ANSWERS

CHAPTER 1

Activities

1. The possible conflict arises because neutrality encompasses freedom from bias, whereas prudence requires the exercise of management's judgement that is likely to result in a bias in the reported financial position and financial performance.

   In resolving the conflict, a balance or compromise should be made so that assets and liabilities as well as income and expenses would not be overstated or understated.

2. Training expenses are not likely to meet the control criterion of an asset definition. Since the entity would find it impossible to have absolute control over the future economic benefits arising from staff training, training expenses should not be recognised as an asset. Instead, they should be expensed when incurred.

Work Them Out

1. C	2. C	3. B	4. B	5. B	6. A	7. C	8. A	9. C	10. D

Short Questions

1.

(a) (i) Under the accrual basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

For example, rent due but not yet paid is recognised as an expense of the period to which it relates and is set off against revenue for the same period.

(ii) Information is material if its omission or misstatement could influence the economic decisions that users make on the basis of the financial statements.

For example, the amount of an inventory write-down through obsolescence should only be disclosed separately in financial statements if material.

(b) To be useful, information must be relevant to the decision-making needs of users. Information is relevant when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirms, or corrects, their past evaluations.

2. The main advantages of historical cost are readily available measurement, objectivity and verifiability.

   Two circumstances under which the historical cost is combined with other measurement bases are:
   - inventories are measured at the lower of (historical) cost and net realisable value
   - marketable securities may be carried at market value.

Long Question

1.

(a) In order to be useful, information contained in financial statements must be relevant and reliable. If information is to represent faithfully the transactions and other events that it purports to represent, the information must be accounted for and presented in accordance with its substance and economic reality and not merely its legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the risks and rewards normally associated with ownership of the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into.

If the substance of transactions is not recorded, the financial statements would not represent faithfully the transactions and other events that had occurred. Although there are many instances where there are genuine commercial reasons for contracts and transactions adopting the legal form that they do (e.g. to create a secure legal title to assets), equally the legal form is often used to achieve less desirable purposes. In general these amount to manipulating the financial statements to create a favourable impression. The typical outcomes of such manipulation are:
- the omission of assets, and particularly liabilities, from the statement of financial position
- improvement to profit and profit smoothing
- improvement of other performance measures such as earnings per share, liquidity ratios, profitability ratios and capital structure ratio

(b) The principal qualitative characteristics are understandability, relevance, reliability, and comparability.

Understandability: An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded on the grounds that it may be too difficult for certain users to understand.

Relevance: To be useful, information must be relevant to users' decision-making needs. Information has the quality of relevance when it helps users to evaluate past, present or future events, or confirms or corrects past evaluations.

Reliability: Information is reliable when it is free from material error and bias and can be depended upon to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Comparability: Users should be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users should also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effect of like transactions and other events should be carried out in a consistent way throughout an entities and over time for that entity, and in a consistent way for different entities.

CHAPTER 2

Activities

1. The receivable is due 13 months after the end of the reporting period (31 December 20X7). The receivable is a non-current asset because:
   • It is not cash or a cash equivalent.
   • It is not expected to be realised or consumed in the entity's normal operating cycle.
   • It is not held for the purpose of trading.
   • It is not expected to be realised within 12 months after the reporting period.

2.

Depreciation of	Function
Vehicles A, B ($200,000)	Cost of sales
Vehicles C, D ($160,000)	Cost of sales
Vehicles E, F ($80,000)	Distribution costs
Vehicle G ($40,000)	Distribution costs
Vehicle H ($20,000)	Administrative expenses

Work Them Out

1. C	2. B	3. C	4. D	5. D	6. A	7. C	8. C	9. B	10. C

Short Questions

1.

Unix Ltd
Statement of Financial Position at 31 December 20X9

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment [$5,000 – ($1,000 + $500 (W1))]	3,500
Current assets	
Inventory	4,000
Trade receivables ($3,400 – $550)	2,850
Total current assets	6,850
Total assets	10,350
EQUITY AND LIABILITIES	
Equity	
Ordinary shares at 50 cents each ($1,000 + 1,000 x $0.50)	1,500
Share premium ($400 + 1,000 x $0.10)	500
Retained earnings [$7,200 – $500 (W1)]	6,700
Total equity	8,700

Non-current liabilities	
8% Debentures	500
Current liabilities	
Trade and other payables	900
Bank overdrafts	100
Tax provision	150
Total current liabilities	1,150
Total liabilities	1,650
Total equity and liabilities	10,350

Working:
(W1) Depreciation = $500,000 ($5,000,000 x 10%)

2.
(a) Valuation on 1 January 20X8:

			$'000	$'000
Dr.	Accumulated depreciation		30,000	
Dr.	Leasehold property (30 years)		30,000	
	Cr.	Revaluation reserve		60,000
To record the revaluation of the leasehold property.				
Dr.	Accumulated depreciation		9,000	
Dr.	Revaluation reserve		6,000	
	Cr.	Leasehold property (15 years)		15,000
To record the revaluation of the leasehold property.				
Dr.	Accumulated depreciation		6,000	
Dr.	Investment property			2,500
	Cr.	Investment property gains		8,500
To record gain on changes in fair value of the investment property.				
<u>Valuation On 31 December 20X8</u>				
Dr.	Accumulated depreciation (W1)		6,000	
Dr.	Leasehold property (30 years)		5,000	
	Cr.	Revaluation reserve		11,000
To record the revaluation of the leasehold property.				
Dr.	Accumulated depreciation (W2)		2,500	
Dr.	Leasehold property (15 years)		7,000	
	Cr.	Revaluation reserve		9,500
To record the revaluation of the leasehold property.				
Dr.	Investment property losses		1,000	
	Cr	Investment property		1,000
To record the loss on changes in fair value of the investment property.				

(b)

Clone Ltd
Statement of Comprehensive Income
for the year ended 31 December 20X8

	$'000
Revenue	125,000
Cost of sales [$77,500 + $6,000 (W1) + $2,500 (W2) + $9,600 (W3)]	(95,600)
Gross profit	29,400
Other income – Gain on changes in fair value of investment property ($8,500 – $1,000)	7,500
Administrative expenses	(13,350)
Distribution costs	(3,500)
Finance costs	(1,250)
Profit before tax	18,800
Income tax expense ($18,800 x 30%)	(5,640)
Profit for the year	13,160
Other comprehensive income for the year	
Gains on revaluation of leasehold properties ($60,000 + $11,000) + (–$6,000 + $9,500)	74,500
Total comprehensive income for the year	87,660

Clone Ltd
Statement of Financial Position at 31 December 20X8

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment ($21,500 + $125,000 + $37,000 + $54,400 (W4))	237,900
Current assets	
Inventory	10,500
Trade receivables	31,000
Cash and bank	1,850
Total current assets	43,350
Total assets	281,250
EQUITY AND LIABILITIES	
Equity	
Ordinary shares at 50 cents each ($45,000 + $22,500)	67,500
Retained earnings ($112,000 – $22,500 + $13,160)	102,660
Revaluation reserve	74,500
Total equity	244,660
Non-current liabilities	
Bank loan	10,000
Current liabilities	
Trade payables	20,500
Current tax payable ($450 + $5,640)	6,090
Total current liabilities	26,590
Total liabilities	36,590

Workings: ($'000)
(W1) $120,000 / 20 = $6,000
(W2) $30,000 / 12 = $2,500
(W3) ($120,000 – $41,000 – $15,000 government grant) x 15% = $9,600
(W4) $120,000 – $41,000 – $15,000 government grant – $9,600) = $54,400

Note: The declaration of the final dividend on 15 January 20X9 is a non-adjusting event after the reporting period at 31 December 20X8 (refer to Chapter 4). Dividends declared after the reporting period but before the financial statements are authorised for issue are disclosed in the notes in accordance with HKAS 1.

Long Question

1.

Apple Tree Ltd
Statement of Comprehensive Income
for the year ended 31 December 20X8

	$
Revenue ($12,930,000 – $96,600)	12,833,400
Cost of sales [$8,330,000 – $92,500 + $256,668 (W7)]	(8,494,168)
Gross profit	4,339,232
Other income [$160,000 (dividends received) + $60,000 (gain on disposal)]	220,000
Administrative expenses [$2,252,000 + $360,000 (W1) + $186,000 (W1)]	(2,798,000)
Distribution costs	(1,338,000)
Other expenses (research and development expenditure)	(830,000)
Finance costs (W2)	(2,415)
Loss for the year	(409,183)
Other comprehensive income for the year	
Gains on revaluation of property, plant and equipment (W3)	1,760,000
Total comprehensive income for the year	1,350,817

Apple Tree Ltd
Statement of Financial Position at 31 December 20X8

	$
ASSETS	
Non-current assets	
Property, plant and equipment (W4)	8,664,000
Current assets	
Inventory ($1,846,000 + $92,500)	1,938,500
Trade receivables ($1,090,000 – $150,000)	940,000
Cash and bank	1,842,000
Total current assets	4,720,500
Total assets	13,384,500
EQUITY AND LIABILITIES	
Equity	
Ordinary shares at 50 cents each	9,000,000
Share premium	1,000,000
Retained earnings (W5)	126,817
Revaluation reserve ($340,000 – $110,000 (W6) + $1,760,000)	1,990,000
Total equity	12,116,817
Current liabilities	
Trade and other payables [$860,000 + accrued interest $2,415 (W2)]	862,415
Loan under sale and repurchase	96,600
Provision for warranties (W7)	256,668
Tax provision	52,000
Total current liabilities	1,267,683
Total liabilities	1,267,683
Total equity and liabilities	13,384,500

Workings:

(W1) Depreciation:

Plant and machinery	$3,600,000 x 10% = $360,000
Furniture and fittings	$1,240,000 x 15% = $186,000

(W2) Finance costs:
Calculation of interest rate: $106,260 / $96,600 = 1.1
Interest rate is therefore 10%
Interest expense for the year ended 31 December 20X8
= $96,600 x 10% x 3/12 = $2,415

(W3) Revaluation surplus:
Revaluation of plant and machinery at 31 December 20X8

Dr. Accumulated depreciation	$1,440,000	
Dr. Plant and machinery	320,000	
Cr. Revaluation reserve		$1,760,000

(W4) Property, plant and equipment:

Freehold land	$4,410,000 ($4,800,000 – $390,000)
Plant and machinery	3,920,000
Furniture and fittings	334,000 ($1,240,000 – $906,000)
	8,664,000

(W5) Retained earnings:

Opening balance	$976,000
Less: Interim dividends paid	(400,000)
Bad debts	(150,000)
Loss for the year	(409,183)
	16,817
Add: Realisation of revaluation surplus	110,000 (W6)
	126,817

(W6) Realisation of revaluation surplus on disposal of freehold land
$390,000 – $280,000 = $110,000

CHAPTER 3

Activities

1. The application of a new accounting policy in respect of the sale and leaseback transaction for the first time is not a change in accounting policy because the event (i.e. sale and leaseback) did not occur in prior periods.

2. Estimates are required in the financial statements, for example, of:
   - allowance for bad debts
   - inventory obsolescence
   - the fair value of assets
   - the useful lives of depreciable assets
   - warranty obligations

Work Them Out

1. B	2. A	3. A	4. C	5. B	6. B	7. C	8. C	9. B	10. D

Short Questions

1. The entity must apply the voluntary change in accounting policy retrospectively. The effect of the change in accounting policy should be presented as a restatement of retained earnings at 1 January 20X8 — decreased by $660,000; and profit for the year ended 31 December 20X8 decreased by $220,000. The cumulative effect of these restatements is an $880,000 decrease of restatement of retained earnings at 1 January 20X9 (the beginning of the current reporting period).

2. This is a prior period error since the bad debts provision should have been made in 20X8 financial statements. The effect of correcting the prior period error is presented as a restatement of profit for the year ended 31 December 20X8 — decreased by $150,000, and a decrease of $150,000 in the restatement of balance of retained earnings at 1 January 20X9 (the beginning of the current reporting period).

Long Question

1. Errors may be related to the recognition, measurement, presentation or disclosure of elements of financial statements. Omissions or misstatements of items are regarded as material errors if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

   In the case of Poka Ltd, errors in the preparation of the financial statements of prior periods have been discovered in the current period. This is an error in accounting treatment arising from the failure to write down the cost of inventories to net realisable value because the company failed to comply with HKAS 2 in prior periods. As the amounts are material (the cumulative effect of the errors amounts to 184% [($1,140,000 – $1,048,000) ÷$50,000] of profit for the year), the errors could affect the economic decisions that users make on the basis of the financial statements.
   HKAS 8 requires that the prior period errors be corrected in the comparative information presented in the financial statements for the current period, unless it is impracticable to do so. Accordingly, Poka Ltd is required to:
   - restate the amount of inventories and cost of sales for the year ended 31 December 20X8, comparative information presented
   - restate the opening balance of retained earnings at 1 January 20X8.

   In addition, Poka Ltd is required to disclose the following:
   - the nature of the prior period error
   - for each prior period presented, to the extent practicable, the amount of the correction for each prior period presented, for each financial statement line item affected and basic and diluted earnings per share, if applicable
   - the amount of the correction at the beginning of the earliest prior period presented
   - if retrospective restatement is impracticable for a particular period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected

CHAPTER 4

Activities

1. The event — settlement of the litigation claim — is an adjusting event after the reporting period. It provides additional evidence that the entity has a valid receivable from the competitor at 31 December 20X8.

2. The event — discovery of material error on prior period's inventory value — is an adjusting event after the reporting period. The entity's 20X8 financial statements need to be restated to correct this error in accordance with HKAS 8.

Work Them Out

1. C	2. A	3. C	4. B	5. C	6. A	7. A	8. B	9. B	10. B

Short Questions

1. Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

   There are two circumstances where events occurring after the reporting period are relevant to the current year's financial statements:
   • Adjusting events provide additional evidence of conditions that existed at the end of the reporting period.
   • Non-adjusting events are indicative of conditions that arose after the end of the reporting period.

2. Both events after the end of the reporting period are material.

(a) Under HKAS 2, the principle of using the lower of cost or net realisable value requires a write-down of the value of the goods by 40 per cent ($400,000 × 40 per cent = $160,000). The following adjusting entries are required:

Dr.	Inventory loss	$160,000	
	Cr. Inventory		$160,000

(b) The plant's asset was sold after the end of the reporting period and resulted in a loss of $200,000. The loss was as a result of the under-depreciation of the asset in all periods up to the date of disposal. HKAS 16 requires regular review of asset lives and the adequacy of depreciation provided in order for the cost or value of the asset to be fairly allocated to each period that has benefited from the use of the asset.

HKAS 10 also lists the disposal of non-current assets after the end of the reporting period as a non-adjusting event. Therefore, no adjustment is required to the plant asset's value at 31 December 20X8. Since the effect is material, disclosure is necessary for the nature and amount of the loss.

Long Question

1.

(a) Despite having no legal obligation to remove the pollutants from the river, the company has publicised its environmental policy. There is an expectation from third parties that the company will honour its commitment to clean up the area, and as a result, there is a constructive obligation. Further, the amount to be incurred for the clean up has been estimated to be $20 million by a consultant. Therefore, a provision should be made.

Dr.	Pollution costs	$20m	
	Cr. Provision for pollution clean-up		$20m

(b) On the date when the details of the restructuring and redundancy package was communicated to the staff concerned, a constructive obligation was created as the company has to honour all the compensation details as made known. Since the event occurred before the year-end date, a provision for the compensation payment has to be made.

Dr.	Redundancy expenses	$6m	
	Cr. Provision for redundancy		$6m

(c) The burglary occurred after the year-end. This is a material event occurring after the end of the reporting period but before the financial statements were authorised for issue. Thus, it is a non-adjusting event after the reporting period. In view of the materiality of the loss, the company has to disclose the event in the notes to the financial statements.

Event after the reporting period
After the year-end date, a burglary took place resulting in the loss of inventory with an approximate value of $26 million. The incident has been reported to the police. An estimated 50 per cent of the loss can be covered by insurance.

(d) Star Link Ltd was sued for infringement of copyright after year-end. This is a material event occurring after the end of the reporting period but before the financial statements were authorised for issue. Thus, it is a non-adjusting event after the reporting period. In view of the materiality of the potential financial loss, the company has to disclose the event in the notes to the financial statements.

Event after the reporting period
After the year-end date, the company was sued by Queen Jewel Ltd for infringement of copyright and received compensation of $40 million. Lawyers advised that the company was unlikely to defend the case successfully.

(e) This is an adjusting event after the reporting period as the information gives further evidence regarding the recoverability of the outstanding debt at the end of the reporting period.

As the customer is in liquidation, there is a doubt of the recoverability of the debt and full provision has to be made against the amount of $10 million outstanding at year-end date.

The other amount of $8 million that represented the shipment after the year-end date relates to the transaction of the following financial year and would have no effect to the current year's financial statements. However, in view of the materiality of the amount, the company should disclose in the notes to the financial statements the incident.

Dr.	Bad debt expenses	$10m	
	Cr. Allowance for doubtful debts		$10m

Event after the reporting period
After the year-end date, the company was informed that one of its major customers, Giro Ltd, has commenced liquidation procedures. The company had made a shipment of $8 million to this customer after the year-end date. There is doubt as to the recoverability of this receivable. Further, full provision has been made against the debt owed by this customer at the year-end date, for a total amount of $10 million.

CHAPTER 5

Activities

1. The financial position and profit or loss of an entity may be affected by a related party relationship even if related party transactions do not occur. Two such situations could be:
   - when a subsidiary terminates relations with a trading partner on acquisition by the parent of a fellow subsidiary engaged in the same activity as the former trading partner
   - when a subsidiary is instructed by its parent not to engage in certain activities, e.g. research and development

2. Additional examples of transactions that are disclosed if they are with a related include:
   - transfers under licence agreements
   - transfers under finance arrangements
   - provision of guarantees or collateral
   - commitments to do something if a particular event occurs or does not occur in the future
   - settlement of liabilities on behalf of the entity or by the entity on behalf of that related party

Work Them Out

1. C	2. C	3. C	4. B	5. A	6. A	7. B	8. D	9. C	10. D

Short Questions

1. Related party relationships could have a significant effect on the financial position and profit or loss of an entity and lead to transactions that would not normally be undertaken.

   Even if transactions between related parties are at an arm's length, the disclosure of related party transactions is useful because it is likely that future transactions could be affected by such relationships.

   Examples:
   - A subsidiary may sell its specialised plant and machinery under special terms to its parent because it is difficult to find another buyer in the market.
   - A parent may lease equipment to a subsidiary on other than market rates for equivalent leases.
   - A parent may sell a large proportion of its inventory to its subsidiary in the event that it cannot find an alternative customer in the market.
   - Two entities in the same line of business may be controlled by a common party that has the ability to increase the volume of business done by each through the sales between them.
   - An associate may refrain from developing or producing a new product that competes with its investor because of the significant influence exerted by the investor.

2. All four companies are related parties of D Ltd (the reporting entity) because:
   - A Ltd has indirect significant influence over D Ltd through its subsidiary, B Ltd — D Ltd is an associate of A Ltd.
   - B Ltd has direct significant influence over D Ltd by virtue of 40 per cent shareholding — D Ltd is an associate of B Ltd.
   - C Ltd has direct significant influence over D Ltd by virtue of 25 per cent shareholding — D Ltd is an associate of C Ltd.
   - E Ltd is directly controlled by D Ltd by its 90 per cent shareholding — E Ltd is a subsidiary of D Ltd.

Long Question

1.

(a) (i) Between Sun Ltd and the other three companies in the group, Mar Ltd, Earth Ltd and Moon Ltd are all related parties of Sun Ltd for the following reasons:
- Mar Ltd and Earth Ltd are controlled by Sun Ltd because Sun Ltd holds 90 per cent of shares in Mar Ltd and 60 per cent of shares in Earth Ltd.
- Mar Ltd and Earth Ltd are under the common control of Sun Ltd because the directors of Sun Ltd are also the directors of Mar Ltd and Earth Ltd.
- Sun Ltd has significant influence over Moon Ltd because Sun Ltd holds 35 per cent of the shares in Moon Ltd.

(ii) Among Mar Ltd, Earth Ltd and Moon Ltd, Mar Ltd and Earth Ltd are related parties. However, these two companies may not be related parties of Moon Ltd for the following reasons:
- Mar Ltd and Earth Ltd are related parties because the directors (key management personnel) of Sun Ltd are also the directors of Mar Ltd and Earth Ltd Sun Ltd.
- Mar Ltd and Earth Ltd are not necessarily related parties of Moon Ltd because there is only one director in common. As a result, it would be difficult for that director to exert any significant influence on the four other directors.

(b) Jupitar Ltd is a related party of Mar Ltd as the director, Mr Lee, controls Jupitar Ltd through shareholdings and is a member of the key management personnel of Mar Ltd. Since the director acts as a consultant of the management board of the company, Mr Lee is considered to be a related party of Sun Ltd and Mar Ltd. Information regarding the relationship among Jupitar Ltd, Mr Lee, Sun Ltd and Mar Ltd should be disclosed in the consolidated financial statements in terms of how one party has control or significant influence over the other.

Based on the explanation above, Jupitar Ltd and Mar Ltd are related parties.

CHAPTER 6

Activities

1. Despite the consideration of the sale of the machine as receivable in instalments, the entity should recognise revenue attributable to the sales price, exclusive of interest, at the date of sale. The sales price (i.e. sales revenue to be recognised) is the present value of the consideration determined by discounting the instalments receivable at the imputed rate of interest. The entity also recognises the difference between the present value and the nominal amount of the instalments receivable, $62,000, as interest revenue using the effective interest method.

The journal entries to recognise the revenue from the instalment sale transaction should be as follows:

	$	$
1 January 20X7		
Dr. Cash	200,000	
Dr. Trade receivable	338,000	
Cr. Sales revenue		538,000
To recognise revenue from instalment sale of a machine.		
31 December 20X7		
Dr. Cash	200,000	
Cr. Trade receivable		178,600
Cr. Interest revenue (see working)		21,400
To record instalment received and recognise interest revenue.		
31 December 20X8		
Dr. Cash	200,000	
Cr. Trade receivable		159,400
Cr. Interest revenue (see working)		40,600
To record instalment received and recognise interest revenue.		

Working:

Date	**Instalment receivable $**	**Present value factor (12%)**	**Present value of instalment $**	**Interest $**
1 January 20X7	200,000	1.000	200,000	0
31 December 20X7	200,000	0.893	178,600	21,400
31 December 20X8	200,000	0.797	159,400	40,600
	600,000		538,000	62,000

2. The journal entries to recognise the revenue earned from the franchise in 20X8 and 20X9 are as follows:

	$	$
1 January 20X8		
Dr. Cash	210,000	
Cr. Franchise revenue		70,000
Cr. Unearned franchise revenue		140,000
To recognise the franchise revenue.		

1 January 20X8			
Dr. Cash		25,000	
Cr. Service fee revenue			25,000
To recognise the service fee revenue			
1 January 20X9			
Dr. Unearned franchise revenue		70,000	
Cr. Franchise revenue			70,000
To recognise the franchise revenue.			
1 January 20X9			
Dr. Cash		25,000	
Cr. Service fee revenue			25,000
To recognise the service fee revenue.			

Work Them Out

1. D	2. C	3. C	4. D	5. A	6. D	7. D	8. C	9. B	10. A

Short Questions

1. In accordance with the requirements of HKAS 18, revenue is normally recognised when the buyer accepts delivery, and installation and inspection are complete. In the case of Voky Ltd, 80 per cent of the sales invoice value (that is, the price of furniture and fixtures) should be recognised at the date of goods accepted by customers.

   However, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount of subsequent servicing should be deferred and recognised as revenue over the period during which the services are performed. The amount of deferred revenue is those which cover the expected costs of the services under the agreement, together with a reasonable profit on those services.

   In this case, 20 per cent of the sales invoice value should be recognised as revenue only when the furniture and fixtures have been successfully fitted at customers' premises.

   The existing accounting policy of recognising sales revenue only when the furniture had been successfully fitted is incorrect. The revenue for sale of the furniture is deferred and this will lead to incorrect understatement of revenue at the year-end.

   The proposed accounting policy to recognise sales revenue when customers order and pay for the furniture, rather than when they have been fitted, also does not meet the principle of revenue recognition as well as the accrual concept as well. To recognise the sales transaction on a cash basis will lead to a wrong cut-off and misstatement of revenue.

2. The sale to Cherry Ltd should not be recognised as a sale of goods in the books of Mango Ltd. This is because Mango Ltd will probably purchase these goods from Cherry Ltd at a higher price after one year. Hence, Mango Ltd has not transferred significant risks and rewards of ownership of the goods to Cherry Ltd.

   In substance, this transaction should be taken as a financing transaction, in which Mango Ltd has obtained finance from Cherry Ltd and in return, Mango Ltd delivered goods to Cherry Ltd as security of the loan. Therefore, Mango Ltd should recognise a loan of $96,600 as well as accrued interest in its books, and the sale of goods that have been recognised previously should be reversed.

Long Question

1. Calculation of revenue, cost of sales and gross profit:

	$
Revenue [$538,200 (Working 1) + $1,333,800 (Working 2)]	1,872,000
Cost of sales (Working 2)	(1,111,500)
Gross profit	760,500

Working 1: Grade A bags

	$
Bags at store, at 30 June 20X8	312,000
Bags from Popo for the year ended 30 June 20X9	2,340,000
	2,652,000
Bags at store, at 30 June 20X9	(260,000)
Sales, at cost price	2,392,000

Sales, at selling price [$2,392,000 x (1 + 50%)]	3,588,000
	x 15%
Commission revenue	538,200

Working 2: Grade B bags

	$
Beginning inventory	130,000
Add: Purchases during the year	1,144,000
	1,274,000
Less: Closing inventory	(162,500)
Cost of sales	1,111,500
Sales value [$1,111,500 x (1 + 20%)]	1,333,800

The rationales for the calculation are as follows:

Revenue From Grade A Bags
Revenue from such sales is generally recognised when the risks and rewards of ownership have passed to the buyer. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale. Sales of the Grade A bags are made by Crab Ltd acting as an agent of Popo. In an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and these inflows of economic benefits do not result in an increase in equity for the entity.

When Crab Ltd sells goods acting as an agent, these sales should not be treated as sales through the agent; rather, it should be treated as amounts collected on behalf of the principal. Therefore, only the commission (15% on sales value) from the sales of Grade A bags is revenue of Crab Ltd in the capacity of the agent of Popo.

Revenue From Grade B Bags
Revenue from the sale of goods should be recognised when the entity has transferred the significant risks and rewards of ownership of the goods to the buyer. Revenue includes only the gross inflows of economic benefits received and receivable by the entity arising in the course of its ordinary activities when those inflows result in an increase in equity.

Sales of the Grade B bags are made by Crab Ltd in the capacity of a principal, not an agent. In this case, Popo Ltd had transferred the risks and rewards of ownership of the Grade B bags to Crab Ltd at the time of sale of goods to Crab Ltd. Therefore, the sales revenue of Grade B bags should be recognised in the books of Crab Ltd when these bags are sold to customers. These sales will be included in revenue with their costs included in cost of sales.

CHAPTER 7

Activities

1. Costs that could be charged to a specific contract include:
   - site labour costs
   - costs of materials used in construction
   - depreciation of plant and equipment used on the contract
   - costs of moving plant, equipment and materials to and from the contract site
   - costs of hiring plant and equipment
   - costs of design and technical assistance that is directly related to the contract
   - the estimated costs of rectification and guarantee work, including expected warranty costs
   - claims from third parties

2. Stage of completion at 31 December 20X9

$$= \frac{\text{Costs incurred for work performed to date}}{\text{Total estimated costs}}$$

$$= \frac{\$21 \text{ million}}{(\$21 \text{ million} + \$9 \text{ million})}$$

$$= 70\%$$

The contractor should recognise in its statement of comprehensive income a revenue of $28 million ($40 million x 70%) and expenses of $21 million for the year ended 31 December 20X9.

Work Them Out

1. B	2. D	3. B	4. B	5. A	6. C	7. D	8. D	9. C	10. C

Short Questions

1.

(a)

	20X7	20X8	20X9
	$'000	**$'000**	**$'000**
Costs incurred to date	1,296	2,850[*]	3,825
Estimated costs to complete	2,304	900[**]	0
Total estimated costs	3,600	3,750	3,825

[*]$3,000,000 costs incurred less $150,000 that relate to 20X9

[**]$750,000 + $150,000

	20X7	20X8	20X9
Stage of completion at 31 December	36%	76%	100%
(20X7: $1,296,000/$2,600,000)			
(20X8: $2,850,000/$3,750,000)			

(b)

	20X7	**20X8**	**20X9**
	$'000	**$'000**	**$'000**
Contract price	4,500	4,800	4,800
Stage of completion at 31 December	36%	76%	100%
Total contract revenue recognised at 31 December	1,620	3,648	4,800

(c)

	To date	**Recognised in prior years**	**Recognised in current year**
	$'000	**$'000**	**$'000**
20X7			
Revenue	1,620	–	1,620
Expenses	1,296	–	1,296
Profit	324	–	324
20X8			
Revenue	3,648	1,620	2,028
Expenses	2,850	1,296	1,554
Profit	798	324	474
20X9			
Revenue	4,820	3,648	1,152
Expenses	3,825	2,850	975
Profit	975	798	177

2.

(a)

	1 October 20X8 (a)	30 September 20X9 (b)		(b) – (a)
	$'000	**$'000**		**$'000**
Sales	1,350	1,980	(W1)	630
Cost of sales	(1,008)	(1,584)	(W2)	(576)
Rectification costs	0	(153)		(153)
Profit / (Loss)	342	243		(99)

Hence, the loss of $99,000 is to be recognised related to the construction contract for the year ended 30 September 20X9.

Workings:

(W1)

	$'000
Sales value up to 30 August 20X9 ($1,620 x 100/90)	1,800
Estimated sales value of the further work completed during 30 September 20X9	180
Total sales value up to 30 September 20X9	1,980

(W2)

	$'000
Contract price	2,700
Less: Total costs incurred to 30 September 20X9	(1,755)
Less: Estimated costs to complete	(405)
Estimated profit	540

(W3)

	$'000
Total sales value up to 30 September 20X9	1,980
Less: Profit recognised to date [$540 (W2) × $1,980/$2,700]	(396)
Total cost of sales up to 30 September 20X9	1,584

(b)

	$'000
Total costs incurred to 30 September 20X9	1,755
Add: Rectification costs	153
Add: Recognised profit	243
	2,151
Less: Progress billings	(1,620)
Gross amounts due from customers at 30 September 20X9	531

Long Question

1.

Hope Consulting Ltd
Statement of Comprehensive Income for the year ended 31 December 20X8

	20X8 $'m	20X7 $'m
Contract revenue recognised (W2)	24.5	22.5
Contract expenses recognised (W3)	(30)	(20)
Expected loss recognised (W2)	(3)	–
Contract profit (loss)	(8.5)	2.5

Hope Consulting Ltd
Statement of Financial Position at 31 December 20X8

	20X8 $'m	20X7 $'m
Current assets		
Contract receivable (retention)	2	–
Contract costs related to future activity	3	–
Gross amounts due from customers for contract work (W3)	5	–
Current liabilities		
Gross amounts due to customers for contract work (W3)	–	1.5

Workings:

	20X8 $'m	20X7 $'m
(W1) Stage of completion	$\frac{(53 - 3)}{100}$ = 50%	$\frac{20}{80}$ = 25%

(W2) Recognised profit/loss to date

	20X8	20X7
Revenue to date (20X8: $94m x 50%; 20X7: $90m x 25%)	47	22.5
Costs incurred to date	(50)	(20)
	(3)	2.5
Expected loss recognised (balancing figure)	(3)	–
Recognised profit (loss) to date	(6)	2.5

[20X8: ($90m + $4m) – ($80m + $20m)]
Revenue recognised for 20X8: $47m – $22.5m = $24.5m

(W3) Gross amounts due from (to) customers for contract work

Contract costs incurred	50	20
Recognised profit (loss) to date (W2)	(6)	2.5
	44	22.5
Less: Progress billings	(39)	(24)
Gross amounts due from (to) customers for contract work	5	(1.5)

Contract expenses recognised for 20X8: \$50m – \$20m = \$30m

CHAPTER 8

Activities

1. The initial cost of the plant is determined as follows:

	$	$
Purchase price (\$420,000 – \$63,000)		357,000
Directly attributable costs		
Shipping and handling costs	4,500	
Installation costs	10,000	
Pre-production costs of testing	12,500	
Site preparation costs	29,000	
(\$21,000 – \$9,500) + \$6,250 + \$11,250		56,000
Dismantling and restoration costs		25,000
Cost of the plant		438,000

Note: The early settlement discount and maintenance costs are revenue items. The purchase taxes on the plant can be reclaimed by the entity. The cost of the specification error is charged to profit or loss as an expense.

2. The extracts to the entity's 20X9 financial statements are as follows:

Statement of Comprehensive Income
for the year ended 31 December 20X9

	$'000
Expenses	
Depreciation (\$2,500/25)	100
Other comprehensive income	
Gain on revaluation of building	900

Statement of Financial Position at 31 December 20X9

	$'000
Non-current assets	
Property, plant and equipment	
Building, at valuation	2,500
Less: Accumulated depreciation	(100)
	2,400
Equity	
Revaluation reserve [\$2,500 – (\$2,000 – \$400)]	900

Work Them Out

1. D	2. B	3. A	4. C	5. B	6. D	7. C	8. A	9. A	10. C

Short Questions

1.

Description			$'000	$'000
Dr.	Accumulated depreciation — Building W		400	
Dr.	Building W		5,600	
	Cr.	Revaluation reserve — Building W [$14,000 – ($8,400 – $400)]		6,000
To recognise gain on revaluation of Building W at 31 December 20X9.				
Dr.	Accumulated depreciation — Building Z		800	
Dr.	Revaluation reserve — Building Z		700	
Dr.	Revaluation loss on buildings (profit or loss) {[$10,000 – ($12,800 – $800)] – $700}		1,300	
	Cr.	Building Z		2,800
To recognise loss on revaluation of Building Z at 31 December 20X9.				
Dr.	Plant and equipment ($10,000 x $16,000/$8,000 - $10,000)		10,000	
	Cr.	Accumulated depreciation – Plant and equipment ($2,000 x $16,000 / $8,000 – $2,000)		2,000
	Cr.	Revaluation reserve — Plant and equipment ($16,000 – $8,000)		8,000
To recognise gain on revaluation of plant and equipment at 31 December 20X9.				

2.

Heywood Ltd
Statement of Comprehensive Income (Extracts)
for the year ended 31 December

	20X8 **$**	**20X9** **$**
Expenses		
Depreciation	100,000	105,000
Loss on revaluation of building		125,000
Other comprehensive income		
(Gain) Loss on revaluation of building	(50,000)	50,000

Heywood Ltd
Statement of Financial Position (Extracts) at 31 December

	20X8 **$**	**20X9** **$**
Non-current assets		
Property, Plant and Equipment		
Buildings, at valuation (Working)	1,155,000	875,000
Equity		
Revaluation reserve		
Balance at 1 January 20X8 / 20X9	250,000	300,000
Revaluation surplus (Working)	55,000	
Balance at 31 December 20X8	305,000	
Transfer to retained profit ($55,000 x 1/11)	(5,000)	
Balance at 31 December 20X8 / 20X9	300,000	
Revaluation loss (Note)		(50,000)
Balance at 31 December 20X9		250,000

Working:

Cost 1 January 20X8	1,200,000
Depreciation for 20X8 ($1,200,000 / 12)	(100,000)
	1,100,000
Revaluation surplus	55,000
Carrying amount at 31 December 20X8	1,155,000
Depreciation for 20X9 ($1,155,000 / 11)	(105,000)
	1,050,000
Revaluation loss charged to revaluation reserve	(50,000)
Remaining loss recognised in profit or loss	(125,000)
Carrying amount at 31 December 20X9	875,000

Note: The revaluation loss on 31 December 20X9 of $175,000 ($1,050,000 – $875,000) is recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset, $50,000; any excess is recognised in profit or loss, $125,000 ($175,000 – $50,000).

Long Question

1.

(a) The initial cost of the plant is calculated as follows:

	$	$
Purchase price (net of trade discount): ($1,920,000 – $1,920,000 x 15%)		1,632,000
Directly attributable costs:		
Shipping costs and handling charges	22,000	
Costs of pre-production testing	100,000	122,000
Installation costs of electrical cable ($112,000 – $48,000)	64,000	
Costs of concrete reinforcement	36,000	
Labour costs allocated to site preparation	60,000	160,000
Initial estimate of dismantling and restoring costs ($120,000 + $24,000)		144,000
Cost of the plant		2,058,000

In accordance with HKAS 16, the initial cost of an item of property, plant and equipment includes the following:

- The purchase price should include any transport and handling costs and non-refundable purchase taxes; however, trade discounts and rebates should be deducted from it. If the payment is deferred beyond normal credit terms this should be taken into account either by the use of discounting or substituting a cash equivalent price.
- The directly attributable costs, which bring the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, include installation costs and site preparation costs and professional fees such as legal fees, architects' fees, etc.
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs when the item is acquired.

(b) After initial recognition as an asset, an item of property, plant and equipment should be measured by applying either the cost model or the revaluation model:

- **Cost model:** An item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
- **Revaluation model:** An item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

An entity allocates, on a systematic basis, the amount initially recognised, i.e. the depreciable amount of an item of property, plant and equipment over its useful life. The depreciation method used should reflect the pattern in which the asset's future economic benefits expected to be consumed by the entity.

If the recoverable amount of an item of property, plant and equipment is less than its carrying amount, the carrying amount of the property, plant and equipment should be reduced to its recoverable amount and that reduction is an impairment loss.

CHAPTER 9

Activities

1. SPK should measure the initial cost of the building on 1 January 20X9 at $19,718,519, being the present value of purchase price ($18,518,519 = $20,000,000 / (1 + 8%) plus directly attributable expenditure $1,200,000 = $1,000,000 + $200,000).

2. On 1 January 20X9 (the date of transfer), the owner-occupied property should be revalued to its fair value of $10 million, and the revaluation surplus of $2 million would be recognised in other comprehensive income and credited to revaluation reserve within equity.

Work Them Out

1. C	2. B	3. C	4. D	5. C	6. B	7. B	8. C	9. D	10. B

Short Questions

1. Investment property is property (land or a building — or part of a building — or both) held (by the owner or by the lessee under a finance lease) 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.

   Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes. Such property is classified as an item of property, plant and equipment under HKAS 16.

The owner of investment properties is expected to benefit from capital appreciation rather than from the properties being held for consumption in the normal course of business. Since investment properties are held as investments for ultimate disposal, their current fair values and the changes in these values are considered more important than their original costs. Depreciation should not be provided on investment properties since these properties are not used in the normal course of business.

2.

(a) HKAS 40 clearly states that if an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as being held for capital appreciation, and therefore falls within the definition of an investment property.

(b) A building that is vacant but is held to be leased out under one or more operating leases should be reported as an investment property. The current vacant situation is regarded as temporary, and as long as the property is held to earn rentals in the long run, it should be reported as an investment property.

(c) Owner-occupied property and owner-occupied property awaiting disposal are covered by HKAS 16. Under HKAS 16, such property is carried at either depreciated cost or revalued amount less subsequent depreciation. In addition, such property is subject to an impairment test.

(d) Property held for sale in the ordinary course of business is covered by HKAS 2. HKAS 2 requires an entity to carry such a property at the lower of cost and net realisable value.

Long Question

1.

(a) (i) As the land will be developed for the company's own use, the property should be classified as property, plant and equipment. Since the plot of land is leasehold land, its cost should be amortised over the remaining term of the lease.

(ii) The villa property was held for rental purposes, so it should be classified as an investment property. No depreciation is required as the company adopts the fair value model to measure the value of the property.

(iii) Since the property is for the company's own use, it should be classified as property, plant and equipment. No amortisation is required for the land as it is freehold. The building is subject to depreciation over its remaining useful life.

(iv) The residential development is for sale in the market, so it should be classified as inventory, and no depreciation is required.

(b) (i)

Dr.	Leasehold land	$420m	
	Cr. Cash		$420m
	To record the purchase of land		
Dr.	Amortisation	$8.4m	
	Cr. Accumulated amortisation		$8.4m
	To record the amortisation of leasehold land ($420m ÷ 50)		

(ii)

Dr.	Changes in fair value of investment property	$30m	
	Cr. Investment property		$30m
	To record the change in fair value of investment property ($120m – $90m)		

(iii)

Dr.	Land and building ($160m – $120m)	$40m	
Dr.	Accumulated depreciation ($80m – $60m)	20m	
	Cr. Revaluation reserve		$60m
	To record the revaluation of land and building		
Dr.	Depreciation ($90m ÷ 15*)	$6m	
	Cr. Accumulated depreciation		$6m
	To record the amortisation of leasehold land ($420m ÷ 50)		

*Remaining useful life of the building after revaluation:
20 years – [($80m – $60m) ÷ 4] years = 15 years

(iv)

Dr.	Impairment loss on inventory	$400m	
	Cr. Inventory		$400m
	To provide for lower of cost and net realisable value for inventory		

(c)

Ka Property Ltd
Statement of Comprehensive Income (Extract)
for the year ended 31 December 20X8

	$'m
Depreciation and amortisation ($8.4m + $6m)	14.4
Impairment loss on inventory	400
Changes in fair value of investment property	30

Ka Property Ltd
Statement of Financial Position (Extract) at 31 December 20X8

	$'m
Non-Current Assets	
Property, plant and equipment: ($420m – $8.4m) + ($160m – $6m)	565.6
Investment property	90
Current Assets	
Inventory ($1,900m – $400m)	1,500

CHAPTER 10

Activities

1. The capitalisation rate is at 8.6 per cent [($5 million × 10% + $3 million x 8% + $2 million × 6%)/ $10 million]. The amount of interest (borrowing cost) to be capitalised as part of the cost of the factory building is $154,800 ($1,800,000 × 8.6%).

2. The extracts to the entity's 20X9 financial statements are as follows:

Statement of Comprehensive Income
for the year ended 31 December 20X9

	$'000
Depreciation	250
Government grant credit	(150)

Statement of Financial Position at 31 December 20X9

	$'000
Non-current assets	
Building, at cost	10,000
Less: Accumulated depreciation ($10,000,000 / 40)	250
	9,750
Non-current liabilities	
Deferred income	
Government grant [($6,000,000 – $6,000,000 / 40) x 38 / 39]	5,700
Current liabilities	
Deferred income	
Government grant [($6,000,000 – $6,000,000 / 40) x 1 / 39]	150

Work Them Out

1. A	2. D	3. B	4. D	5. A	6. B	7. C	8. C	9. D	10. C

Short Questions

1. Average borrowings = [(Opening cumulative borrowings + Closing cumulative borrowings) / 2]

Average borrowings, 20X8	= [($0 + $1,000,000) / 2] = $500,000
Capitalised interest, 20X8	= $500,000 × 12% = $60,000
Average borrowings, 20X9	= [($1,000,000 + $60,000) + ($1,060,000 + $1,880,000)] / 2 = $2,000,000
Capitalised interest, 20X9	= ($1,000,000 × 12%) + [$1,000,000 × 8.6% (Working*)] = $206,000

**Working*:
Capitalisation rate

$$= \frac{\text{Total general borrowing costs for the period}}{\text{Weighted average total general borrowings}}$$

$$= \frac{(\$3{,}000{,}000 \times 10\% + \$7{,}000{,}000 \times 8\%)}{\$3{,}000{,}000 + \$7{,}000{,}000}$$

$$= 8.6\%$$

2. Bow Ltd's accounting treatment for government grants does not comply with the requirements of HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

   HKAS 20 allows two methods of accounting for government grants:
   - setting the grant against the cost of the related asset and depreciating the net carrying amount
   - carrying the grant as a deferred income which is subsequently recognised in profit or loss over the useful life of the depreciable asset to offset the depreciation expense

   Thus the grant should be removed from profit or loss and only $800,000 ($8 million/ 10 years) credited to profit or loss. The balance of $7.2 million should be shown as a deferred income or deducted from the cost of the plant asset.

Long Question

1. HKAS 23 *Borrowing Costs* requires that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

   The capitalisation of borrowing costs as part of the cost of a qualifying asset should begin on the commencement date. The commencement date is the date when the entity first meets all the following conditions:
   - Expenditures for the asset are being incurred.
   - Borrowing costs are being incurred.
   - Activities that are necessary to prepare the asset for its intended use or sale are undertaken.

   In the case of Oscar Ltd, capitalisation of borrowing costs as part of the cost of the constructed plant should begin on 1 October 20X8; when expenditures have been incurred for the technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction.

   Borrowing costs incurred in obtaining a qualifying asset eligible for capitalisation should be determined as the actual costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. In the case of Oscar Ltd, the amount of interest to be capitalised is calculated as follows:

		Year ended 31 December 20X8		Year ended 31 December 20X9
		$		$
5% Bank loan	$300,000 × 5% × 3/12	3,750	$300,000 × 5%	15,000
8% Bank loan		–	$100,000 × 8% × 7/12	4,667
		3,750		19,667

   Oscar Ltd should disclose in its financial statements information for the amount of borrowing costs capitalised during the year and the capitalisation rate used.

CHAPTER 11

Activities

1. The brand is certainly controlled by the entity and it is probable to bring future economic benefits. Entities can charge a higher premium for branded products. The event or past transaction that gave rise to an internally generated brand, however, is difficult to identify as it arose as a result of a series of events and not as a result of a single transaction. Therefore, they do not meet the definition of an intangible asset and cannot be recognised as an intangible asset under HKAS 38.

2. **Project A**
   The research on recovery rate is primary investigation undertaken with the prospect of gaining new scientific or technical knowledge. The research expenditures incurred should therefore be recognised as an expense for the year ended 31 December 20X9.

Project B and Project C
The two projects meet the criteria for recognition of development expenditures as an intangible asset.
Amounts of development expenditures to be capitalised for the year ended 31 December 20X9 were as follows:

Project	**B**	**C**
	$	**$**
Materials and wages	400,000	200,000
Salary of research and development director	30,000	20,000
Depreciation on plant and machinery used specifically for each project	50,000	14,000
	480,000	234,000

Work Them Out

1. B	2. B	3. D	4. C	5. B	6. B	7. A	8. D	9. B	10. A

Short Questions

1.

Description		
	$'000	**$'000**
1 January 20X8		
Dr. Intangible assets — Patents	8,000	
Cr. Cash		8,000
Purchase of a patent right.		
31 December 20X8		
Dr. Amortisation of intangible assets ($8,000/5)	1,600	
Cr. Intangible assets — Patent		1,600
Amortisation of the patent right over its useful life.		
Dr. Impairment loss [($8,000 – $1,600) – $4,500]	1,900	
Cr. Intangible assets — Patent		1,900
Reduction of the carrying amount of the patent to the recoverable amount.		
31 December 20X9		
Dr. Amortisation of intangible assets ($4,500/3)	1,500	
Cr. Intangible assets — Patent		1,500
Amortisation of the patent right over its useful life.		

2. The main issue in accounting for the outlays is determining at what point of time expenditures can be capitalised. This is resolved by applying the criteria for capitalising development costs in HKAS 38.

(a) **May 20X9:** There is no concrete market study or financial plan to demonstrate that the project is commercially feasible, therefore $1.55 million must be recognised as an expense.

(b) **June 20X9:** $1.45 million must be recognised as an expense as Carp Ltd is not yet convinced it has a product that it can sell, nor is there any indication of future profit.

(c) **August 20X9:** Carp Ltd now has an intention to complete and sell the machine. Potentially, due to the improvements suggested by the engineering companies, Carp Ltd is not yet able to measure the cost of the machine reliably, and thus not yet able to make an informed decision about the potential for the commercial sale. If that is the case, costs of $770,000 incurred during this period must be recognised as an expense.

(d) **1 September 20X9:** Carp Ltd now should be able to meet all the HKAS 38 criteria and all subsequent outlays should be capitalised as part of the cost of an intangible asset. $430,000 should be recognised as a patent, an internally generated intangible asset.

(e) **Between October and November 20X9:** The project is in the development stage and all outlays can be capitalised as part of the cost of an intangible asset. $590,000 and $40,000 should be capitalised as additions to the patent recognised earlier.

Long Question

1.

(a) **Project A**
The project was successfully completed, sales have commenced, and it is expected that the product will bring in a good return. The research and development expenditure incurred for the project should be capitalised as part of the cost of an intangible asset and be amortised over the estimated product life cycle.

Since the company started to earn economic benefits for the project during the year when commercial sales of the product commenced, amortisation of the capitalised development expenditure of the project should also be commenced.

Project B
There is doubt regarding the completion of the project due to the uncertainty of financial resources. Therefore, all research and development expenditure that was incurred, including the balance of capitalised development expenditure that was brought forward from previous year, has to be recognised as an expense.

Project C
The project is at a research stage and there is uncertainty regarding the ultimate success of the project, all research and development expenditure that was incurred has to be recognised as an expense.

(b)

A-Plus Skin Laboratory Ltd
Statement of Comprehensive Income (Extract)
for the year ended 31 December 20X9

		$'000
Research and development expenditure	(W1)	28,060
Depreciation of equipment	(W2)	600
Amortisation of patent	(W3)	300
Amortisation of capitalised development expenditure	(W4)	4,650
Market research		2,400

A-Plus Skin Laboratory Ltd
Statement of Financial Position (Extract) at 31 December 20X9

	$'000
Non-current assets	
Property, plant and equipment [$1,800 – $600 (W2) x 2]	600
Intangible assets	
Patent ($900 – $300)	600
Capitalised development expenditure [$37,200 – $4,650 (W4)]	32,550

Workings: ('000)

(W1) Research and development expenditure (Project B and Project C):
($6,530 + $7,200 + $3,500 + $2,350) + ($5,400 + $1,300 + $1,780)
= $28,060

(W2) Depreciation of equipment: $1,800 / 3 = $600

(W3) Amortisation of patent: $900 / 3 = $300

(W4) Amortisation of capitalised development expenditure (Project A):
[$19,950 + $8,600 + $4,500 + $3,700 + ($2,700 / 3) x 6 / 12] / 8
= $37,200 / 8
= $4,650

CHAPTER 12

Activities

1. Why each of the five situations indicates a lease as a finance lease:
   - **First and second situations:** The lessee has the legal ownership of the asset at the end of the lease term.
   - **Third situation:** A major part of the economic life (measured in years term) logically imply a transfer of substantially all the risks and rewards of ownership (measured in money term).
   - **Fourth situation:** The payment of substantially all the fair value (purchase price) of the asset, after discounting to present value, indicates that the economic substance and financial reality of the transaction is an outright purchase on credit terms.
   - **Fifth situation:** The lessee can derive rewards from possession of the particular asset.

2.

		$
Minimum lease payments ($15,000 x 6)		90,000
Present value of minimum lease payments	61, 671	
Total finance charges		28,329

The total finance charges of $28,329 are allocated over the lease term using the sum-of-the-digits method as follows:

Year ended 31 Dec					**$**
20X4	6/21	x	$28,329	=	8,094
20X5	5/21	x	$28,329	=	6,745
20X6	4/21	x	$28,329	=	5,396
20X7	3/21	x	$28,329	=	4,047
20X8	2/21	x	$28,329	=	2,698
20X9	1/21	x	$28,329	=	1,349
					28,239

The breakdown of each lease rental payment between interest and capital throughout the lease period is as follows:

Year ended 31 Dec	**Principal (opening obligation) $ (i)**	**Rental paid $ (ii)**	**Finance charge $ (iii)**	**Principal repaid $ (iv) = (ii) – (iii)**	**Principal (closing obligation) $ (v) = (i) – (iv)**
20X4	61,671	15,000	8,094	6,906	54,765
20X5	54,765	15,000	6,745	8,255	46,510
20X6	46,510	15,000	5,396	9,604	36,906
20X7	36,906	15,000	4,047	10,953	25,953
20X8	25,953	15,000	2,698	12,302	13,651
20X9	13,651	15,000	1349	13,651	0
Total		90,000	28,329	61,671	

Work Them Out

1. C	2. A	3. B	4. D	5. D	6. A	7. A	8. C	9. B	10. A

Short Questions

1.

(a) Present value of minimum lease payments
= $100,000 x (0.9524 + 0.9070 + 0.8638 + 0.8227)
= $354,590

(b) Present value of minimum lease payments
= $100,000 x (0.9524 + 0.9070 + 0.8638 + 0.8227) + $10,000 x 0.8227
= $354,590 + $8,227
= $362,817

If the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable so that, at the inception of the lease, it is reasonably certain that the option to purchase the asset is to be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

2.

(a) The lease arrangement with Hirer Ltd (the lessee) is a finance lease because:

- The lease term (four years) is the same as the economic life of the equipment.
- At the inception of the lease, the present value of the minimum lease payments [$17,481 being lease payments $4,500 x (0.8929 + 0.7972 + 0.7118 + 0.6355) plus guaranteed residual value $6,000 x 0.6355)] amounts substantially all the fair value of the leased equipment of $17,500.
- The leased equipment is of such a specialised nature that only the lessee can use them without major modifications.
- The lease is non-cancellable, so gains or losses from the fluctuation in the fair value of the residual fall to the lessee.

Journal entries to record the financing lease transactions in the books of Hirer Ltd (the lessee):

1 January 20X9

Dr.	Leased asset (Equipment)	$17,481	
	Cr. Lease liability		$17,481

To recognise the finance lease at the present value of the minimum lease payments, being lower than the fair value.

31 December 20X9

Dr.	Lease liability	$2,402	
Dr.	Interest expenses ($17,481 × 12%)	2,098	
	Cr. Cash		$4,500

To record the lease rentals payment.

31 December 20X9

Dr. Depreciation ($17,481/4)	$4,370	
Cr. Accumulated depreciation		$4,370

To provide depreciation for the leased equipment.

(b) The lease arrangement with Alta Ltd (the lessor) is an operating lease because:

- The lease term is only half of the economic life of the machine.
- At the inception of the lease, the present value of the minimum lease payments is $112,984 [= $42,000 x (1 + 0.8929 + 0.7972)], which is significantly less than the fair value of the leased machine of $150,000.
- The machine has to be returned to Alta Ltd at the end of the lease term.

Journal entries to record the operating lease arrangement with Alta Ltd:

1 January 20X9

Dr. Cash	$42,000	
Cr. Rental income		$42,000

To record the lease rentals income.

Long Question

1.

(a) The lease is a finance lease in the books of both Ways Ltd (the lessee) and Rail Ltd (the lessor) because:

- The lease transfers ownership of the equipment to the lessee by the end of the lease term as it was mentioned that the lessee will most likely exercise the option to purchase the equipment at the end of the lease term.
- The lease term of four years is for the major part of the economic life (five years) of the equipment.
- The present value of the minimum lease payments, $550,471 (Working), amounts to approximately 95 per cent (i.e. substantially all) of the fair value ($580,000) of the leased equipment at the inception of the lease.
- Gains or losses from the fluctuation in the fair value of the residual value accrue to the lessee.

Based on the above, it can be concluded that substantially all the risks and rewards incidental to the ownership of the equipment have been transferred from Rail Ltd to Ways Ltd at the inception of the lease contract.

Working:

Present value of minimum lease payments

= ($145,000 + $145,000 x 0.8929 + $145,000 x 0.7972 + $145,000 x 0.7118 + $80,000 x 0.6355 + $10,000 x 0.6355)

= $550,471

(b) In Ways Ltd's books:

1 January 20X8

Dr. Leased asset (Equipment) (Working)	$550,471	
Cr. Lease liability		$550,471

To recognise the finance lease at the present value of the minimum lease payments, being lower than the fair value ($580,000).

1 January 20X8

Dr. Lease liability	$145,000	
Cr. Cash		$145,000

To record the lease rentals payment.

31 December 20X8

Dr. Interest expenses (W2)	$48,656	
Cr. Lease liability		$48,656

To recognise the accrued interest charges.

31 December 20X8

Dr. Depreciation ($550,471 / 5)	$110,094	
Cr. Accumulated depreciation		$110,094

To provide depreciation for the leased equipment.

(c)

Ways Ltd
Statement of Comprehensive Income (Extract)
for the year ended 31 December 20X8

	$
Cost of sales (include depreciation on finance leased equipment)	110,094
Finance costs (include interest expenses on finance leased equipment)	48,656

Ways Ltd
Statement of Financial Position (Extract) At 31 December 20X8

	$
Non-current assets	
Equipment held under finance leases	
Cost	550,471
Less: Accumulated depreciation	110,094
	440,377
Non-current liabilities	
Finance lease liability (Working: $454,127 – $145,000)	309,127
Current liabilities	
Finance lease liability (Working)	145,000

Rail Ltd
Statement of Comprehensive Income (Extract)
for the year ended 31 December 20X8

	$
Other income (include interest earned on finance leases)	48,656

Rail Ltd
Statement of Financial Position (Extract) at 31 December 20X8

	$
Non-current assets	
Lease receivable (Working: $454,127 – $145,000)	309,127
Current assets	
Lease receivable (Working)	145,000

Working:
Lease amortisation schedule — 20X8 and 20X9

Year ended 31 Dec	Capital sum at beginning of year	Lease payment	Outstanding capital sum during year	Finance charge (12%)	Capital sum at end of year
	$	$	$	$	$
20X8	550,471	145,000	405,471	48,656	454,127
20X9	454,127	145,000	309,127	37,095	346,222

CHAPTER 13

Activities

1. The obligating event is the giving of the guarantee, which gives rise to a present legal obligation and it is probable that an outflow of resources embodying economic benefits would be required to settle the obligation. Thus, the entity should recognise a provision in its financial statements.

2. Journal entries to record the events relating to the two lawsuits:

15 July 20X9		
Dr. Provision for an environmental lawsuit	$1,000,000	
Cr. Other income – Reversal of provision		$1,000,000
To reverse the provision previously recognised due to dismissal of the lawsuit case.		
20 December 20X9		
Dr. Compensation for damages	$800,000	
Cr. Provision for patent infringement		$800,000
To recognise the provision for patent infringement.		

Work Them Out

1. A	2. D	3. A	4. B	5. B	6. D	7. B	8. C	9. B	10. B

Short Questions

1. All provisions are contingent because they are uncertain in timing or amount. “Contingent” refers to liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Provisions are recognised when a reliable estimate of the amount can be made, because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations.

Contingent liabilities refer to liabilities that do not meet the recognition criteria of provision because they are either:
- possible obligations, as they have not yet been confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or
- a sufficiently reliable estimate of the amount of the obligation cannot be made.

2. The appropriate accounting treatment should be:

Item (a)
A provision should be recognised when the following conditions are met:
- An entity has a present obligation as a result of a past event — the present obligation to settle the loan defaulted by the subsidiary is caused by the guarantees provided by Camel Ltd for its subsidiary.
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation — on 30 April 20X9, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, i.e. the loan defaulted by the subsidiary.
- A reliable estimate can be made of the amount of the obligation — the amount of the borrowings outstanding, at the time the subsidiary is declared bankrupt, is probably is the best estimate of the obligation to settle the default on the loan.

Since the above conditions are met, the outstanding amount of the borrowings guaranteed by Camel Ltd should be recognised on 31 March 20X9. The accounting entries should be:

Dr.	Loan guarantee expense	$8,000,000	
	Cr. Provision for loan guarantee		$1,300,000

Item (b)
Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. Based on the legal advisor's advice, a favourable settlement is probable, but not virtually certain. Therefore, the past event — the breach of contract of its business partner — does not give rise to a contingent asset because it does not provide evidence that an inflow of economic benefits to the entity is virtually certain. A contingent asset is disclosed where an inflow of economic benefits is probable. Therefore, Camel Ltd should not recognise any contingent asset but should disclose the nature of the contingent asset at the end of the reporting period and an estimate of its financial effect, where practical.

Item (c)
A provision should be recognised when the following conditions are met:
- An entity has a present obligation as a result of a past event — the decision to close the division has been communicated to the customers and employees; this is an obligating event which creates a valid expectation that the division will be closed.
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation — therefore, the resource outflow relating to the costs of carrying out the division's closure is probable.
- A reliable estimate can be made of the amount of the obligation — since the redundancy notices were sent to the division's staff and assuming the redundancy plan has already been fixed, the management of Camel Ltd should be able to estimate the amount of redundancy costs reliably.

Since the above conditions have been met, Camel Ltd is required to make a provision for the redundancy costs of $3 million at the end of the reporting period. The accounting entry should be:

Dr.	Redundancy costs	$3,000,000	
	Cr. Provision for redundancy		$3,000,000

Long Question

1.

Phob Ltd
Statement of Financial Position (Extract) at 31 December 20X9

	$'m
Non-current assets	
Property, plant and equipment — Processing plant [($45m + $15m) x 11 / 12]	55.0
Non-current liabilities	
Provision for decontamination costs [$16.5m / (1 + 10%)]	15.0
Accrued finance costs ($15m x 10%)	1.5

Statement of Comprehensive Income (Extract)
for the year ended 31 December 20X9

	$'m
Cost of sales ($30m + $60m / 12)	35.0
Finance costs	1.5

Note 1: Recognition and measurement of provision
A provision for decontamination costs should be recognised because all the following conditions are met:
- Phob Ltd has a present legal obligation as a result of a past event of having an agreement with the government that the plant must be decontaminated at the end of its life
- it is probable that an outflow of resources embodying economic benefits will be required to complete the decontamination
- a reliable estimate had been made by an expert of the amount required for completing the decontamination work

Future events that may affect the amount required to settle an obligation should be reflected in the amount of provision where there is sufficient objective evidence that they will occur. Therefore, future decontamination costs must be provided for in full at the time they become unavoidable.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. In determining the best estimate of amount of provision, the following issues should be considered:
- The estimate made by an expert is a reliable one.
- Since the effect of the time value of money is material, the amount of a provision should be the present value ($15 million) of the expenditure expected to be required to settle the obligation ($16.5 million). Therefore, the finance costs (the unwinding of the discount on the provision) should be $1.5 million.
- The discount rate(s) should be a pre-tax rate(s) that reflect current market assessments of the time value of money and the risks specific to the liability. In this case, the discount rate of 10 per cent is an appropriate discount rate for discounting the future value to present value.

Note 2: Cost of property, plant and equipment
The cost of an item of property, plant and equipment comprises its purchase price, any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, and the initial estimate of the obligation for which an entity incurs. Therefore, the decontamination costs of $15 million, which is an obligation an entity incurs when the asset is added to the cost of the plant ($45 million) and depreciated over the expected useful life of the asset.

Note 3: Depreciation of property, plant and equipment
The depreciable amount of an asset should be allocated on a systematic basis over its useful life and requires the depreciation charge for each period should be recognised in profit or loss unless it is included in the carrying amount of another asset. In the case of Phob Ltd, the depreciation charge must be based on the full cost of the plant which must include the decontamination costs; the annual depreciation charge for the plant should be $5 million ($60 million / 12 years).

CHAPTER 14

Activities

1.

PAR Ltd
Consolidated Statement of Financial Position at 31 December 20X9

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment ($400,000 + $200,000)	600
Current assets ($200,000 + $160,000)	360
Total assets	960
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	500
Retained earnings	200
Total equity	700
Current liabilities ($140,000 + $120,000)	260
Total equity and liabilities	960

2.

PUB Ltd
Consolidated Statement of Financial Position at 31 December 20X9

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment ($500,000 + $250,000)	750
Current assets ($220,000 + $150,000)	370
Total assets	1,120
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	500
Retained earnings	300
	800
Non-controlling interest ($300,000 x 40%)	120
Total equity	920
Current liabilities ($100,000 + $100,000)	200
Total equity and liabilities	1,120

Work Them Out

1. B	2. C	3. D	4. B	5. D	6. C	7. C	8. C	9. A	10. C

Short Questions

1. HKAS 27 defines a subsidiary as an entity, including an unincorporated entity such as a partnership, that is controlled by another entity.

   The key element is "control", which means the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

   Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

   Control also exists when the parent owns half or less of the voting power of an entity when there is:
   - power over more than half of the voting rights by virtue of an agreement with other investors
   - power to govern the financial and operating policies of the entity under a statute or an agreement
   - power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body
   - power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body

2. In preparing consolidated financial statements, the following steps should be taken:
   - The financial statements of the parent and its subsidiaries are combined line by line by adding together like items of assets, liabilities, equity, income and expenses.
   - The carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated.
   - Non-controlling interests in the profit or loss of consolidated subsidiaries for the reporting period are identified.
   - Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the parent shareholders' equity in them.
   - Intragroup balances and transactions, including income, expenses and dividends, are eliminated in full.

Long Question

1.

(a) Significant influence is defined by HKAS 28 as the power to participate in the financial and operating policy decisions of the investee, but it does not have control or joint control over those policies.

(b) The investor is assumed to have significant influence if it holds, directly or indirectly 20 per cent or more of the voting power of the investee, except when it can be clearly demonstrated that this is not the case.

Moreover, one or more of the following demonstrate the existence of significant influence of an investor over its investee:
- representation on the board of directors or equivalent governing body of the investee
- participation in policy-making processes, including participation in decisions on dividends or other distributions
- material transactions between the investor and the investee
- interchange of managerial personnel
- provision of essential technical information

CHAPTER 15

Activities

1. An investment in ordinary shares listed on the SEHK does not qualify as cash equivalents because they are subject to a significant risk of changes in value.

2. **Pump Ltd**
Statement of Cash Flows for the year ended 31 December 20X9

	$'000	$'000
Cash flows from operating activities		
Profit before tax	300	
Adjustments for:		
Depreciation	540	
Gain on disposal of a plant	(140)	
Impairment loss of intangible assets	100	
Interest expense	180	
	980	
Increase in inventories ($200 – $120)	(80)	
Decrease in trade receivables ($250 – $320)	70	
Decrease in trade payables ($100 – $110)	(10)	
Cash generated from operations	960	
Interest paid ($100 + $180 – $120)	(160)	
Income taxes paid ($300 + $240 – $200)	(340)	
Net cash from operating activities		460

Work Them Out

1. C	2. C	3. A	4. B	5. C	6. A	7. D	8. B	9. D	10. D

Short Questions

1. **Bold Ltd**
Statement of Cash Flows For The Year Ended 31 December 20X9

	$'m	$'m
Cash flows from operating activities		
Profit before tax	61	
Adjustments for:		
Depreciation ($230 – $184)	46	
Provision for product warranty ($9 – $3)	6	
Interest expense	8	
	121	
Decrease in inventories ($48 – $59)	11	
Decrease in trade receivables ($20 – $35)	15	
Increase in trade payables ($51 – $36)	15	
Cash generated from operations	162	
Interest paid	(8)	
Income taxes paid [$11 + $21 – $13)]	(19)	
Net cash from operating activities		135
Cash flows from investing activities		
Purchases of property, plant and equipment ($671 – $496)	(175)	
Net cash used in investing activities		(175)
Cash flows from financing activities		
Proceeds from issuance of share capital [($207 + $28) – ($162 + $18)]	55	
Proceeds from issuance of debentures ($36 – $0)	36	
Repayment of bank loan ($0 – $72)	(72)	
Dividends paid	(5)	
Net cash from financing activities		14
Net decrease in cash and cash equivalents		(26)
Cash and cash equivalents at beginning of period		7
Cash and cash equivalents at end of period		(19)

2.

Hall Ltd
Statement of Cash Flows for the year ended 31 December 20X9

	$'000	$'000
Cash flows from operating activities		
Cash receipts from customers (W1)	583	
Cash paid to suppliers (W2)	(320)	
Cash paid to employees (W3)	(180)	
Cash generated from operations	(187)	
Interest paid	(30)	
Income taxes paid	(35)	
Net cash used in operating activities		(252)
Cash flows from investing activities		
Purchases of property, plant and equipment (W4)	(230)	
Proceeds from disposal of property, plant and equipment (W5)	105	
Interest received	20	
Net cash used in investing activities		(105)
Cash flows from financing activities		
Proceeds from issuance of share capital (W6)	363	
Proceeds from new borrowings (W7)	210	
Net cash from financing activities		573
Increase in cash and cash equivalents		486
Cash and cash equivalents at beginning of period (Note)		(136)
Cash and cash equivalents at end of period (Note)		350

Note: Analysis of the balances of cash and cash equivalents:

	20X9 $'000	20X8 $'000
Cash and bank balances	360	14
Bank overdrafts	(10)	(150)
	350	(136)

Workings: ($'000)

(W1) Cash receipts from customers
= Sales – Change in trade receivables
= $500 – ($90 – $173)

(W2) Cash paid to suppliers
= Purchases (= Cost of sales + Change in inventories) – Change in trade payables
= $150 + ($345 – $195) – ($205 – $225)

(W3) Cash paid to employees
= Wages – Change in accrued wages
= $170 – ($95 – $105)

(W4) Income taxes paid
= Income tax expense – Change in income tax payable
= $25 – ($20 – $30)

(W5) Purchases of property, plant and equipment
= Change in carrying amount + Depreciation for the year + Carrying amount of assets disposed
= ($450 – $375) + $80 + $75

(W6) Proceeds from disposal of property, plant and equipment
= Carrying amount of assets disposed of + Gain on disposal
= $75 + $30

(W7) Proceeds from issuance of share capital
= Change in share capital + Change in share premium
= ($320 + $80) – ($37 + $0)

(W8) Proceeds from new borrowings
= $240 – $30

Long Question

1.

Mike Ltd
Statement of Cash Flows for the year ended 30 June 20X9

	$'000	$'000
Cash flows from operating activities		
Loss before tax		(748)
Adjustments for:		
Depreciation — Building (Working 1)	204	
Depreciation — Plant and equipment (Working 2)	1,377	
Amortisation — Intangible assets ($8,670 – $6,800)	1,870	
Loss on disposal of plant	204	
Interest income	(204)	
Interest expense	408	3,859
		3,111
Decrease in inventories ($5,950 – $7,140)		1,190
Increase in trade receivables ($13,736 – $6,324)		(7,412)
Increase in trade payables ($9,010 – $8,755)		255
Cash generated from operations		(2,856)
Interest paid		(272)
Income taxes paid ($3,145 + $17 – $1,785)		(1,377)
Net cash used in operating activities		(4,505)
Cash flows from investing activities		
Purchases of land and buildings (Working 1)	(1,870)	
Purchases of plant and equipment	(1,020)	
Proceeds from disposals of plant and equipment	255	
Interest received ($204 – $85 + $51)	170	
Net cash used in investing activities		(2,465)
Cash flows from financing activities		
Issue of ordinary shares ($5,100 + $1,020 – $3,400)	2,720	
Issue of variable rate loan ($2,720 – $34 issue costs)	2,686	
Repayment of fixed rate loan ($2,550 + $102 penalty)	(2,652)	
Dividends paid (Working 4)	(425)	
Net cash used in financing activities		2,329
Net decrease in cash and cash equivalents		(4,641)
Cash and cash equivalents at beginning of period (Note)		3,315
Cash and cash equivalents at end of period (Note)		(1,326)

Note: Analysis of the balances of cash and cash equivalents

	20X9 **$'000**	**20X8** **$'000**
Cash and bank balances	255	1,275
Short-term deposits	544	2,040
Short-term borrowings — Bank overdrafts	(2,125)	–
	(1,326)	3,315

Working 1:

	$'000
Land and buildings at beginning of the year	7,140
Add: Revaluation gains	1,190
Less: Depreciation for the year	(204)
Land and buildings at end of the year	(9,996)
Purchases of land and building	(1,870)

Working 2:

	$'000
Plant and equipment, accumulated depreciation at beginning of the year	1,785
Less: Disposal during the year (see Working 3)	(646)
Less: Plant and equipment, accumulated depreciation at end of the year	(2,516)
Depreciation of plant and equipment for the year	(1,377)

Working 3:

	$'000
Plant an equipment, cost at beginning of the year	7,565
Add: Additions during the year	1,020
Less: Plant and equipment, cost at end of the year	(7,480)
Cost of plant disposed of	1,105

Cost of plant disposed of	1,105
Less: Loss on disposal	(204)
Less: Proceeds from disposal	(255)
Accumulated depreciation of plant disposed of	646

Working 4:	**$'000**
Retained earnings at beginning of the year	19,805
Less: Loss for the year	(765)
Add: Transfer from revaluation reserve	51
Less: Retained earnings at end of the year	(18,666)
Dividends paid	425

CHAPTER 16

Activities

1. All figures are in $'000

• Return on capital employed

$$= \frac{\text{Profit before interest and tax}}{\text{Total equity + Long-term liabilities}} \times 100\%$$

$$= \frac{\$7{,}289 + \$74}{\$13{,}690 + \$1{,}850} \times 100\%$$

= 47.38%

• Asset turnover

$$= \frac{\text{Sales revenue}}{\text{Total assets less current liabilities}}$$

$$= \frac{\$31{,}450}{\$20{,}165 - \$4{,}625}$$

= 2.02 times

• Net profit margin

$$= \frac{\text{Profit before interest and tax}}{\text{Sales revenue}} \times 100\%$$

$$= \frac{\$7{,}289 + \$74}{\$31{,}450} \times 100\%$$

= 23.41%

• Current ratio

$$= \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$= \frac{\$4{,}921}{\$4{,}625}$$

= 1.06 : 1

• Liquid ratio

$$= \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

$$= \frac{\$4{,}921 - \$1{,}369}{\$4{,}625}$$

= 0.77 : 1

• Inventory turnover

$$= \frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$= \frac{\$22{,}015}{(\$1{,}369 + \$1{,}300)/2}$$

= 16.50 times

• Receivables collection period

$$= \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

$$= \frac{\$3,552}{\$31,450} \times 365 \text{ days}$$

= 41.22 days

• Payables payment period

$$= \frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

$$= \frac{\$3,811}{\$22,084} \times 365 \text{ days}$$

= 62.99 days

Note: Based on alternative definitions, students may produce different answers, for example, for return on capital employed, asset turnover and net profit margin.

2. All figures are in $'000

• Gearing ratio (using total equity plus debt capital as the denominator)

$$= \frac{\text{Debt capital}}{\text{(Ordinary share capital + Reserves + Retained earnings) + Debt capital}} \times 100\%$$

$$= \frac{\$1,850}{\$13,690 + \$1,850} \times 100\%$$

= 11.90%

• Interest cover

$$= \frac{\text{Profit before interest and tax}}{\text{Interest expense}}$$

$$= \frac{\$7,289 + \$74}{\$74}$$

= 99.50 times

• Earnings per share

$$= \frac{\text{Profit after tax and preference dividends}}{\text{Weighted average number of ordinary shares outstanding}}$$

$$= \frac{\$5,550}{(\$1,000 \div \$1)}$$

= $5.55

• Price earnings ratio

$$= \frac{\text{Current market price of each ordinary share}}{\text{Earnings per share}}$$

$$= \frac{\$36}{\$5.55}$$

= 6.49

• Dividend cover

$$= \frac{\text{Profit after tax and preference dividends}}{\text{Ordinary dividends paid}}$$

$$= \frac{\$5,550}{\$1,000}$$

= 5.5 times

• Dividend yield

$$= \frac{\text{Ordinary dividends per share}}{\text{Current market price of each ordinary share}} \times 100\%$$

$$= \frac{\$1,000 \div (\$1,000 \div \$1)}{\$36} \times 100\%$$

= 2.78%

Answers

Work Them Out

1. A	2. C	3. C	4. B	5. C	6. B	7. A	8. D	9. C	10. D

Short Questions

1. **Profitability**

The profitability of Ham Ltd has shown an improvement from a ROCE 41.2 per cent during 20X8 to 53.78 per cent in 20X9. However, the asset turnover has declined from 2.6 to 2.3 times from 20X8 to 20X9. The improvement in ROCE could come from the significant improvement in net profit margin, which increased from 15.84 per cent to 23.41 per cent.

Liquidity

The liquidity position of Ham Ltd has deteriorated significantly in view of the significant decline in both current ratio and liquid ratio. Since the liquidity position is not satisfactory, it is worth finding out the reasons for the deteriorating cash flow position:

- Inventory turnover declined from 20 to 16 times, however, the holding period for inventory is still reasonable.
- The receivables collection period shows an increase of 7.5 days in collecting cash from trade customers. However, the collection period for 41.2 days during 20X9 is still acceptable.
- The payables payment period increased from 44.8 days in 20X8 to 63.2 days in 20X9. This provides additional evidence to the deterioration in Ham Ltd's cash flows, so Ham Ltd has delayed payments made to trade suppliers.
- Ham Ltd has raised long-term interest-bearing finance of $1.85 million, indicating the shortage of cash flows and so the company needs to borrow from outside.

Gearing

In 20X8, Ham had no problem with gearing because the company had no long-term debt. In 20X9, Ham Ltd reached gearing ratio of 50 per cent which may be considered a slightly high. At this gearing level, if the high net profit margin of 23.41 per cent cannot be maintained, the company may have face problems in repaying the long-term borrowing and resulting in the deterioration of its financial position.

Overall financial position and performance

The major concern for Ham Ltd's financial position is the deterioration in the payment period to trade suppliers. This may lead to a deterioration of the relationship with suppliers and thus the company may not be able to receive further goods on credit. Moreover, the reason of raising the large long-term borrowing should be investigated because this will affect Ham Ltd's liquidity position in the long run. The overall financial performance of Ham Ltd, however, is considered satisfactory as there is both improvements in ROCE and asset turnover in 20X9 compared with 20X8.

2. The report should include the following comments as revealed by the financial ratios:
   - **Net profit margin:** Ozon Ltd has a higher net profit margin, indicating that it has higher selling prices and/or lower unit costs.
   - **Asset turnover:** Both are capital-intensive companies with low asset turnover but Ozon Ltd has a higher level of activity and productivity.
   - **Return on capital employed:** Ozon Ltd has utilised its assets better to generate revenue and profit.
   - **Gearing ratio:** Hove Ltd has a much higher gearing ratio and hence a greater financial risk. The high gearing ratio has probably led to a larger return on equity.
   - **Dividend cover:** Ozon Ltd has a relatively high dividend cover.
   - **Dividend yield:** Hove Ltd has a relatively high dividend yield.

Overall conclusion

Ozon Ltd appears to be a better investment because it has a lower financial risk, has a higher level of activity and productivity, and is more profitable. Although Ozon Ltd has a relatively lower dividend yield than Hove Ltd, it is likely to have earnings growth (thus growth in dividends) in the future because of a higher price earnings ratio.

Long Question

1. **Profitability**

Sun Ltd earns a higher profit margin compared to Shine Ltd but the percentage of operating costs is also higher (i.e. 12 per cent v 7 per cent). This may indicate that Sun Ltd focused more on high-end services and charges higher price, but at the same time incurred higher operating costs in its services.

Return on capital employed

Shine Ltd has a larger return on capital employed when compared to Sun Ltd. (i.e. 30 per cent vs. 24 per cent). This would partly be due to a higher asset turnover enjoyed by Shine Ltd (i.e. Shine Ltd: 2 times; Sun Ltd: 1.2 times). Hence, Shine Ltd has employed its assets more efficiently, and this may be due to the two companies serving different tiers of the market.

Working capital management and liquidity

Sun Ltd has more efficient working capital management. Sun Ltd has a shorter receivables collection period and a longer payables payment period than Shine Ltd. This may indicate that Sun Ltd has better negotiation ability in its credit terms. As Shine Ltd has a longer payables payment period and a shorter receivables collection period, the company needs extra cash to finance its trade payables' accounts.

Also, Sun Ltd has a much better current ratio than Shine Ltd. Therefore, the liquidity position of Sun Ltd is considered better than that of Shine Ltd.

Gearing ratio

Shine Ltd has a higher gearing ratio when compared to Sun Ltd, so Shine Ltd has a higher financial risk. However, the higher gearing ratio could bring in a higher return on equity, which means a higher return to ordinary shareholders.

Conclusion

Overall, it appears that Sun Ltd is a better investment option for Park Ltd. The business strategy of Sun Ltd, that focuses more on high-end service, is more in line with that of Park Ltd. In addition, Sun Ltd is more profitable, has a better management of its working capital, and has a lower financial risk.