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

To: Ms. Wong, Director of PPY
From: Tommy Lau, Accounting Manager, PPY
c.c.: Renee Ho, Chris Wong, Adrian Cheung (Directors)
Date: dd/mm/yyyy
Subject: Consolidated financial statements of PPY as at 31 March 2010

I refer to your e-mail dated 8 May 2010 regarding your queries about the draft consolidated financial statements for PPY as at 31 March 2010.

Answer 1(a)

Capitalisation of borrowing costs

HKAS 23 (Revised) *Borrowing costs* specifies that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

Since PPY has borrowed the funds specifically for the purpose of obtaining the qualifying asset (the plant), PPY shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

In this case, since the expenditure on the qualifying asset (HK$18 million), i.e. the plant, is higher than the fund borrowed (HK$10 million), it is expected that there is no investment income on temporary investment.

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Therefore, during the year ended 31 March 2010, the interest should be capitalised only for the period from 1 April 2009 to 30 November 2009, i.e. 8 months.

Borrowing costs that should have been capitalised in the current year:
= HK$10,000,000 x 9% x 8/12
= HK$600,000

Answer 1(b)

Investment property

HKAS 40 defines an investment property as a property held 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.

From the perspective of PPY, the property is an investment property because it meets the definition stated above by leasing it to another party (a senior manager of SFL). Therefore, PPY correctly treats the property as an investment property in its separate financial statements.

However, PPY's property is leased to, and occupied by, an employee of its subsidiary (SFL).

Paragraph 9(c) of HKAS 40 specified that owner-occupied property includes property occupied by employees (whether or not the employees pay rent at market rates) and it is one of the examples of items that are not investment property and are therefore outside the scope of HKAS 40.

From the perspective of the group, an employee of SFL is an employee of the group. Thus the property does not qualify as an investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group.

Therefore, the relevant investment property, with a fair value of HK$6 million, has to be reclassified as property, plant and equipment in the consolidated financial statements.

Nonetheless, the rental paid by the senior manager of SFL to PPY is not an intragroup income and expense and thus the relevant rental income is not eliminated in preparing the consolidated financial statement.

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

Best regards,
Tommy Lau

Answer 1(c)

Annex

(i) Worksheet for the consolidated statement of comprehensive income

	PPY	SFL	Eliminations			Consolidated
	HK$	HK$	Dr(HK$)	working	Cr(HK$)	HK$
Sales	80,000,000	38,400,000	4,800,000	W7		113,600,000
Cost of sales	(51,200,000)	(25,600,000)	640,000	W7	4,800,000	(72,490,000)
			250,000	W2/W6	400,000	
Gross profit	28,800,000	12,800,000				41,110,000
Other income (Dividend income)	1,280,000	--	1,280,000	W3		--
Distribution costs	(3,000,000)	(2,300,000)				(5,300,000)
Administrative expenses	(5,000,000)	(2,500,000)				(7,500,000)
Finance costs	(5,760,000)	(1,120,000)		(a)	600,000	(6,280,000)
Profit before tax	16,320,000	6,880,000				22,030,000
Income tax expense	(3,520,000)	(2,080,000)	66,000	W6/W7	105,600	(5,519,150)
				W2	41,250	
Profit for the year	12,800,000	4,800,000				16,510,850
Other comprehensive income: revaluation surplus	6,000,000	1,200,000				7,200,000
Total comprehensive income	18,800,000	6,000,000				23,710,850
Profit attributable to:						
Owners of the parent						15,632,680
Non-controlling interests			878,170	W4		878,170
						16,510,850
Other comprehensive income attributable to:						
Owners of the parent						6,960,000
Non-controlling interests			240,000	W4a		240,000
						7,200,000

(ii) Worksheet for consolidated statement of financial position

	PPY	SFL	Eliminations			Consolidated
	HK$	HK$	Dr(HK$)	working	Cr(HK$)	HK$
Property, plant and equipment, net	40,000,000	7,600,000	600,000	(a)		54,200,000
			6,000,000	(b)		
Investment properties	20,800,000	12,000,000		(b)	6,000,000	26,800,000
Investment in SFL, at cost	25,600,000	--		W1	25,600,000	--
Goodwill	--	--	1,530,000	W1		1,530,000
Other intangible assets, net	--	11,200,000	2,500,000	W1/W2	750,000	12,950,000
Deferred tax asset	--	--	105,600	W7		105,600
Inventories	51,200,000	21,600,000		W7	640,000	72,160,000
Trade and other receivables	25,000,000	14,000,000				39,000,000
Cash and cash equivalents	23,000,000	10,400,000				33,400,000
	185,600,000	76,800,000				240,145,600
Share capital	32,000,000	16,000,000	16,000,000	W1		32,000,000
Retained earnings	46,000,000	25,000,000				56,071,480
Revaluation surplus	10,000,000	2,200,000				11,760,000
	88,000,000	43,200,000				99,831,480
Non-controlling interests	--	--		W1	6,017,500	8,825,370
			100,000	W2	16,500	
			320,000	W3/W4	878,170	
				W4a	240,000	
				W5	1,960,000	
				W5a	200,000	
			80,000	W6	13,200	
Deferred tax liability			123,750	W2/W1	412,500	288,750
Trade and other payables	47,600,000	13,600,000				61,200,000
Long term loan	50,000,000	20,000,000				70,000,000
	185,600,000	76,800,000	49,816,020		49,816,020	240,145,600

Working:

Reconciling consolidated retained earnings and consolidated revaluation surplus

	PPY	SFL	Eliminations			Consolidated
	HK$	HK$	Dr(HK$)	working	Cr(HK$)	HK$
Retained earnings, 1 April 2009	36,400,000	21,800,000	400,000	W2	66,000	43,638,800
			320,000	W6	52,800	
			12,000,000	W1		
			1,960,000	W5		
Profit for the year attributable to the owners of the parent	12,800,000	4,800,000				15,632,680
Dividends declared	(3,200,000)	(1,600,000)		W3	1,600,000	(3,200,000)
Retained earnings, 31 March 2010	46,000,000	25,000,000				56,071,480

	PPY	SFL	Eliminations			Consolidated
	HK$	HK$	Dr(HK$)	working	Cr(HK$)	HK$
Revaluation surplus, 1 April 2009	4,000,000	1,000,000	200,000	W5a		4,800,000
revaluation for the year	6,000,000	1,200,000				6,960,000
Revaluation surplus, 31 March 2010	10,000,000	2,200,000				11,760,000

Note: The journal entries are for illustrative purpose only. They are not required by the question.

			HK$	HK$
W1 - Elimination of investment in subsidiary				
Dr	Share capital		16,000,000	
Dr	Retained earnings		12,000,000	
Dr	Goodwill		1,530,000	
Dr	Intangible assets		2,500,000	
	Cr Deferred tax liability			412,500
	Cr Investment in SFL			25,600,000
	Cr Non-controlling interests (BS)	(30,087,500 x 20%)		6,017,500
W2 - Past and current amortisation on revalued intangible assets				
Dr	Opening retained earnings	(2.5m/10*2*80%)	400,000	
Dr	Non-controlling interests (BS)	(2.5m/10*2*20%)	100,000	
Dr	Amortisation	(2.5m/10)	250,000	
	Cr Accumulated amortisation			750,000
Dr	Deferred tax liability	(750,000 x 16.5%)	123,750	
	Cr Opening retained earnings	(400,000 x 16.5%)		66,000
	Cr Non-controlling interests	(100,000 x 16.5%)		16,500
	Cr Tax expense	(250,000 x 16.5%)		41,250
W3 - Eliminate dividend income				
Dr	Dividend income	(1,600,000 x 80%)	1,280,000	
Dr	Non-controlling interests (BS)	(1,600,000 x 20%)	320,000	
	Cr Dividends declared			1,600,000

			HK$	HK$
W4 - Current income to Non-controlling interests				
Dr	Non-controlling interests (IS)		878,170	
	Cr Non-controlling interests (BS)			878,170

Profit of SFL before adjustment		4,800,000
Add: previous year's unrealised profit now realised	(1.2m-0.8m)	400,000
Tax effects on previous year's unrealised profit	(400,000 x 16.5%)	(66,000)
Less: current year's unrealised profit	(40%*(4.8m - 3.2m))	(640,000)
Tax effects on current year unrealised profit	(640,000 x 16.5%)	105,600
Less: amortisation on revalued intangible assets		(250,000)
Tax effects on amortisation on revalued intangible assets	(250,000 x 16.5%)	41,250
Adjusted profit		4,390,850
Non-controlling interests' share (20%)		878,170

W4a - Current revaluation surplus to Non-controlling interests

Dr	Non-controlling interests (IS) (1,200,000 x 20%)	240,000	
	Cr Non-controlling interests (BS)		240,000

W5 - Assign post-acquisition Retained Earnings to Non-controlling interests

Dr	Opening retained earnings (from 1 April 2007 to 31 March 2009) [20%*(21.8m-12m)]	1,960,000	
	Cr Non-controlling interests (BS)		1, 960,000

W5a - Assign post-acquisition revaluation surplus to Non-controlling interests

Dr	Opening revaluation surplus (from 1 April 2007 to 31 March 2009) [20%*(1m-0m)]	200,000	
	Cr Non-controlling interests (BS)		200,000

W6 - Realisation of beginning unrealised inventory in inventory

Dr	Opening retained earnings	320,000	
Dr	Non-controlling interests (BS)	80,000	
	Cr Cost of sales		400,000
Dr	Tax expense (400,000 x 16.5%)	66,000	
	Cr Opening retained earnings (320,000 x 16.5%)		52,800
	Cr Non-controlling interests (BS) (80,000 x 16.5%)		13,200

		HK$	HK$
W7 - Elimination of intercompany sale of inventory			
Dr	Sales	4,800,000	
	Cr Cost of sales		4,800,000
Dr	Cost of sales (1.6m x 40%)	640,000	
	Cr Inventory		640,000
Dr	Deferred tax asset (640,000 x 16.5%)	105,600	
	Cr Tax expense		105,600

Reconciliation of Non-controlling interests (BS):

Shareholders' equity of SFL at 31 March 2010	43,200,000
Fair value adjustment of intangible assets	2,500,000
Tax on fair value adjustment of intangible assets (2.5m x 16.5%)	(412,500)
Accumulated amortisation on fair value adjustment of intangible assets (2.5m/10x3)	(750,000)
Tax on acc. amortisation on fair value adjustment of intangible assets	123,750
Unrealised profit on upstream sale	(640,000)
Tax on unrealised profit on upstream sale	105,600
Adjusted shareholders' equity of SFL at 31 March 2010	44,126,850
NCI's share @ 20%	8,825,370

or

		20% NCI
Shareholders’ equity of SFL at 31 March 2010	43,200,000	8,640,000
Fair value adjustment of intangible assets	2,500,000	500,000
Tax on fair value adjustment of intangible assets (2.5m x 16.5%)	(412,500)	(82,500)
Accumulated amortisation on fair value adjustment of intangible assets (2.5m/10x3)	(750,000)	(150,000)
Tax on acc. amortisation on fair value adjustment of intangible assets	123,750	24,750
Unrealised profit on upstream sale	(640,000)	(128,000)
Tax on unrealised profit on upstream sale	105,600	21,120
Adjusted shareholders’ equity of SFL at 31 March 2010	44,126,850	8,825,370

* * * END OF SECTION A * * *

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

Answer 2(a)

Share-based compensation expenses for the year ended 31 March 2009:

= [(2,000,000 / 4 x HK$8)] + [(2,000,000 / 4 x HK$8) / 2] + [(2,000,000 / 4 x HK$8) / 3] + [(2,000,000 / 4 x HK$8) / 4]

= HK$4,000,000 + HK$2,000,000 + HK$1,333,333 + HK$1,000,000 = HK$8,333,333

Share-based compensation expenses for the year ended 31 March 2010:

= [(2,000,000 / 4 x HK$8) / 2] + [(2,000,000 / 4 x HK$8) / 3] + [(2,000,000 /4 x HK$8) / 4]

= HK$2,000,000 + HK$1,333,333 + HK$1,000,000 = HK$4,333,333

Answer 2(b)

Accounting implication of cancellation of unvested awarded share options on 1 April 2010:

According to HKFRS 2.28, if a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense.

Share-based compensation expense originally to be recognised from 1 April 2010 to 31 March 2012:
= [(2,000,000 / 4 x HK$8) / 3] + [(2,000,000 / 4 x HK$8) / 4 x 2]
= HK$1,333,334 + HK$2,000,000 = HK$3,333,334

OR**

Accumulated compensation expense recognised up to 31 March 2010:
HK$8,333,333 + HK$4,333,333 = HK$12,666,666

[(2,000,000 x HK$8) – HK$12,666,666] = HK$3,333,334

Payment exceeds the fair value of the share options granted and cancelled, measured at 1 April 2010:
= HK$5,500,000 – [(2,000,000 / 4 x 2) x HK$5]
= HK$500,000

Total compensation expense recognised upon cancellation unvested awarded share options on 1 April 2010 = HK$3,333,334 + HK$500,000 = HK$3,833,334

Answer 2(c)

According to HK(IFRIC) – Int 11 para. 8, provided that the share-based arrangement is accounted for as equity-settled in the consolidated financial statements of the parent, the subsidiary shall measure the services received from its employees in accordance with the requirements applicable to equity-settled share-based payment transactions, with a corresponding increase recognised in equity as a contribution from the parent.

The journal entries to be recorded by BS for the year ended 31 March 2010 were:

Dr Share compensation expense	HK$4,333,333	
Cr Contribution from MDS		HK$4,333,333

Answer 3(a)

The amount of goodwill is calculated as follows:

Consideration transferred: HK$72 million

Amount of non-controlling interests: HK$45 x 2,000,000 x 20% = HK$18 million

Identifiable net assets of BDC acquired:

Net carrying amount in the books of BDC = HK$42 million

Fair value adjustments:

Property, plant and equipment = HK$76 - HK$60 million = HK$16 million
Intangible asset = HK$8 million

Net of the acquisition-date amounts of the identified assets acquired and the liabilities assumed = HK$[42 + 16 + 8] million = HK$66 million

Goodwill acquired = HK$[72 + 18 – 66] million = HK$24 million

Answer 3(b)

Non-controlling interests in BDC as at 1 April 2010 before the Distribution to be reflected in the consolidated statement of financial position of SCL:

Net of the acquisition-date amounts of the identified assets acquired and the liabilities assumed (as above) = HK$66 million

Post acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 2010 = HK$8 million

Additional depreciation for the period from 1 October 2009 to 31 March 2010:
= HK$16 million / 10 x 0.5
= HK$0.8 million

Additional amortisation for the period from 1 October 2009 to 31 March 2010:
= HK$8 million / 10 x 0.5
= HK$0.4 million

Adjusted post acquisition profit of BDC incorporated into the consolidated financial statements of SCL up to 1 April 2010 = HK$[8 – 0.8 – 0.4] million = HK$6.8 million

Non-controlling interest of 20% = HK$18 million + [HK$6.8 million x 20%]
= HK$19.36 million

Answer 3(c)

According to paragraphs 30 and 31 of HKAS 27, changes in a parent's ownership interest in a subsidiary that do not result in a loss of control (i.e. still accounted for as a subsidiary) are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners). In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.

The journal entries to be recorded by SCL for the Distribution were:

Dr Dividend	HK$14,520,000	
Cr Non-controlling interest		HK$14,520,000

(15/80 of the goodwill attributable to SCL and 15% of adjusted net assets of BDC incorporated into the consolidated financial statements of SCL as at 1 April 2010 = HK$[72 + (6.8 x 80%)] million x 15/80

[OR**
15% of total goodwill and adjusted net assets of BDC incorporated into the consolidated financial statements of SCL as at 1 April 2010 = HK$(66 + 6.8 + 24) million x 15%])

HK(IFRIC) – Int 17 para. 7 states that in accordance with paragraph 5, this Interpretation does not apply when an entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary. The entity making a distribution that results in the entity recognising a non-controlling interest in its subsidiary accounts for the distribution in accordance with HKAS 27 (as amended in 2008).

<u>Answer 4(a)</u>

The fair value of the financial liability component of the CB at initial recognition:

[(6% x HK$800 / 1.08) + (6% x HK$800 / 1.08^2) + (6% x HK$800 / 1.08^3) + (6% x HK$800 / 1.08^4) + (HK$800 / 1.08^4)] million

= HK$[44.4 + 41.2 + 38.1 + 35.3 + 588] million
= HK$747 million

The initial carrying amount of the equity component of the CB:
= HK$(800 – 747) million = HK$53 million

Journal entries for the issue of the convertible bond (CB) on 1 December 2008:

Dr Cash	HK$800 million	
Cr Convertible Bond – liability		HK$747 million
Cr Equity – conversion option		HK$53 million

<u>Answer 4(b)</u>

Carrying amount of the financial liability component of the CB at 1 April 2010:
HK$[(747 million x 1.08) - (800 million x 6%)] x [1 + (0.08 x 4/12)]

= HK$(806.76 – 48) million x 1.027
= HK$779 million

Journal entries for the conversion of CB into shares on 1 April 2010:

Dr Convertible Bond – liability	HK$779 million	
Dr Equity – conversion option	HK$53 million	
Cr Share capital		HK$100 million
Cr Share premium		HK$732 million

Answer 4(c)

HKAS 39 requires an entity to measure the financial liability at fair value, plus transaction costs that are directly attributable to the issue of the financial liabilities, at initial recognition.

Estimation of the fair value of the interest-free loan of HK$500 million based on the effective interest rate of other borrowings of AML, i.e. 6%:
HK$500 million / 1.06^2 = HK$445 million

The journal entries for the recognition of the interest-free loan on 1 April 2010:

Dr	Bank or Cash	HK$500 million
	Cr Loan from a shareholder	HK$445 million
	Cr Equity - contribution from a shareholder	HK$55 million

Answer 5

CML did not have public accountability as it was not an issuer of securities and it was not in the process of issuing publicly traded equity or debt securities.

In terms of size test, CML met the following two quantitative conditions:

- The entity had no revenue, i.e. annual revenue did not exceed HK$50 million, for the year.

- The entity did not have assets in excess of HK$50 million at 31 December 2009.

  Under SME-FRS s.4 *Intangible asset*, an intangible asset arising from development phase of an internal project should be recognised if, and only if, an entity can demonstrate all the conditions set out in 4.7 are fulfilled.

  One of these conditions is the technical feasibility of completing the intangible asset so that it will be available for use or sale. Based on the information stated, CML did not demonstrate that this condition has been met. Accordingly, the HK$28 million expenditure cannot be recognised as an intangible asset, but charged to profit or loss.

  As a result, the total assets of CML at 31 December 2009 was estimated to be approximately HK$37 million [= 60 – (28 – 5) million].

Provided that both shareholders of CML agree to prepare the financial statements in accordance with the SME-FRS, CML qualifies for reporting under the SME-FRS for the year ended 31 December 2009.

* * * END OF EXAMINATION PAPER * * *