

Fundamentals Level – Skills Module

# Financial Reporting (Hong Kong)

Wednesday 13 June 2012



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

**Do NOT open this paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

Paper F7 (HKG)

**ACCA**

**ALL FIVE questions are compulsory and MUST be attempted**

- 1 On 1 April 2011, Pyramid acquired 80% of Square's equity shares by means of an immediate share exchange and a cash payment of 88 cents per acquired share, deferred until 1 April 2012. Pyramid has recorded the share exchange, but not the cash consideration. Pyramid's cost of capital is 10% per annum.

The summarised statements of financial position of the two companies as at 31 March 2012 are:

	Pyramid \$'000	Square \$'000
<b>Assets</b>		
Non-current assets		
Property, plant and equipment	38,100	28,500
Investments – Square	24,000	
– Cube at cost (note (iv))	6,000	
– Loan notes (note (ii))	2,500	
– Other equity (note (v))	2,000	nil
	72,600	28,500
Current assets		
Inventory (note (iii))	13,900	10,400
Trade receivables (note (iii))	11,400	5,500
Bank (note (iii))	900	600
	98,800	45,000
<b>Equity and liabilities</b>		
Equity		
Equity shares of \$1 each	25,000	10,000
Share premium	17,600	nil
Retained earnings – at 1 April 2011	16,200	18,000
– for year ended 31 March 2012	14,000	8,000
	72,800	36,000
Non-current liabilities		
11% loan notes (note (ii))	12,000	4,000
Deferred tax	4,500	nil
Current liabilities (note (iii))	9,500	5,000
	98,800	45,000

The following information is relevant:

- (i) At the date of acquisition, Pyramid conducted a fair value exercise on Square's net assets which were equal to their carrying amounts with the following exceptions:
- An item of plant had a fair value of \$3 million above its carrying amount. At the date of acquisition it had a remaining life of five years. Ignore deferred tax relating to this fair value.
  - Square had an unrecorded deferred tax liability of \$1 million, which was unchanged as at 31 March 2012.
- Pyramid's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose a share price for Square of \$3.50 each is representative of the fair value of the shares held by the non-controlling interest.
- (ii) Immediately after the acquisition, Square issued \$4 million of 11% loan notes, \$2.5 million of which were bought by Pyramid. All interest due on the loan notes as at 31 March 2012 has been paid and received.

- (iii) Pyramid sells goods to Square at cost plus 50%. Below is a summary of the recorded activities for the year ended 31 March 2012 and balances as at 31 March 2012:

	Pyramid \$'000	Square \$'000
Sales to Square	16,000	
Purchases from Pyramid		14,500
Included in Pyramid's receivables	4,400	
Included in Square's payables		1,700

On 26 March 2012, Pyramid sold and despatched goods to Square, which Square did not record until they were received on 2 April 2012. Square's inventory was counted on 31 March 2012 and does not include any goods purchased from Pyramid.

On 27 March 2012, Square remitted to Pyramid a cash payment which was not received by Pyramid until 4 April 2012. This payment accounted for the remaining difference on the current accounts.

- (iv) Pyramid bought 1.5 million shares in Cube on 1 October 2011; this represents a holding of 30% of Cube's equity. At 31 March 2012, Cube's retained profits had increased by \$2 million over their value at 1 October 2011. Pyramid uses equity accounting in its consolidated financial statements for its investment in Cube.
- (v) The other equity investments of Pyramid are carried at their fair values on 1 April 2011. At 31 March 2012, these had increased to \$2.8 million.
- (vi) There were no impairment losses within the group during the year ended 31 March 2012.

**Required:**

**Prepare the consolidated statement of financial position for Pyramid as at 31 March 2012.**

**(25 marks)**

2 The following trial balance relates to Fresco at 31 March 2012:

	\$'000	\$'000
Equity shares of 50 cents each (note (i))		45,000
Share premium (note (i))		5,000
Retained earnings at 1 April 2011		5,100
Leased property (12 years) – at cost (note (ii))	48,000	
Plant and equipment – at cost (note (ii))	47,500	
Accumulated amortisation of leased property at 1 April 2011		16,000
Accumulated depreciation of plant and equipment at 1 April 2011		33,500
Inventory at 31 March 2012	25,200	
Trade receivables (note (iii))	28,500	
Bank		1,400
Deferred tax (note (iv))		3,200
Trade payables		27,300
Revenue		350,000
Cost of sales	298,700	
Lease payments (note (ii))	8,000	
Distribution costs	16,100	
Administrative expenses	26,900	
Bank interest	300	
Current tax (note (iv))	800	
Suspense account (note (i))		13,500
	500,000	500,000

The following notes are relevant:

- (i) The suspense account represents the corresponding credit for cash received for a fully subscribed rights issue of equity shares made on 1 January 2012. The terms of the share issue were one new share for every five held at a price of 75 cents each. The price of the company's equity shares immediately before the issue was \$1.20 each.
- (ii) Non-current assets:
- To reflect a marked increase in property prices, Fresco decided to revalue its leased property on 1 April 2011. The Directors accepted the report of an independent surveyor who valued the leased property at \$36 million on that date. Fresco has not yet recorded the revaluation. The remaining life of the leased property is eight years at the date of the revaluation. Fresco makes an annual transfer to retained profits to reflect the realisation of the revaluation reserve. In Fresco's tax jurisdiction the revaluation does not give rise to a deferred tax liability.
- On 1 April 2011, Fresco acquired an item of plant under a finance lease agreement that had an implicit finance cost of 10% per annum. The lease payments in the trial balance represent an initial deposit of \$2 million paid on 1 April 2011 and the first annual rental of \$6 million paid on 31 March 2012. The lease agreement requires further annual payments of \$6 million on 31 March each year for the next four years. Had the plant not been leased it would have cost \$25 million to purchase for cash.
- Plant and equipment (other than the leased plant) is depreciated at 20% per annum using the reducing balance method.
- No depreciation/amortisation has yet been charged on any non-current asset for the year ended 31 March 2012. Depreciation and amortisation are charged to cost of sales.
- (iii) In March 2012, Fresco's internal audit department discovered a fraud committed by the company's credit controller who did not return from a foreign business trip. The outcome of the fraud is that \$4 million of the company's trade receivables have been stolen by the credit controller and are not recoverable. Of this amount, \$1 million relates to the year ended 31 March 2011, and the remainder to the current year. Fresco is not insured against this fraud.
- (iv) Fresco's income tax calculation for the year ended 31 March 2012 shows a tax refund of \$2.4 million. The balance on current tax in the trial balance represents the under/over provision of the tax liability for the year ended 31 March 2011. At 31 March 2012, Fresco had taxable temporary differences of \$12 million (requiring a deferred tax liability). The income tax rate of Fresco is 25%.

**Required:**

- (a) (i) Prepare the statement of comprehensive income for Fresco for the year ended 31 March 2012.  
(ii) Prepare the statement of changes in equity for Fresco for the year ended 31 March 2012.  
(iii) Prepare the statement of financial position of Fresco as at 31 March 2012.

The following mark allocation is provided as guidance for this requirement:

- (i) 9 marks  
(ii) 5 marks  
(iii) 8 marks

(22 marks)

- (b) Calculate the basic earnings per share for Fresco for the year ended 31 March 2012.

(3 marks)

Notes to the financial statements are not required.

**(25 marks)**

- 3 (a) Tangier is a public listed company. Its summarised financial statements for the years ended 31 March 2012 and the comparative figures are shown below.

**Statements of comprehensive income for the year ended 31 March:**

	<b>2012</b>	<b>2011</b>
	<b>\$ m</b>	<b>\$ m</b>
Revenue	2,700	1,820
Cost of sales	(1,890)	(1,092)
Gross profit	810	728
Distribution costs	(230)	(130)
Administrative expenses	(345)	(200)
Finance costs	(40)	(5)
Profit before tax	195	393
Income tax expense	(60)	(113)
Profit for the year	135	280
Other comprehensive income	80	nil
Total comprehensive income	215	280

**Statements of financial position as at 31 March:**

	<b>2012</b>		<b>2011</b>	
	<b>\$ m</b>	<b>\$ m</b>	<b>\$ m</b>	<b>\$ m</b>
<b>Assets</b>				
Non-current assets				
Property, plant and equipment		680		410
Intangible asset: manufacturing licence		300		200
Investment at cost: shares in Raremetal		230		nil
		1,210		610
Current assets				
Inventory	200		110	
Trade receivables	195		75	
Bank	nil	395	120	305
Total assets		1,605		915
<b>Equity and liabilities</b>				
Equity				
Equity shares of \$1 each		350		250
Reserves				
Revaluation		80		nil
Retained earnings		375		295
		805		545
Non-current liabilities				
5% loan notes	100		100	
10% secured loan notes	300	400	nil	100
Current liabilities				
Bank overdraft	110		nil	
Trade payables	210		160	
Current tax payable	80	400	110	270
Total equity and liabilities		1,605		915

The following information is relevant:

Depreciation/amortisation charges for the year ended 31 March 2012 were:

	\$ m
Property, plant and equipment	115
Intangible asset: manufacturing licence	25

There were no sales of non-current assets during the year, although property has been revalued.

**Required:**

**Prepare the statement of cash flows for the year ended 31 March 2012 for Tangier in accordance with the indirect method in accordance with HKAS 7 *Statement of cash flows*.** (11 marks)

(b) The following additional information has been obtained in relation to the operations of Tangier for the year ended 31 March 2012:

- (i) On 1 June 2011, Tangier won a tender for a new contract to supply Jetside with aircraft engines that Tangier manufactures under a recently-acquired licence. The bidding process was very competitive and Tangier had to increase its manufacturing capacity to fulfil the contract.
- (ii) Tangier also decided to invest in Raremetal by acquiring 8% of its equity shares in order to secure supplies of specialised materials used in the manufacture of the engines. No dividends were received from Raremetal nor had the value of its shares changed since acquisition.
- (iii) Tangier revalued its property during the year to facilitate the issue of the 10% loan notes.

On seeing the results for the first time, one of the company's non-executive directors is disappointed by the current year's performance.

**Required:**

**Explain how the new contract and its related costs may have affected Tangier's operating performance, identifying any further information that may be useful to your answer.**

Your answer may be supported by appropriate ratios (up to 4 marks available), but ratios and analysis of working capital are not required. (14 marks)

**(25 marks)**

- 4 (a) The objective of HKAS 36 *Impairment of assets* is to prescribe the procedures that an entity applies to ensure that its assets are not impaired.

**Required:**

**Explain what is meant by an impairment review. Your answer should include reference to assets that may form a cash generating unit.**

**Note: you are NOT required to describe the indicators of an impairment or how impairment losses are allocated against assets.** (4 marks)

- (b) (i) Telepath acquired an item of plant at a cost of \$800,000 on 1 April 2010 that is used to produce and package pharmaceutical pills. The plant had an estimated residual value of \$50,000 and an estimated life of five years, neither of which has changed. Telepath uses straight-line depreciation. On 31 March 2012, Telepath was informed by a major customer (who buys products produced by the plant) that it would no longer be placing orders with Telepath. Even before this information was known, Telepath had been having difficulty finding work for this plant. It now estimates that net cash inflows earned from the plant for the next three years will be:

	\$'000
year ended: 31 March 2013	220
31 March 2014	180
31 March 2015	170

On 31 March 2015, the plant is still expected to be sold for its estimated realisable value.

Telepath has confirmed that there is no market in which to sell the plant at 31 March 2012.

Telepath's cost of capital is 10% and the following values should be used:

value of \$1 at:	\$
end of year 1	0.91
end of year 2	0.83
end of year 3	0.75

- (ii) Telepath owned a 100% subsidiary, Tilda, that is treated as a cash generating unit. On 31 March 2012, there was an industrial accident (a gas explosion) that caused damage to some of Tilda's plant. The assets of Tilda immediately before the accident were:

	\$'000
Goodwill	1,800
Patent	1,200
Factory building	4,000
Plant	3,500
Receivables and cash	1,500
	12,000

As a result of the accident, the recoverable amount of Tilda is \$6.7 million

The explosion destroyed (to the point of no further use) an item of plant that had a carrying amount of \$500,000.

Tilda has an open offer from a competitor of \$1 million for its patent. The receivables and cash are already stated at their fair values less costs to sell (net realisable values).



**Required:**

**Calculate the carrying amounts of the assets in (i) and (ii) above at 31 March 2012 after applying any impairment losses.**

Calculations should be to the nearest \$1,000.

The following mark allocation is provided as guidance for this requirement:

(i) 4 marks

(ii) 7 marks

(11 marks)

**(15 marks)**

- 5 (a) The methods by which Accounting Standards are developed differ considerably throughout the world. It is often argued that there are two main systems of regulation that determine the nature of Accounting Standards: a rules-based system and a principles-based system.

**Required:**

**Briefly explain the difference between the two systems and state which system you believe is most descriptive of Hong Kong Financial Reporting Standards (HKFRS).** (4 marks)

- (b) Baxen is a public listed company that currently uses local Accounting Standards for its financial reporting. The board of directors of Baxen is considering the adoption of Hong Kong Financial Reporting Standards (HKFRS) in the near future. The company has ambitious growth plans which involve extensive trading with many foreign companies and the possibility of acquiring at least one of its trading partners as a subsidiary in the near future.

**Required:**

**Identify the advantages that Baxen could gain by adopting HKFRS for its financial reporting purposes.** (6 marks)

**(10 marks)**

**End of Question Paper**