra entry.

Other controls

An exception report will be generated for any booking requests that eventually did not turn into a record of completion of services on a daily basis. Shop managers are required to review these individually and make updates to the system manually.

The accounting officer is responsible for the extraction of information from the system to prepare the daily sales journal; the accounting supervisor is responsible for checking this journal for proper extraction before it is posted to the accounting system.

Answer 6

(i) Inventory

The valuation and rights and ownership assertions are the assertions with a higher risk for inventory following the recall.

The risk of material misstatement is considered to be high in this case because of the following.

BB HK has not registered *Trim Up Easy* in Hong Kong, its inventory is no longer saleable in Hong Kong. BB HK might need to incur more costs and sell at lower prices in other markets which might trigger provision for inventory.

There is also a risk that the Department of Health might detain or confiscate BB HK's *Trim Up Easy* in Hong Kong.

As part of the audit procedures, we shall conduct an inquiry with management and review correspondence between BB HK and the Department of Health ("DH") to determine if there is any inventory being detained by DH.

We shall also discuss with BB HK's legal counsel to confirm if the rights and ownership to the inventory will be affected given the fact that BB HK has breached Hong Kong Law.

We shall discuss with BB HK's legal counsel to see if BB HK will be able to retroactively register its existing products and the related costs involved.

We shall also check with management if it is feasible to transfer the product to other markets for sale and the prevailing prices in these markets.

We shall also compare the price and quantity sold subsequent to the reporting period end against the carrying value and quantity at the reporting period end.

Any other appropriate audit procedures (e.g. the auditor may request management to make an assessment as to the implications for other products following the recall of a particular product)

(ii) Provision for recall (including claims and contingent liabilities)

The completeness, accuracy and disclosure assertions are the assertions having a higher risk for provision for recall (including claims and contingent liabilities) following the recall.

The risk of material misstatement is considered to be high in this case because of the following.

BB HK received a lot of inquiries and claims from customers. We shall request that BB HK prepares a complete list of these claims and inquiries, and arrange BB HK's legal counsel to assess the exposure from each of these as well as to assess exposure for those customers who have not lodged a claim yet.

We shall also review the full list of all the costs involved for the recall estimated by BB HK and request management to assess whether any of these costs represent present obligation of past events and whether a provision is required.

We shall also review the list of contingent liabilities prepared by BB HK and cross-match the details of the list against the full customer listing for completeness, and assess if BB HK has provided an estimate of the possible outcome with further assistance and information from BB HK's legal counsel.

We shall also review the list of actual claims subsequent to the reporting period and against estimates made by management in closing their books.

* * * END OF SECTION A * * *

SECTION B – ESSAY QUESTIONS (Total: 25 marks)

Answer 7(a)

The legal requirements of stamping include:

- any lease/agreement for lease of immovable property is chargeable to stamp duty under Head 1(2) of SDO, to be stamped within 30 days after its execution.
- the SD payable is 0.5% of yearly rent (HK\$50,000x12x0.5%= HK\$3,000)
- since the delay is more than 2 months, there will be a penalty of up to 10 times the duty payable (up to HK\$3,000 x10).
- failure of stamping will render the lease agreement not admissible as evidence in civil proceedings except in the recovery of the stamp duty by the Collector. Public officers and bodies corporate are prohibited from filing, registering, or in any way acting upon an instrument which has not been duly stamped.

Answer 7(b)

The general treatment of tax loss:

- governed by s.19C of IRO;
- tax loss can only be carried forwards but not backwards;
- tax loss carried forward can be used to set-off future assessable profits indefinitely (there is no time limit to utilize it); and
- no group relief of tax loss is allowed.

Answer 7(c)

Considerations for deductibility of BB-R&D's various expenses:

- As BB R&D did not derive any assessable profits for the year of assessment 2011/12, it is likely that the IRD can challenge the deduction claim.
- The Statement of Loss issued by IRD may mark "no trading, no tax loss to be agreed". Also, the Statement of Loss is not final and conclusive and is subject to review and revision by the IRD.
- It is especially difficult for the claiming of substantial Directors' entertainment expenses and motor vehicle expenses and it is difficult to justify the deductibility of such expenses where the company is inactive in 2011/12.

- However, BB R&D can argue that (some of) the amounts incurred are for the survival of the BB R&D and are incurred for the production of future assessable profits and hence should be deductible – s.16(1) of IRO refers.
- As it is highly likely that the directors' entertainment expenses and motor vehicle expenses will be disallowed, assuming there will not be further adjustment by the IRD, the revised tax loss available will be HK\$5,122,000 which can be utilized to set-off future assessable profits of BB R&D.

Answer 7(d)

Considerations for challenge by IRD against tax loss utilisation:

- The transfer of loss company for tax avoidance is prevented under s.61B.
- The CIR is authorized to disallow the setting off of a tax loss if he is satisfied that the sole and dominant purpose of the change was to use a tax loss and to obtain a tax benefit from another taxpayer.
- Super Textile was not engaged in R&D before and it is apparent that the acquisition is solely for the tax loss accrued in Super Textile and as such s.61B is likely to be triggered, unless BB-R&D can prove that the sole and dominant purpose was not for avoidance of payment/defer of payment of tax. The facts in this case are not strong to support such a tax loss utilisation.

Answer 8(a)

Tax treatment of the relevant research and development expenses is as follows:

- salary of the researchers – deductible under s.16(1).
- rental expenses and relevant stamp duty & penalty paid of BB R&D rental and SD are deductible under s.16(1), but not the penalty.
- donation to Hong Kong community chest of HK\$500,000 – deductible up to 35% of assessable profits of BB R&D under Sec 16D.
- capital expenditures in acquiring the plant and machinery for research and development purposes – deductible in full in the year of assessment in the basis period for which it is incurred under s.16B(6).

Answer 8(b)

At the commencement of BB Group's employment of the researchers, Employer's Returns (IR56E) have to be filed within 3 months after commencement of employment under s.52(4). If they are still under employment as at 31 March, Employer's Returns (IR 56B) have to be filed within one month after 31 March to report the annual remunerations under s.52(2).

For researchers who are self-employed, the filing of Returns IR56E and IR56B is not required. However, if their commission, fees and other remunerations received are over HK25,000 per annum, Return IR56M should be filed to the IRD together with form IR6036B which is the cover letter for IR56M.

* * * END OF EXAMINATION PAPER * * *