Hong Kong Institute of Certified Public Accountants
香港會計師公會

Hong Kong's CPA Qualification
香港會計師專業資格

Qualification Programme

Module 6
Financial Accounting

Pilot Examination Paper

Time Allowed	3 hours	
Examination Assessment Allocation		
Section A – Multiple Choice Questions	20 Marks	All FIFTEEN questions are compulsory
Section B – Written Questions	80 Marks	All FIVE questions are compulsory

Do not open this question paper until instructed by the supervisor.

<u>You should answer Section A – Multiple Choice Questions on the first page of the Script Booklet and answer Section B – Written Questions on the rest of the pages.</u>

This question paper must not be removed from the examination centre.

Published in October 2019

<u>Module 6 – Financial Accounting</u>

This examination is divided into TWO sections.

- Section A (20%). This consists of <u>FIFTEEN compulsory multiple choice questions</u>. You should allocate approximately 36 minutes in total for Section A.

- Section B (80%). This consists of <u>FIVE compulsory written questions</u>. You should allocate approximately 2 hours and 24 minutes in total for Section B.

Suggested time allocation (by marks):

Marks	Approximate time in minutes
1	2
2	3
3	5
4	7
5	9
6	11
7	12
8	14
9	16
10	18
11	20
12	21
13	23
14	25
15	27
16	29
17	30
18	32
19	34
20	36

SECTION A – MULTIPLE CHOICE QUESTIONS (Total: 20 marks)

Answer **ALL** questions in this section. Choose the best answer for each question. Together they are worth 20% of the total marks for this examination.

Questions 1 to 10 carry 1 mark each. (10 marks – approximately 18 minutes)

1. In 2014, Bill Limited ("BIL") purchased freehold land for HK$300,000 that was revalued in 2015 at HK$360,000 with the revaluation surplus of HK$60,000 credited to revaluation reserves. In 2016, BIL revalued the freehold land again at HK$330,000.

According to HKAS 16 Property, Plant and Equipment, determine the amount to be recognised in 2017 if BIL revalued the freehold land down from HK$330,000 to HK$260,000 in 2017.

A Profit or loss (debit): HK$70,000.

B Profit or loss (debit): HK$40,000.

C Profit or loss (debit): HK$30,000.

D Profit or loss (debit): Nil.

2. Diva Limited is being sued for damages. When preparing its 2013 financial statements, the lawyers took the view that the likelihood of any payments having to be made to the claimant was remote.

In preparing the 2014 financial statements, their view was that it was possible that such payments would have to be made. In preparing the 2015 financial statements, their view was that such payments were probable.

For the 2016 financial statements, their view was that it was virtual certainty that the payments would have to be made. Such payments were made during the 2017 accounting period.

In accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, determine that the provision for the payments shall first be recognised in the

A 2013 financial statements.

B 2014 financial statements.

C 2015 financial statements.

D 2016 financial statements.

3. Friend Limited ("FRL") was finalising the draft financial statements for the year ended 31 March 2017 and expected to be issued on 31 May 2017.

On 20 April 2017, a customer who owed FRL HK$51,600 for the past six months went into liquidation. No provision had been made against this debt.

On 17 May 2017, a manufacturing plant was destroyed by fire resulting in a financial loss of HK$264,000.

On 24 May 2017, a dividend of HK$270,000 was declared and a contractual obligation to a pre-determined employee profit sharing payment of HK$30,000 as at 31 March 2017 was settled, both based on the profits for the year ended 31 March 2017.

According to HKAS 10 *Events after the Reporting Period*, calculate the amount of expense to be recognised in FRL's statement of profit or loss and other comprehensive income for the year ended 31 March 2017 to reflect adjusting events after the reporting period.

A HK$270,000.

B HK$300,000.

C HK$81,600.

D HK$294,000.

4. Identify which of the following examples would NOT give rise to a temporary difference under HKAS 12 *Income Taxes*.

A Development costs of HK$500 is capitalised and amortised to the statement of profit or loss over three years but is deducted in determining taxable profit in the period in which it is paid.

B Inventories with a carrying amount of HK$500 and is expected to be recovered when it is sold. The cost of the inventory is deductible for tax purpose at the point of sale.

C Accumulated depreciation of an asset in the financial statements is HK$500 less than the cumulative tax depreciation allowance as of year end.

D Current liabilities include interest income received in advance with a carrying amount of HK$500. The related interest income will be taxable for tax purposes only when it is received.

5. Identify which of the following is one of the underlying assumptions for the preparation of financial statements as stated in the HKICPA *Conceptual Framework for Financial Reporting 2010*.

A Relevance.

B Financial capital maintenance.

C Going concern.

D Faithful representation.

6. Under HKAS 24 *Related Party Disclosures*, identify which of the following are the related parties of Jovy Limited ("JOL").

(1) David Lee, a non-executive director of JOL.

(2) Edward Chan, an executive director of Rich Limited which controls JOL.

(3) Victory Limited, which owns 8% of JOL's equity.

(4) Star Limited is a significant customer of JOL, buying 35% of its annual output.

A (1) and (2).

B (1), (2) and (4).

C (3) and (4).

D All of the above.

7. During the year ended 31 December 2017, the following events occurred at Felix Limited ("FEL"):

1) It was decided to write off HK$120,000 from inventory which was obsolete in 2017.
2) Sales of HK$90,000 had been omitted from the financial statements for the year ended 31 December 2016.
3) It changed the estimated useful life of a building to calculate the depreciation based on the straight-line method from 20 years to 25 years remaining as at 1 January 2017. The net effect of the change amounted to a HK$30,000 reduction in depreciation.

According to HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, calculate the net amount in profit or loss to be accounted for as a prior period error in FEL's financial statements for the year ended 31 December 2017.

A HK$90,000 increase.

B HK$120,000 decrease.

C HK$210,000 decrease.

D HK$60,000 decrease.

8. During the year ended 31 December 2017, Layman Limited ("LML") purchased the following new items for resale:

Purchase date	Number of items	Cost price per item
March 2017	30	HK$16.5
June 2017	30	HK$19.5

30 items were left unsold on 31 December 2017. At that date, LML could resell each at HK$18.0. LML determines cost of inventory under the first-in, first-out method.

According to HKAS 2 *Inventories*, calculate the amount of cost of inventory in the statement of financial position as at 31 December 2017

A HK$450.

B HK$495.

C HK$540.

D HK$585.

9. Majesty Limited is a British company with a presentation currency of pound sterling(£) and its subsidiary, Deutsche Limited ("DEL") is based in Germany. DEL has a significant degree of autonomy from Majesty Limited. The operation of DEL is reselling goods manufactured in Australia to customers in Australia. All operations, trading and finance sourcing are located in Australia and all the transactions are denominated in Australian dollars($). DEL presents its financial statements in Euros(€).

Identify the functional currency of DEL in accordance with HKAS 21 *The Effects of Changes in Foreign Exchange Rates*.

A Euro(€).

B Australian dollar($).

C Pound sterling(£).

D None of the above.

10. On 1 January 2017, Nate Limited drew a loan of HK$30 million in order to finance the renovation of a building. The renovation work started on the same date. The loan carried interest at 10% per annum.

The renovation work of the building was substantially completed on 31 October 2017. The loan was repaid on 31 December 2017 and investment income of HK$285,000 was earned during the period from 1 January 2017 to 31 October 2017 on those parts of the loan not yet used for the renovation.

Calculate the total amount of borrowing costs to be capitalised in the cost of the building according to HKAS 23 *Borrowing Costs*.

A HK$2,715,000.

B HK$2,500,000.

C HK$2,215,000.

D HK$3,000,000.

Questions 11 to 15 carry 2 marks each. (10 marks – approximately 18 minutes)

11. Cool Engineering Limited ("CEL") has two cash generating units, A and B. The carrying amounts of the two units are as follows:

Unit	A	B
Plant	HK$500,000	HK$400,000
Machinery	HK$300,000	HK$220,000
Total	HK$800,000	HK$620,000

CEL also has a corporate asset, namely: its headquarters building with a carrying amount of HK$160,000. The headquarters building has always been used equally by both units and therefore can be allocated to each unit on a 50:50 basis. It does not generate independent cash flows for CEL.

The recoverable amounts of the two cash-generating units are:

Unit A	HK$900,000
Unit B	HK$665,000

According to HKAS 36 *Impairment of Assets*, calculate the total impairment loss of the two cash-generating units of CEL.

A HK$35,000.

B HK$15,000.

C HK$55,000.

D HK$0.

12. The Small and Medium-sized Entity Financial Reporting Framework ("SME-FRF") sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standards ("SME-FRS").

Determine that which of the following companies qualifies for reporting under the SME-FRF.

A A private company incorporated under the Hong Kong Companies Ordinance that is a subsidiary of a listed group.

B A company carries on any banking business and holds a valid banking license granted under the Banking Ordinance (Cap.155).

C A private company incorporated under the Hong Kong Companies Ordinance that has annual revenue of HK$90 million and total assets of HK$80 million at the reporting date.

D A company that carries on an insurance business, other than solely acting as an insurance agent.

13. On 1 April 2017, Sonic Limited ("SOL") issued HK$10 million zero-coupon bonds at HK$9,038,400. Issue costs payable to professional advisers were HK$400,000 on 31 March 2017. The bonds are to be redeemed at par on 31 March 2020. The effective interest rate for similar bonds with equivalent risk is 5% per annum.

Calculate the balance of the bonds to be recognised in the statement of financial position of SOL as at 31 March 2019 in accordance with HKFRS 9 *Financial Instruments* assuming that the bonds are measured at amortised cost.

A HK$9,070,320.

B HK$9,523,836.

C HK$9,910,320.

D HK$0.

14. Key Limited ("KEL") sells a home sound system to a customer for a total contract price of HK$62,000 with a warranty guarantee. This warranty lasts for a one-year period with an estimated cost of HK$2,100 to repair defects so as to guarantee the quality of the system at the point of sale with no significant financing component. In addition, the price of the system includes an extended warranty for two years beyond the one-year period with additional services provided and a free installation service to set up the system. Such an installation service can be obtained by a competitor of KEL and does not significantly modify the system. Without such an installation service provided by KEL, the customer can still install the system by following a step-by-step installation guide stated in the instruction manual.

The stand-alone sales value of the system, two-year extended warranty and installation service are HK$60,000, HK$4,000 and HK$2,000 respectively at the contract inception.

Determine the transaction price allocated to each performance obligation at the contract inception, in accordance with HKFRS 15 *Revenue from Contracts with Customers*.

A Sale of system with all warranties and installation service revenue: HK$62,000.

B Sale of system with all warranties: HK$56,364;
Installation service revenue: HK$5,636.

C Sale of system with assurance warranty: HK$56,364;
Service warranty revenue: HK$3,758;
Installation service revenue: HK$1,878.

D Sale of system: HK$60,000;
Service warranty revenue: HK$4,000;
Installation service revenue: HK$2,000.

15. The HKFRS for Private Entities is a self-contained standard incorporating accounting principles that are based on full HKFRS, but which have been simplified to suit the private entities within its scope.

Identify the simplification that is allowed in HKFRS for Private Entities.

A All financial assets are measured at cost.

B All intangible assets are considered to have a finite useful life.

C All borrowing costs are immediately capitalised.

D Inventories are measured at cost.

* * * END OF SECTION A * * *

SECTION B – WRITTEN QUESTIONS (Total: 80 marks)

Answer **ALL** questions in this section. Marks are indicated at the end of each question. Together they are worth 80% of the total marks for this examination.

Question 1 (20 marks – approximately 36 minutes)

On 1 June 2015, Smart Systems Limited ("SSL") acquired 360,000 ordinary share capital of Wise Technology Limited ("WTL"), when the retained earnings and revaluation reserve of WTL were HK$162,000 and HK$225,000 respectively. SSL has the ability to affect the returns of WTL through its power over WTL. On 1 June 2016, SSL acquired 120,000 ordinary shares of Clever Engineering Limited ("CEL"). SSL has demonstrated significant influence through its power to participate in the financial and operating policy decisions of CEL but has neither control nor joint control over CEL.

The draft summarised statements of financial position of the three companies as at 31 May 2017 are shown below:

	SSL	WTL	CEL
	HK$	HK$	HK$
ASSETS			
Non-current assets			
Property, plant and equipment	2,471,550	883,950	566,250
Investments	975,000	-	-
Current assets			
Inventories	1,156,350	268,350	369,600
Trade and other receivables	439,500	131,700	148,950
Cash and cash equivalents	35,700	2,550	1,200
Total assets	5,078,100	1,286,550	1,086,000
EQUITY AND LIABILITIES			
Equity			
Ordinary share capital @HK$1	(1,500,000)	(450,000)	(300,000)
Revaluation reserves	(600,000)	(225,000)	-
Retained earnings	(2,161,800)	(337,350)	(548,400)
	(4,261,800)	(1,012,350)	(848,400)
Current liabilities			
Trade and other payables	(472,800)	(167,700)	(146,100)
Current tax liability	(343,500)	(106,500)	(91,500)
Total equity and liabilities	(5,078,100)	(1,286,550)	(1,086,000)

Additional information:

(i) The consideration to purchase 360,000 (out of 450,000) shares in WTL was HK$600,000 in cash, paid on 1 June 2015. The fair value of the assets and liabilities of WTL at the date of acquisition by SSL were equal to their carrying amounts. SSL measures the non-controlling interests in WTL at fair value of HK$414,000 at the acquisition date.

(ii) The consideration to purchase 120,000 (out of 300,000) shares in CEL was HK$375,000 in cash, paid on 1 June 2016. The fair values of the assets and liabilities of CEL at the date of acquisition by SSL were equal to their carrying amounts, with the exception of a machine that had a fair value HK$55,000 in excess of its carrying amount. The machine had a remaining useful life of five years on 1 June 2016. No fair value adjustment has yet been made in the books of CEL.

(iii) On 30 April 2016, SSL purchased goods at a price of HK$90,000 from WTL. All sales made by WTL are priced on a cost plus a mark-up of 20% basis. SSL sold out all these goods to its customers within the year ended 31 May 2017.

(iv) As at 31 May 2017, SSL's other receivables included HK$38,400 due from WTL. WTL's other payables included only HK$28,050 due to SSL. The difference was due to cash in transit.

(v) An impairment loss in respect of goodwill arising on the acquisition of WTL of HK$30,000 was identified as at 31 May 2017 and needs to be recognised in proportion to the respective percentage of equity interests of SSL and non-controlling interests.

(vi) There have been no shares issued by WTL and CEL since SSL acquired the shares in these companies.

(vii) Extract from the statements of changes in equity of SSL, WTL and CEL for the year ended 31 May 2017:

	SSL	WTL	CEL
	HK$	HK$	HK$
As at 1 June 2016	(2,250,000)	(231,000)	(248,400)
Dividend paid	838,200	30,000	-
Total comprehensive income	(750,000)	(136,350)	(300,000)
As at 31 May 2017	(2,161,800)	(337,350)	(548,400)

Note: Parentheses indicate a credit balance.

Required:

(a) **Prepare the consolidated statement of financial position of SSL group as at 31 May 2017 in accordance with HKFRS 10 *Consolidated Financial Statements* and HKAS 28 *Investment in Associates and Joint Ventures*. Ignore the effect of deferred taxation.**

Note: Consolidation adjustments are to be shown in the form of a worksheet. For this question, you may wish to use the templates printed on the green paper provided to prepare your answers or continue your answer in the script booklet. You have to show the supporting calculation for each figure in the worksheet, but journal entries are not required.

(15 marks)

(b) If WTL issued an option to its non-controlling shareholders other than SSL on 1 June 2015, who hold 90,000 ordinary shares of WTL, to buy all 450,000 new ordinary shares issued by WTL at an exercise option price of HK$5 per share. The exercise price of the option is considered to be lower than the expected market price of the shares of WTL. The option can be exercisable for two years from 1 June 2015. You may assume that, in the absence of other factors, an investor with more than 50% of the voting rights will have the current ability to direct the relevant activities of the investee.

Required:

Comment on the impact of control and analyse the change in classification of investment in WTL on the consolidated financial statements of SSL group as at 31 May 2016 if WTL issued the above option to its non-controlling shareholder other than SSL on 1 June 2015.

(5 marks)

Question 2 **(20 marks – approximately 36 minutes)**

On 1 July 2017, Pilot Technology Limited ("PTL") went to the local car yard, Green Automobiles Limited ("GAL"), and discussed the price of a new environmental-friendly vehicle, as known as Green Vehicle, which PTL wishes to acquire as a company car. PTL and GAL agreed at a price at fair value of HK$570,000. Since PTL was short of cash to finance the acquisition, GAL decided to package the sale of Green Vehicle to PTL in the form of a lease arrangement.

GAL wrote a lease agreement, incurring initial direct costs of HK$6,499 in the process. The lease agreement contained the following clauses:

Initial payment on 1 July 2017	HK$200,000
Payments on 1 July 2018 and 1 July 2019	HK$200,000

The lease agreement included the following terms:

- The lease was cancellable by PTL at any stage. If PTL cancels the lease, GAL's losses associated with the cancellation are borne by PTL;
- PTL was required to guarantee the payment of residual value of HK$15,000. At the end of the lease term, 30 June 2020, or if cancelled earlier, Green Vehicle would automatically revert to the lessor.

Green Vehicle had an expected economic life of four years. GAL expected the fair value of Green Vehicle as at 30 June 2020 to be HK$25,000.

At commencement date, PTL expected that Green Vehicle would have a value of HK$4,714 at the end of the lease. The implicit interest rate of the lease determined by GAL is 8%. PTL did not know the implicit interest rate of the lease and adopted the incremental borrowing rate of 7% per annum.

Required:

With reference to HKFRS 16 *Leases*,

(a) explain the lease classification of the lease from the perspective of GAL as the lessor.
(6 marks)

(b) (i) prepare journal entries of PTL as the lessee in relation to the lease for the year ended 30 June 2018.
(9 marks)

(ii) prepare an extract of the statement of financial position and the statement of profit or loss and other comprehensive income of PTL for the year ended 30 June 2018 in respect of the lease.
(5 marks)

Question 3 **(20 marks – approximately 36 minutes)**

Big Surplus Property Development Limited ("BSP") is engaged in property development and investment. It adopts the following accounting policies for owner-occupied property and investment property.

BSP adopts the fair value model for its investment properties and the revaluation model for owner-occupied properties. When an item of depreciable owner-occupied property is revalued, accumulated depreciation at the date of revaluation is eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. Depreciation is calculated on a monthly basis using the straight-line method. There is no residual value for all owner-occupied properties. The entire revaluation reserve balance of each property to retained earnings upon derecognition of that property.

During the year ended 31 December 2017, BSP had the following transactions of properties:

(i) BSP held a property in Quarry Bay (Property QB) with a view to resale originally but then leased it out to a tenant under an operating lease from 1 July 2017. Property QB was acquired on 1 January 2017 at a cost of HK$19,200,000 by cash at bank. The expected useful life of Property QB is assumed to be 40 years after the initial recognition.

(ii) The head office building of BSP in Central District (Property CD) was vacated on 1 October 2017 and would be leased out to earn rental income. Property CD originally cost HK$9,000,000 on 1 January 2014 and it was revalued at HK$11,750,000 on 31 December 2016. The expected useful life of Property CD is assumed to be 50 years after initial recognition.

(iii) BSP moved its head office from Property CD to a property in Kwun Tong (Property KT) upon the expiry of the operating lease with the existing tenant of Property KT on 1 October 2017. Property KT was acquired on 1 January 2015 at a cost of HK$31,000,000 and its fair value as at 31 December 2016 was HK$29,000,000. The expected useful life of Property KT is assumed to be 50 years after initial recognition.

Below are the fair values of each of the respective properties as at 1 July 2017, 1 October 2017 and 31 December 2017 respectively.

	1 July 2017	1 October 2017	31 December 2017
Property QB	HK$25,000,000		HK$24,000,000
Property CD		HK$14,000,000	HK$18,000,000
Property KT		HK$29,840,000	HK$22,540,000

Required:

(a) **Explain the classification under each of the above events in respect of Properties QB, CD and KT in the preparation of the financial statements of BSP for the year ended 31 December 2017. You are not required to provide any calculation to support your answer.**

(6 marks)

(b) **Prepare the journal entries for transactions related to Properties QB and CD in the preparation of the financial statements of BSP for the year ended 31 December 2017.**

(9 marks)

(c) **Prepare an extract of the statement of financial position and statement of profit or loss and other comprehensive income of BSP for the year ended 31 December 2017 in respect of the Property KT.**

(5 marks)

Question 4 (15 marks – approximately 27 minutes)

Bright Electronic Limited ("BEL") is a company incorporated and listed in Hong Kong and is principally engaged in the manufacturing of electronic products. The draft financial statements for the year ended 30 September 2017 are shown as follows:

Draft statement of profit or loss and other comprehensive income of BEL for the year ended 30 September 2017 (extract):

	Notes	HK$
Operating profit	(i)	875,760
Interest expense	(ii)	(145,200)
Interest income	(ii)	29,400
Profit before tax		759,960
Tax expense		(306,000)
Profit for the year		453,960
Other comprehensive income:		
Revaluation surplus on property, plant and equipment	(iii)	159,600
Total comprehensive income for the year		613,560

Draft statement of financial position of BEL as at 30 September 2017:

	Notes	2017 HK$	2016 HK$
ASSETS			
Non-current assets			
Property, plant and equipment	(iii)	4,279,800	3,959,280
Current assets			
Inventories		2,016,264	1,426,080
Trade receivable		643,320	660,840
Interest receivable		9,000	7,200
Cash and cash equivalents		206,136	4,140
Total assets		7,154,520	6,057,540
EQUITY AND LIABILITIES			
Equity			
Share capital		2,292,000	1,848,000
Revaluation reserves	(iii)	614,400	522,000
Retained earnings		2,013,000	1,731,840
Total equity		4,919,400	4,101,840
Non-current liabilities			
Bank loans		720,000	600,000
Current liabilities			
Trade payable		514,920	502,740
Interest payable		18,000	14,400
Bank loans		652,200	543,360
Tax payable		330,000	295,200
Total equity and liabilities		7,154,520	6,057,540

Draft statement of changes in equity of BEL for the year ended 30 September 2017:

	Notes	Share capital HK$	Revaluation reserves HK$	Retained earnings HK$	Total HK$
Balance as at 1 October 2016		1,848,000	522,000	1,731,840	4,101,840
Total comprehensive income for the year		-	159,600	453,960	613,560
Final dividend paid	(iv)	-	-	(240,000)	(240,000)
New issue of shares		444,000	-	-	444,000
Transfer from revaluation reserves to retained earnings	(iii)	-	(67,200)	67,200	-
Balance as at 30 September 2017		2,292,000	614,400	2,013,000	4,919,400

Additional Information:

(i) Operating profit for the year has been arrived at after charging depreciation of HK$798,720 and crediting a gain on disposal of property, plant and equipment of HK$30,720.

(ii) Interest income is classified as a cash flow from investing activities and interest expense is classified as a cash flow from operating activities.

(iii) An analysis of the movement of the property, plant and equipment during the year showed that the property, plant and equipment with a carrying amount of HK$692,040 was sold. BEL adopts the revaluation model for all of its property, plant and equipment and opts for a transfer between the revaluation reserves and retained earnings on an annual basis.

(iv) During the year ended 30 September 2017, BEL paid a final ordinary dividend of HK$240,000.

(v) No significant cash transaction is noted.

Required:

Prepare the statement of cash flows, using the indirect method, for BEL for the year ended 30 September 2017, beginning with profit before tax in accordance with HKAS 7 *Statement of Cash Flows*.

(15 marks)

Question 5 **(5 marks – approximately 9 minutes)**

On 1 December 2017, Excel Investments Limited ("EIL") acquired 200,000 ordinary shares of Big Date Limited ("BDL") at a cost of HK$8 million.

EIL intended not to hold these shares for trading purpose and has no intention to make an irrevocable election at initial recognition to measure them at fair value through other comprehensive income. At the date of purchase, BDL had 20 million ordinary shares in issue.

Required:

With reference to HKFRS 9 *Financial Instruments*, explain the accounting classification of the above financial instrument to be recognised in EIL on 1 December 2017.

(5 marks)

* * * END OF EXAMINATION PAPER * * *

Instructions:

1. You may wish to answer Question 1(a) by using this template as a supplement and continuing your answer in the script booklet.
2. This template, whether used or unused, must be inserted into the Question 1(a) answer pages in the script booklet and submitted to the Centre Supervisor at the end of the examination.
3. Please DO NOT USE "Pencil" on this template.

Candidate No.	
Centre No./Section No.	
Desk No.	

Question 1(a)

Workings for consolidated statement of financial position as at 31 May 2017:

			Consolidation adjustments										Consolidated Total
	SSL	WTL											
	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$	HK$
	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)	Dr / (Cr)
ASSETS													
Non-current assets													
Property, plant, and equipment	2,471,550	883,950											
Investment (in associate)	975,000	-											
	3,446,550	883,950											
Current assets													
Inventories	1,156,350	268,350											
Trade and other receivables	439,500	131,700											
Cash and cash equivalents	35,700	2,550											
Total assets	5,078,100	1,286,550											
EQUITY AND LIABILITIES													
Equity													
Ordinary share capital	(1,500,000)	(450,000)											
Revaluation reserves	(600,000)	(225,000)											
Retained earnings	(2,161,800)	(337,350)											
	(4,261,800)	(1,012,350)											
Current liabilities													
Trade and other payables	(472,800)	(167,700)											
Current tax liability	(343,500)	(106,500)											
Total equity and liabilities	(5,078,100)	(1,286,550)											

Module 6
Financial Accounting

Answers

The suggested answers are longer than what candidates are expected to give in the examination. The purpose of the suggested answers is meant to help candidates in their revision and learning. The suggested answers may not contain all the correct points and candidates should note that credit will be awarded for valid answers which may not fully covered in the suggested answers.

SECTION A – MULTIPLE CHOICE QUESTIONS (Total: 20 marks)

Questions	Answers	Marks allocation
1.	B	1
2.	C	1
3.	C	1
4.	B	1
5.	C	1
6.	A	1
7.	A	1
8.	C	1
9.	B	1
10.	C	1
11.	A	2
12.	C	2
13.	B	2
14.	C	2
15.	B	2

* * * END OF SECTION A * * *

SECTION B – WRITTEN QUESTIONS **(Total: 80 marks)**

Answer 1(a)

SSL Consolidated Statement of Financial Position as at 31 May 2017

	SSL HK$	WTL HK$		CJE HK$(Dr)	CJE HK$(Cr)		Group HK$
ASSETS							
Non-current assets							
Goodwill	-	-	*1*	177,000	30,000	*4*	147,000
Property, plant and equipment	2,471,550	883,950					3,355,500
Investment (in associate)	975,000	-	*8*	120,000	600,000	*1*	490,600
					4,400	*9*	
Current assets							
Inventories	1,156,350	268,350					1,424,700
Trade and other receivables	439,500	131,700			38,400	*7*	532,800
Cash and cash equivalents	35,700	2,550	*7*	10,350			48,600
Total assets	5,078,100	1,286,550					5,999,200
EQUITY AND LIABILITIES							
Equity							
Ordinary share capital	(1,500,000)	(450,000)	*1*	450,000			(1,500,000)
Revaluation reserves	(600,000)	(225,000)	*1*	225,000			(600,000)
Retained earnings	(2,161,800)	(337,350)	*1*	162,000	15,000	*3*	(2,393,680)
			2	13,800	30,000	*6*	
			3	12,000	120,000	*8*	
			4	30,000			
			5	24,270			
			6	24,000			
			9	4,400			
Non-controlling interests	-	-	*3*	3,000	414,000	*1*	(443,070)
			6	6,000	13,800	*2*	
					24,270	*5*	
	(4,261,800)	(1,012,350)					(4,936,750)
Current liabilities							
Trade and other payables	(472,800)	(167,700)	*7*	28,050			(612,450)
Current tax liability	(343,500)	(106,500)					(450,000)
Total equity and liabilities	(5,078,100)	(1,286,550)					(5,999,200)

<u>The following journal entries are for illustration and are not required for the purpose of the examination</u>

1)	Dr	Share capital	HK$450,000	
	Dr	Revaluation reserves	HK$225,000	
	Dr	Retained earnings	HK$162,000	
	Dr	Goodwill	HK$177,000	
		Cr Non-controlling interests		HK$414,000
		Cr Investment		HK$600,000
	Elimination of investment in WTL			

2)	Dr	Retained earnings	HK$13,800	
		Cr Non-controlling interests		HK$13,800
	(HK$231,000 – HK$162,000) x 20%			
	Allocation of post-acquisition to NCI up to beginning of current year			

3)	Dr	Retained earnings (HK$15,000 x 80%)	HK$12,000	
	Dr	Non-controlling interests (HK$15,000 x 20%)	HK$3,000	
		Cr Cost of sales (HK$90,000 – HK$90,000 / 1.2)		HK$15,000
	Adjustment of last year unrealised profit in inventory now realised (after tax)			

4)	Dr	Impairment loss	HK$30,000	
		Cr Goodwill		HK$30,000
	Recognition of impairment loss for goodwill			

5)	Dr	Income to non-controlling interests	HK$24,270	
		Cr Non-controlling interests		HK$24,270
		(HK$136,350 + HK$15,000 – HK$30,000) x 20%		
	Allocation of current year profit to non-controlling interests			

6)	Dr	Dividend income (HK$30,000 x 80%)	HK$24,000	
	Dr	Non-controlling interests (HK$30,000 x 20%)	HK$6,000	
		Cr Retained earnings - Dividend paid		HK$30,000
	Elimination of dividend paid			

7)	Dr	Other payables	HK$28,050	
	Dr	Cash in transit	HK$10,350	
		Cr Other receivables		HK$38,400
	Elimination of inter-company balances			

8)	Dr	Investment in associate	HK$120,000	
		Cr Share of profits of associate (HK$300,000 x 40%)		HK$120,000
	Share of associate's current year post-acquisition profits from 1 June 2016 to 31 May 2017			

9)	Dr	Share of profits of associate	HK$4,400	
		Cr Investment in associate (HK$55,000 x 1 / 5 x 40%)		HK$4,400
	Share of associate's additional depreciation on fair value adjustment of machine from 1 June 2016 to 31 May 2017			

Analytical check of consolidated retained earnings as at 31 May 2017

	HK$
Retained earnings of SSL	(2,161,800)
Share of post-acquisition retained earnings of WTL	
(HK$337,350 – HK$162,000) x 80%	(140,280)
Share of post-acquisition retained earnings of CEL	
{[HK$548,400 – HK$55,000 x 1 / 5] – HK$248,400} x 40%	(115,600)
Impairment loss on goodwill	
HK$30,000 x 80%	24,000
	(2,393,680)

Analytical check of non-controlling interests as at 31 May 2017

	HK$
Non-controlling interests' share of net assets of WTL	
HK$1,012,350 x 20%	(202,470)
Non-controlling interests' share of unimpaired balance of goodwill	
{HK$414,000 – [HK$450,000 + HK$225,000 + HK$162,000] x 20%} – HK$30,000 x 20%	(240,600)
	(443,070)

Analytical check of investment in associate as at 31 May 2017

	HK$
Share of associate's net assets of CEL	
HK$848,400 x 40%	339,360
Share of associate's unamortised balance of fair value adjustments	
HK$55,000 x 4 / 5 x 40%	17,600
Share of associate's unimpaired balance of goodwill	
HK$375,000 – [HK$300,000 + HK$248,400 + HK$55,000] x 40%	133,640
	490,600

Answer 1(b)

Potential voting rights (per HKFRS 10. Appendix B47) are rights to obtain voting rights of an investee, such as those within an option or convertible instrument. Such rights are considered only if they are substantive (i.e. the holder has the practical ability to exercise the option (HKFRS 10 Appendix B22) and rights also need to be exercisable when decisions over the relevant activities need to be made (HKFRS 10. Appendix B25)).

In assessing whether the existing shareholders other than SSL have power over WTL, one should consider the purpose and design of the options, as well as the purpose and design of any other involvement the investor has with the investee. This includes an assessment of the various terms and conditions of the options as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions (HKFRS 10. Appendix B48).

In order to have the ability to direct, the investor should have the practical ability to exercise the rights. According to HKFRS 10 Appendix B22, that means that the investor's rights should be substantive rights. Judgement is required in assessing whether rights are substantive. Appendix B23 of HKFRS 10 provides some factors (but not limited) to consider in making that determination.

- Whether there are any barriers (economic or otherwise) that prevent a holder from exercising the rights.
- Where more than one party is involved, whether there is a mechanism in place to enable those parties to practically exercise the rights.
- Whether the party or parties that holds the rights would benefit from the exercise of those rights

Without considering the potential voting rights, SSL holds 80% of the voting rights of WTL. The other shareholder holds the other 20% (90,000 / 450,000) and holds an option to acquire 450,000 new ordinary shares of WTL with the option being exercisable at a fixed price over the next two years starting from 1 June 2015.

Since the other shareholders have currently exercisable options to purchase additional voting rights, the terms and conditions associated with those options are such that the options are considered substantive as they would have power over WTL [60% = (90,000 + 450,000) / 900,000] to direct the activities of WTL.

In the absence of control, WTL will be considered as either an associate (as per HKAS 28 *Investments in Associates and Joint Ventures*) or a financial asset (as per HKFRS 9 *Financial Instruments*) of SSL.

An associate is an entity over which the investor has significant influence (HKAS 28.3). Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- Representation on the board of directors or equivalent governing body of the investee
- Participation in policy-making processes, including participation in decisions about dividends or other distributions
- Material transactions between the entity and its investee
- Interchange of managerial personnel
- Provision of essential technical information

If an entity holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case (HKAS 28.5-9).

In this case, since SSL holds 40% of WTL when the other shareholders exercise the option, it is likely that WTL is an associate of SSL.

Answer 2(a)

Lease classification from the perspective of the lessor

A lessor shall classify the lease contract as either an operating lease or finance lease at the inception of the lease (HKFRS 16.61).

HKFRS 16 provides indicators that individually or in combination (in the substance of the lease agreement) would normally lead to a finance lease.

- The lease is cancellable lease and the lessor's losses associated with the cancellation are borne by the lessee. (HKFRS 16.64(a)).
- Lease term is a major part of the economic life of the underlying asset. (3 / 4 = 75%) (HKFRS 16.63(c)).
- The present value of lease payments (HK$568,560 (See below working)) is substantially all (~99.7%) of the asset's fair value (HK$570,000). (HKFRS 16.63(d)).

Conclusion: Given the above, GAL (the lessor) will classify the transaction as a finance lease.

Workings (in HK$):

$$\underset{(2017)}{200{,}000} + \underset{(2018)}{\frac{200{,}000}{1.08}} + \underset{(2019)}{\frac{200{,}000}{(1.08)^2}} + \underset{(2020)}{\frac{15{,}000}{(1.08)^3}} = 568{,}560$$

Answer 2(b)(i)

Journal entries for lessee, PTL

For the year ended 30 June 2018

Dr	Right-of-use asset	HK$570,000	
	Cr Lease liability (see below working)		HK$370,000
	Cr Bank		HK$200,000

Initial recognition of right-of-use asset and lease liability

Workings (in HK$):

$$\underset{(2018)}{\frac{200{,}000}{1.07}} + \underset{(2019)}{\frac{200{,}000}{(1.07)^2}} + \underset{(2020)}{\frac{(15{,}000 - 4{,}714)}{(1.07)^3}} = 370{,}000$$

Date	Opening balance HK$	Payment HK$	Interest expense @7% HK$	Closing balance HK$
30 June 2018	370,000		25,900	395,900
30 June 2019	395,900	(200,000)	13,713	209,613
30 June 2020	209,613	(200,000)	673	*10,286**
			40,286	

**PTL would include the expected amount to pay as the residual value guarantee, i.e. HK$10,286 (HK$15,000 – HK$4,714)*

Dr	Interest expense	HK$25,900	
	Cr Lease liability		HK$25,900

Recognition *of interest expense*

Dr	Depreciation expense	HK$190,000	
	Cr Right-of-use asset (1 / 3 x HK$570,000)		HK$190,000

Recognition of depreciation of right-of-use asset

Answer 2(b)(ii)

Extract of the statement of financial position of PTL as at 30 June 2018

	HK$
ASSETS	
Non-current assets	
Right-of-use asset (HK$570,000 – HK$190,000)	380,000
EQUITY AND LIABILITIES	
Non-current liabilities	
Lease liability	395,900

Extract from the statement of profit or loss and other comprehensive income of PTL for the year ending 30 June 2018

	HK$
Depreciation	190,000
Finance cost	25,900

Answer 3(a)

HKAS 40 *Investment Property* requires that property that is held by the owner or the lessee as a right-of-use asset to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes or sale in the ordinary course of business, must be recognised as investment property.

Owner-occupied property is the property held by the owner (or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

In substance, it is property accounted for under HKAS 16 *Property, Plant and Equipment* (or by the lessee under HKFRS 16 *Leases*).

Property intended for sale in the ordinary course of business should be classified as inventory under HKAS 2 *Inventories*.

Property QB

Property QB reclassified from inventories in accordance with HKAS 2 to an investment property in accordance with HKAS 40 on 1 July 2017 because there is evidence of a change in use being the commencement of an operating lease (HKAS 40.57(d)).

Property CD

Property CD reclassified from owner-occupied property in accordance with HKAS 16 to investment property in accordance with HKAS 40 upon the end of the owner-occupation from 1 October 2017 because there is evidence of a change in use being moved out from head office (HKAS 40.57(c)).

Property KT

Property KT reclassified from investment property in accordance with HKAS 40 to owner-occupied property in accordance with HKAS 16 upon the commencement of the owner-occupation from 1 October 2017 because there is evidence of a change in use being moved into KT as its new head office (HKAS 40.57(a)).

Answer 3(b)

Property QB

Journal entry for purchase of inventory on 1 January 2017:

Dr	Inventory	HK$19,200,000	
	Cr Bank		HK$19,200,000

Journal entry for reclassification from inventory to investment property on 1 July 2017:

Dr	Investment property	HK$25,000,000	
	Cr Inventory		HK$19,200,000
	Cr Fair value gain – profit or loss		HK$5,800,000

Journal entry for revaluation of investment property on 31 December 2017:

Dr	Fair value loss – profit or loss	HK$1,000,000	
	Cr Investment property (HK$25,000,000 – HK$24,000,000)		HK$1,000,000

Property CD

Journal entry for depreciation expense for the period from 1 January 2017 to 1 October 2017:

Dr	Depreciation expense [HK$11,750,000 x 9 months / (50 years x 12 – 36 months)]	HK$187,500	
	Cr PPE – Accumulated depreciation		HK$187,500

Journal entry for revaluation of owner-occupied property on 1 October 2017 before reclassification:

Dr	PPE – Accumulated depreciation [HK$11,750,000 x 9 months / (50 years x 12 – 36 months)] (i.e. 9 months = 1 Jan 2017 to 1 Oct 2017)	HK$187,500	
Dr	Property, plant and equipment – Cost (HK$14,000,000 – HK$11,750,000)	HK$2,250,000	
	Cr Revaluation surplus – OCI		HK$2,437,500

Journal entry for reclassification from owner-occupied property to investment property on 1 October 2017:

Dr	Investment property	HK$14,000,000	
	Cr Property, plant and equipment – Cost		HK$14,000,000

Journal entry for revaluation of investment property on 31 December 2017:

Dr	Investment property (HK$18,000,000 – HK$14,000,000)	HK$4,000,000	
	Cr Fair value gain – profit or loss		HK$4,000,000

Answer 3(c)

Extract of the statement of financial position of BSP as at 31 December 2017

	HK$
ASSETS	
Non-current assets	
Property, plant and equipment	22,540,000

Extract of the statement of profit or loss and other comprehensive income of BSP for the year ended 31 December 2017

	HK$
Depreciation expense [HK$29,840,000 x 3 months / (50 years x 12 – 33 months)]	157,884
Revaluation deficit [HK$22,540,000 – (HK$29,840,000 – HK$157,884)]	7,142,116
Fair value gain (HK$29,840,000 – HK$29,000,000)	840,000

Answer 4

Statement of cash flows for the year ended 30 September 2017

	HK$	HK$
Cash flows from operating activities		
Profit before tax	759,960	
Adjustments for:		
Interest income	(29,400)	
Interest expense	145,200	
Depreciation charge	798,720	
Gain on disposal of property, plant and equipment	(30,720)	
Operating profits before working capital changes	1,643,760	
Increase in inventories (W1)	(590,184)	
Decrease in accounts receivable (W2)	17,520	
Increase in accounts payable (W3)	12,180	
Cash generated from operations	1,083,276	
Interest paid (W4)	(141,600)	
Tax paid (W5)	(271,200)	
Net cash from operating activities		670,476
Cash flows from investing activities		
Purchase of property, plant and equipment (W6)	(1,651,680)	
Proceeds from sales of property, plant and equipment (W7)	722,760	
Interest received (W8)	27,600	
Net cash used in investing activities		(901,320)
Cash flows from financing activities		
Proceeds from issue of ordinary share capital	444,000	
Proceeds from short–term borrowings (W9)	108,840	
Proceeds from long–term borrowings (W9)	120,000	
Dividend paid	(240,000)	
Net cash from financing activities		432,840
Net increase in cash and cash equivalents		201,996
Cash and cash equivalents at beginning of year		4,140
Cash and cash equivalents at end of year		206,136

Workings (in HK$):

W1	Closing inventories – Opening inventories 2,016,264 – 1,426,080 = 590,184
W2	Closing AR – Opening AR 643,320 – 660,840 = 17,520
W3	Closing AP – Opening AP 514,920 – 502,740 = 12,180
W4	Opening interest payable + Interest expense – Closing interest payable 14,400 + 145,200 – 18,000 = 141,600
W5	Opening tax payable + Tax expense – Closing tax payable 295,200 + 306,000 – 330,000 = 271,200
W6	Opening PPE – Dep – Disposal + Revaluation surplus – Closing PPE 3,959,280 – 798,720 – 692,040 + 159,600 – 4,279,800 = 1,651,680
W7	Disposal PPE + Gain on disposal 692,040 + 30,720 = 722,760
W8	Opening interest receivable + Interest income – Closing interest receivable 7,200 + 29,400 – 9,000 = 27,600
W9	Increase in short–term borrowings: Closing loans – Opening loans (652,200 – 543,360) = 108,840 Increase in long–term borrowings: Closing loans – Opening loans (720,000 – 600,000) = 120,000

Answer 5

Investment in BDL shares

The investment in BDL's ordinary shares is considered as a financial asset as it is an equity instrument of another entity (HKAS 32.11(b)).

Upon initial recognition, HKFRS 9 requires that financial assets to be measured either at amortised cost or fair value.

This classification is made on the basis of both:

(a) the entity's business model for managing the financial assets; and
(b) the contractual cash flow characteristics of the financial asset.

A financial asset is classified as measured at amortised cost where:

(a) the objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and
(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Equity investments are measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments.

In general, all equity investments are to be measured at fair value with the recognition of gains and losses in profit or loss, i.e. fair value through profit or loss (FVTPL). (HKFRS 9.4.1.4)

- EIL has a small shareholding (200 / 20,000 = 1%) in BDL. 1% is less likely to support control or significant influence of BDL.
- EIL does not intend to hold the shares of BDL for trading purposes.
- However, EIL does not make an irrevocable election to measure the shares at fair value through other comprehensive income (FVTOCI).

<u>Conclusion</u>: Therefore, the shares of BDL should follow the classification of FVTPL in accordance with HKFRS 9 *Financial Instruments*. The gain or loss arising from the fair value change should be recognised in profit or loss.

* * * END OF EXAMINATION PAPER * * *