SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

To : Jody Wong, Chief Executive Officer
From : Philip Chan, Accounting Manager
Date : dd/mm/yyyy
Subject : Consolidated statement of cash flows

I refer to your query regarding the classifications of various items in the consolidation statement of cash flows of PJL.

(a) Pledged bank deposits

The information delivered by a statement of cash flows depends on the items treated as "cash and cash equivalents". Therefore it is essential to properly determine the components of "cash and cash equivalents" in the first place. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value (paragraph 6 of HKAS 7).

"Cash equivalents" are held for the purpose of meeting short-term cash commitments. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition (paragraph 7 of HKAS 7).

Pledged deposits do not meet the definition of a cash equivalent because they have restrictions in use. Therefore, bank deposits pledged for a long term loan cannot meet short-term cash commitments and should not be included in cash and cash equivalents.

Hence, in the cash flow statement, the movement of these pledged bank deposits should be disclosed as financing or investing activities according to the nature and intention of the underlying transaction and not as part of cash and cash equivalents.

(b) Changes in ownership interests in a subsidiary that do not result in a loss of control

According to HKAS 7.42A, cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control should be classified as cash flows from financing activities, unless the subsidiary is held by an investment entity, as defined in HKFRS 10, and is required to be measured at fair value through profit or loss.

Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see HKFRS 10), unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss. Accordingly, the resulting cash flows should be classified in the same way as other transactions with owners (HKAS 7.42B).

(c) Securities held for trading

An entity may hold securities for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities should be classified as operating activities (HKAS 7.15).

(d) Reporting financing and investing cash flows on a net basis

According to HKAS 7.21, an entity should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 of HKAS 7 are reported on a net basis.

Thus, financing or investing cash flows (e.g. bank borrowings, PJL's to or from related companies) should be reported on a gross basis and not net unless they had met the limited exemptions permitted by the standard (HKAS 7 paragraphs 22 to 24).

(e) Deferred consideration in relation to acquisitions of subsidiaries

Deferred consideration in relation to acquisitions of subsidiaries that was paid in the following year should not be classified in operating activities.

The aggregate cash flows arising from obtaining control of subsidiaries should be presented separately and classified as investing activities (HKAS 7.39).

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

Best Regards,
Philip Chan

Answer 2

10% test

HKFRS 8 specifically requires an entity to report separately information about an operating segment that meets of the following quantitative thresholds:

(a) Revenue test – the entity's reported revenue, including both from external and inter-segment, is 10% or more of the combined revenue (internal and external) of all operating segments.

(b) Profit test – the absolute amount of the entity's reported profit or loss is 10% or more of the greater, in absolute amount, of

  (i) the combined reported profit of all operating segments that did not report a loss; and

  (ii) the combined reported loss of all operating segments that reported a loss.

(c) Asset test – the entity's assets are 10% or more of the combined assets of all operating segments. (HKFRS 8.13)

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

Quantitative thresholds are calculated based on the totals for the operating segments, not the total for PJL (HKFRS 8.13):

	Revenue % of total	Profit / (Loss) % of total	Assets % of total
Gold	30.83	28.43	40.32
Silver	15.79	18.80	10.24
Diamond	53.38	52.77	49.44
Total for the three segments	*100.00*	*100.00*	*100.00*

An operating segment needs to meet one of the three quantitative thresholds in order to qualify as the reportable segment. In this case, all three operating units meet all the three quantitative thresholds and thus all three operating units are reportable segments.

75% of consolidated revenue

The reportable segments need to account for 75% of the consolidated revenue. This test is applied to the external revenues of the segments (HKFRS 8.15).

	HK$ million
Total external operating segment revenue (410 + (210 – 170) + 710)	1,160
Divided by: Total consolidated revenue (after inter-segment eliminations)	1,630
	71.17%

Since the reportable segments do not account for 75% or more of the consolidated revenue, additional operating segments need to be identified. The management needs to further analyse the other businesses and identify another reportable segment from that component.

Answer 3

PJL group - Consolidated statement of cash flows for the year ended 31 December 2017

	HK$'million	HK$'million
Cash flows from operating activities		
Profit before tax	553	
Adjustment for:		
Depreciation expense (W1)	**107**	
Gain on disposal of machinery	(30)	
Share of associate profit	(105)	
Interest expense	45	
Operating profit before working capital changes	*570*	
Increase in trade receivables (555 – 383 – 8)	(164)	
Increase in inventories (593 – 320 – 10)	(263)	
Increase in trade payables (150 – 84 – 20)	46	
Cash flows from operation	*189*	
Financial assets, at fair value through profit or loss (103 –123)	*(20)*	
Interest paid (9 + 45 – 12)	(42)	
Tax paid (69 + 5 + 149 – 148)	(75)	
		52
Cash flows from investing activities		
Proceeds from disposal of machinery	150	
Purchase of machinery (W1)	**(355)**	
Dividend received from associate (300 + 105 – 330)	75	
Increase in bank deposits with more than three months to maturity when placed or pledged (400 – 700)	(300)	
Purchase of subsidiary (34 – 4)	30	
		(400)
Cash flows from financing activities		
Proceeds from issue of ordinary share capital (2,047 – 1,229 – 84)	734	
Proceeds from bank loans (427 – 148)	279	
Payments of lease liabilities (53 + 60 + 235 – 224 – 72)	(52)	
Dividend paid to NCI (0 + 19 + 30 – 35)	(14)	
Dividend paid (374 + 750 – 1,034)	(90)	
		857
Net increase in cash and cash equivalent		509
Cash and cash equivalent at beginning of period (546 – 400)		146
Cash and cash equivalent at end of period (1,355 – 700)		655

(W1) Depreciation expense and purchase of machinery

Building's depreciation = HK$(267 – 230) million = HK**$37 million**

Machinery	Cost	Accumulated Depreciation
	HK$million	HK$million
b/f	420	330
Disposal	(160)	(40)
Acquisition of SDL	50	
Right-of-use assets under lease arrangement	235	
Addition by cash	***355***	
Depreciation		***70***
c/f		
	900	360

Total depreciation expense = HK$(37 + 70) million = HK$107 million

Answer 4

GIL

When GIL was an investment entity, it was allowed to account for its investment in subsidiaries at fair value through profit or loss in accordance with HKFRS 10, and was required to apply the same accounting for each category of investments in accordance with HKAS 27 (2011).

However, when GIL ceases to be an investment entity, it is required to account for its investment in subsidiaries in accordance with HKAS 27.11B (2011) in the separate financial statements.

- the date of the change of status is the deemed acquisition date; and

- the fair value of the subsidiary at the deemed acquisition date represents the transferred deemed consideration when accounting for the investment in accordance with HKAS 27.10 (2011).

Even though HKAS 27 (2011) does not specifically require application of HKFRS 3 (revised) to account for its investments in subsidiaries as deemed acquisition when an entity ceases to be an investment entity, HKAS 27 (2011) states that the date of the change of status is the deemed acquisition date, and the fair value of the subsidiary at the deemed acquisition date represents the transferred deemed consideration.

It implicitly requires that the investment in the subsidiary is deemed as an acquisition of subsidiary and therefore should be accounted for in accordance with HKFRS 3 (revised).

PJL

For PJL, it is an acquisition of a subsidiary (from associate to subsidiary).

In the separate financial statements of PJL, PJL could elect to account for its investments either at cost, or in accordance with HKFRS 9 *Financial Instruments*, or using the equity method.

Under HKFRS 3 (revised) *Business Combination*, the acquirer should identify the acquisition date, which is the date on which it obtains control of the acquiree (HKFRS 3 (revised) paragraph 8). Thus, acquisition accounting is triggered only at the point of attaining control in the acquiree.

Prior to attaining control in the acquiree, the acquirer's pre-existing equity interest in the acquiree may be accounted for either as a financial asset, or as an associate, or as a joint venture, as appropriate.

In such a business combination achieved in stages, once the equity ownership in the acquiree reaches the point when the control is achieved, the acquirer should re-measure its previously held equity interest in the acquiree (as financial asset or associate) at fair value on the acquisition date; and recognise the resulting gain or loss in profit or loss (HKFRS 3 (revised) paragraph 42).

* * * END OF SECTION A * * *

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

Answer 5(a)

A provision shall be recognised when (a) an entity has a present obligation (legal or constructive) as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised. [HKAS 37.14]

HKAS 37 defines a restructuring as "a programme that is planned and controlled by management, and materially changes either (a) the scope of a business undertaken by an entity; or (b) the manner in which that business is conducted". [HKAS 37.10]

The plan of BBL to wind up a line of business, i.e. the spa and massage business, falls within the scope of restructuring under HKAS 37.

HKAS 37 requires that restructuring costs be recognised only when the general recognition criteria in the standard are met, i.e., there is a present obligation (legal or constructive) as a result of a past event, in respect of which a reliable estimate can be made of the probable cost. [HKAS 37.71]

There will only be a constructive obligation where the entity has, before the end of the reporting period (a) started to implement the restructuring plan; or (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring. [HKAS 37.75]

BBL communicated the plan to wind up on 1 December 2017 to its customers and the masseurs and has started to implement the wind up plan raising a valid expectation in them that BBL will carry out the restructuring.

A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both: (a) necessarily entailed by the restructuring; and (b) not associated with the ongoing activities of the entity.

(a) The total nail art course fee of HK$140,000 borne by BBL shall not be recognised as a provision and shall be expensed as incurred because the retraining relates to their future employment as a professional nail technician with BBL, i.e., ongoing activities.

(b) The total payment in lieu of notice of HK$360,000 for the termination of three masseurs is a present obligation as a result of the communication of the decision to wind up the business with the masseurs before the year end. To the extent that such amount has not been settled, it should be recognised as a provision at the year end date.

(c) Salaries of the three masseurs retained to continue to carry out their duties up to the end of 31 December 2018 and the 20% extra bonus shall only be recognised over the period when the services are provided.

(d) The share of the rental and overhead costs for maintaining the spa and massage business of HK$468,000 shall not be provided as part of restructuring provision unless they relate to an onerous contract. [HKAS 37.82] Instead such costs would be recognised as incurred.

(e) The cost of dismantling the jacuzzi of HK$110,000 is not an eligible restructuring provision because it is associated with ongoing activities for the facial business. [HKAS 37.80] It will be recognised when incurred.

(f) The refund of the spa and massage package of HK$560,000 relates to future revenue which is yet to be earned and does not qualify as a restructuring provision. Having said that, a contract liability (deferred revenue) would have been recognised for the service yet to be transferred to the customer.

Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

Answer 5(b)

Keith Ong as the accounting manager of BBL and who is a certified public accountant may be at the risk of breaching the following fundamental principles of the Code of Ethics for Professional Accountants ("COE").

The COE states that a professional accountant should be straightforward and honest in all professional and business relationships. Keith must not knowingly be associated with reports which he believes contain information that is a materially false or misleading statement.

Keith must not follow bias, conflict of interest or undue influence of others to override his professional and business judgements. The amount of bonus to be received should not affect the judgement of Keith in making the allowance for bad debts of the receivable.

Keith should also maintain adequate professional knowledge and skills at a high level to ensure that his employer receives competent professional service based on current developments in practice and legislation, e.g. in accordance with HKFRS 9, credit loss should be provided under the expected credit loss model. Keith should therefore maintain adequate professional knowledge of such.

Further, Keith should act diligently, carefully, timely and in accordance with applicable professional standards when providing professional services.

The potential threat that the financial controller was involved in is a self-interest threat. This is a threat that the financial interest, i.e. annual bonus payment would inappropriately influence a professional accountant's judgement or behaviour.

The other potential threat is an intimidation threat. The threat may cause the financial controller, as a professional accountant, to deter from acting objectively because of actual or perceived pressures, including attempts to exercise influence over the professional accountant e.g. influence on the accounting manager or influence from the director.

Answer 6(a)

(1) Residential estate

- The town house on the residential estate should be accounted for as inventory at 31 December 2017. [HKAS 2.8]

- UDL is engaged in the business of developing and selling commercial and residential properties. The town houses on the residential estate have been constructed for sale individually.

- Sales marketing is underway with an objective to sell all remaining properties in the ordinary course of business.

- HKAS 40 states that transfers from inventories to investment property shall be made when and only when there is change in use, evidenced by e.g. the commencement of an operating lease to another party. At 31 December 2017, none of the houses on the residential estate are either leased under an operating lease or held with the immediate intention of renting it out under an operating lease.

- Management's intentions alone are not sufficient evidence of a change in use despite the fact that the board has intended to put the remaining houses up for rent if they are still unsold at 31 January 2018.

As the net realisable value (the estimated net selling price) as at 31 December 2017 is higher than the carrying amount, no write down to the inventories is necessary.

UDL would record inventories of HK$89,000,000 as current assets in the statement of financial position relating to the residential estate.

(2) Apartment unit

- The apartment unit was acquired to provide housing for the consultant who came from abroad to work on UDL's building projects. Where a property is occupied by employees, it is owner-occupied and not an investment property under HKAS 40.

- The fact that UDL charges the consultant a nominal rent for the stay had no impact on the classification as HKAS 40 is clear that owner-occupied property includes property occupied by employees no matter whether the employees pay rent at market rates.

- As the apartment unit was owner occupied and was used in the operations of UDL, it meets the definition of property, plant and equipment according to HKAS 16.

- During the year, the apartment unit underwent a change in use. It ceased to be used by UDL's employees and was offered for rent. [HKAS 40.57]

- Though management has decided to use the apartment unit as an investment property in the future and had begun to advertise the apartment for rent on 31 March 2017, the owner occupation has not yet ended because the consultant was still staying in the apartment unit, i.e., the apartment unit was still occupied by UDL. The apartment unit should still be treated as property, plant and equipment until 30 April 2017 when the consultant moved out from the apartment unit.

- A property ceases to be classified as property, plant and equipment and becomes classified as an investment property when the definition and recognition criteria of HKAS 40 have been met. To be classified as an investment property, the property must be held for rental income or capital appreciation.

- Property that is being constructed or developed for future use as investment property meets the definition of investment property. Despite the fact that the remodelling work took place on 30 April and was not yet completed until 30 June 2017, UDL can treat the apartment unit as an investment property from 30 April 2017 given it meets the definition of an investment property. [HKAS 40.8(e)]

- UDL applied HKAS 16 up to the date of change in use when an owner occupied property became an investment property that will be carried at fair value.

- UDL should recognise a depreciation expense of HK$100,000 in the statement of profit and loss for the period from 1 January 2017 to 30 April 2017 [HK$15,000,000 x 1/50 years x 4/12].

- UDL should recognise the difference between the carrying amount of the apartment unit and its fair value of HK$2,200,000 as a revaluation reserve in the statement of comprehensive income for the year ended 31 December 2017 [HK$16,800,000 – (HK$15,000,000 – HK$15,000,000 x 1/50 x 16/12 i.e.HK$400,000)].

- UDL should derecognise the property, plant and equipment of HK$14,600,000, recognise investment property of HK$16,800,000 and fair value change in other comprehensive income of HK$2,200,000 at 30 April 2017.

- UDL should recognise a fair value gain of HK$4,200,000 arising from the change in the fair value of investment property in the statement of profit and loss (HK$21,000,000 – HK$16,800,000) for the year ended 31 December 2017.

- UDL should recognise an investment property of HK$21,000,000 as at 31 December 2017 relating to the apartment unit.

Answer 6(b)

The issue in accounting for income taxes is how to account for the current and future tax consequences of the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position and transactions and other events of the current period that are recognised in an entity's financial statements.

It is inherent in the recognition of an asset or liability that the entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, the entity is required to recognise a deferred tax liability (deferred tax asset), with certain exceptions.

HKAS 12 *Income Taxes* adopts the statement of financial position approach which focuses on the temporary differences being calculated as the difference between carrying amounts of assets and liabilities and their tax base.

A taxable temporary difference arises when the tax base of an asset (a liability) is less (more) than its carrying amount. A deductible temporary difference arises when the tax base of an asset (a liability) is more (less) than its carrying amount.

The tax base of an asset or a liability is the amount attributed to that asset or liability for tax purposes.

Apartment unit

- The apartment unit was classified as an investment property at 31 December 2017 at fair value of HK$21,000,000.

- A 4% commercial building allowance was allowed as a tax deduction, therefore the tax base of the apartment unit at 31 December 2017 was HK$13,800,000 [HK$15,000,000 – (HK$15,000,000 x 4% x 2)].

- In the case of investment property measured at fair value, HKAS 12 contains a rebuttable presumption that deferred tax is measured based on recovery through sale rather than use. As there is no capital gains tax in Hong Kong and therefore on the sale of an investment property at a price in excess of cost, the only tax effect on the investment property is the claw back of capital allowances claimed by UDL.

  As at 31 December 2016, UDL should recognise a deferred tax liability of HK$49,500 in its statement of financial position representing the difference between the carrying amount and tax base of the apartment unit [(HK$14,700,000 – HK$14,400,000) x 16.5%].

- As at 31 December 2017, UDL should recognise a deferred tax liability of HK$198,000 in its statement of financial position representing the difference between the carrying amount (excluding fair value uplift because there is no capital gains tax in Hong Kong) and tax base of the apartment unit [(HK$15,000,000 – HK$13,800,000) x 16.5%].

Answer 7(a)

At the inception of the lease contract on 1 October 2016, BHL should assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [HKFRS 16.9]

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, the customer shall obtain substantially all the economic benefits from use of the identified asset and the right to direct the use of the identified asset. The lease agreement explicitly states that the lease conveys exclusive use of the retail space by BHL and BHL would obtain substantially all the economic benefits from the use of the retail space for its business. BHL also has full discretion on the usage of the retail space throughout the lease period.

An asset is typically identified by being explicitly specified in a contract. The lease contract of BHL specified that it is for the lease of 900 square feet of retail space No. 2047 in a shopping centre.

However, even if an asset is specified, a customer does not have the rights to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both conditions exist: (a) the supplier has the practical ability to substitute alternative assets throughout the period of use; and (b) supplier would benefit economically from the exercise of its right to substitute the asset.

In the case of BHL, though APL can require BHL to move to another retail space, the substitution right is not substantive as the owner benefits from relocating BHL only if there is a new tenant that pays a certain rate. It is also noted that it is possible that these circumstances may arise but it is unlikely.

Accordingly, the lease contract that BHL entered into with APL contains a lease.

Answer 7(b)

Journal entries of BHL in relation to the lease for the year ended 31 December 2017:

Dr. Right-of-use asset	HK$232,380	
Cr. Lease liability		HK$220,380
Cr. Bank		HK$12,000

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

Dr. Depreciation expense	HK$58,095	
Cr. Accm. Dep – ROU asset		HK$58,095

Recognition of depreciation of right-of-use asset (HK$232,380 / 4 years)

Dr. Lease liability	HK$60,000	
Cr. Bank		HK$60,000

Recognition of first annual rental payment

Dr. Interest expense	HK$9,623	
Cr. Lease liability		HK$9,623

Recognition of accrued interest

Working:

(i) Present value of the lease payable at the commencement date:

Annual discount rate:	6.00%			
	Year	**Lease payment**	**Discount factor**	**Present value of lease payment**
2017	0	-60,000	1.000	-60,000
2018	1	-60,000	0.943	-56,604
2019	2	-60,000	0.890	-53,400
2020	3	-60,000	0.840	-50,376
				-220,380

(ii) Payment of initial direct costs for writing the contracts and agency fee totaling HK12,000.

	Year	Lease liability b/f	Lease payment	Interest	Decrease in lease liability	Lease Liability c/f
2017	0	-220,380	60,000	-9,623	50,377	-170,003
2018	1	-170,003	60,000	-6,600	53,400	-116,603
2019	2	-116,603	60,000	-3,397	56,603	-60,000
2020	3	-60,000	60,000	0	60,000	0
					220,380	

Answer 7(c)

Where a change in accounting policy is the result of the initial application of a HKFRS, that change should be accounted for in accordance with the specific transitional provisions, if any, in that HKFRS, i.e. HKFRS 16.

Otherwise, a change in accounting policy should be applied retrospectively.

As a result of a change in accounting policy, retrospective adjustments should be reported as an adjustment to the opening balance of each affected component of equity.

Comparative information should also be restated unless it is impracticable to do so. This means that all comparative information must be restated as if the new policy had always been in force, with amounts relating to earlier periods reflected in an adjustment to opening reserves of the earliest period presented.

Certain disclosures are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods. These include:

(a) reasons for the change;

(b) amount of the adjustment for the current period and for each period presented;

(c) amount of the adjustment relating periods prior to those included in the comparative information; and

(d) the fact that comparative information has been restated or that it is impracticable to do so.

* * * END OF EXAMINATION PAPER * * *