

**HONG KONG FINANCIAL ACCOUNTING
JUNE 2004**

The examination paper is divided into TWO Sections. Section A is compulsory and carries 40 marks. Candidates should attempt THREE questions from Section B, all of which carry 20 marks each.

You should allow yourself approximately 70 minutes in total to answer the questions in Section A, and 35 minutes for each of the questions attempted in Section B.

Tuesday morning 1st June 2004

Time allowed: 3 hours

SECTION A

(Compulsory – answer all parts of this question)

1. (a) Define income (profit) under the “capital maintenance” concept. Identify the alternative ways of measuring capital under this concept. *(4 marks)*
- (b) Explain why it is incorrect to include the first year’s annual maintenance charge as part of the cost of a machine, while it is appropriate to include the freight charges and installation and testing charges as part of the cost of a machine. *(4 marks)*
- (c) During the course of examining the financial statements of Hoi Kee Limited for the year ended 31 December 2003, you discover the following:

Inventory at 1 January 2003 was understated by \$60,000.
Inventory at 31 December 2003 was overstated by \$50,000.

The company’s gross profit on sales is 50%; net income reported on 2003 income statement (profit and loss account) (before reflecting the adjustments above) is \$30,000.

What is the correct income for the year ended 31 December 2003, and what other accounts are affected? *(4 marks)*
- (d) Orange Limited acquired 30% of the shares of Apple Limited on 1 April 2003 for long-term investment. Orange Limited appointed a representative on the Board of Directors of Apple Limited on that date. What is the most appropriate accounting method used to incorporate the results of Apple Limited into Orange Limited’s financial statement, and why it is the most appropriate accounting method? *(4 marks)*
- (e) A Ltd. has investments in two companies, B Ltd and C Ltd.. B Ltd. and C Ltd are 40% and 80% owned by A Ltd respectively. Mr. Chan, a company director

of A Ltd., owns 60% of the share capital of B Ltd., while his grandfather holds 10% of that of C Ltd.

What disclosures would HKSSAP 20 "Related Party Disclosure" require in the financial statement of A Ltd.? *(4 marks)*

- (f) The financial statements of White Limited for the year ended 31 December 2003 contain the following information:

Issued share capital : 2,000,000 ordinary shares of \$1 each

	\$
Net profit before tax	950,000
Less: Taxation	<u>(350,000)</u>
Net profit after tax	600,000
Less: Proposed dividend	<u>(200,000)</u>
Retained profit for the year	<u>400,000</u>

- (i) Calculate the basic earnings per share for the year ended 31 December 2003 *(1 mark)*
- (ii) Referring to part (i), and assuming all financial information remains unchanged, calculate the earnings per share on the basis that White Limited made a rights issue on 1 July 2003 in the proportion of 1 for every 2 ordinary shares held, at a price of \$2.20. The market price for the shares on the last day of quotation cum rights was \$4 per share. *(3 marks)*
- (g) The Companies (Amendment) Ordinance 1999 was enacted on 30 June 1999 and came into operation on 11 November 1999. One of the major amendments made to the Companies Ordinance was the provision of "merger relief" on certain share swaps and intra-group transactions. Shortly after the amendment, HKSSAP27 "Accounting for Group Reconstructions" became effective. Explain what is a "merger relief". *(4 marks)*
- (h) The following information is provided in relation to two assets owned by a business:

	Asset I	Asset II
	\$'000	\$'000
Discount present value	200	50
Carrying value	100	100
Net realizable value	50	500

For each asset, identify the relevant "value to business", and state whether the management should retain the assets or dispose of them. *(4 marks)*

- (i) It is generally accepted that the working capital ratio is an indicator of a firm's short term financial strength. Do you agree? *(4 marks)*
- (j) State the impact of the inclusion of intangible assets in the balance sheet on the financial ratios. *(4 marks)*

(Total: 40 marks)

SECTION B

(Answer THREE questions from this Section)

2. Hung Limited prepared the following balances:

Hung Limited Draft Balance Sheet for the year ended 31 December 2003

	\$		\$
Working capital	21,500	Non-current liabilities	62,000
Other assets	<u>153,300</u>	Shareholders equity	<u>112,800</u>
	<u>174,800</u>		<u>174,800</u>

Your analysis of the above items reveals the following information:

1. Working capital comprises:

	\$
Land	12,000
Accounts due from customer	18,000
Accounts due to suppliers	(24,000)
Inventories	35,500
Tax payable	(16,400)
Wages payable	(3,600)
Bank loan (due 31 December 2007)	(17,000)
Investment in associates	<u>17,000</u>
	<u>21,500</u>

2. Other assets include:

	\$
Cash	14,000
Prepaid insurance	2,400
Building and equipment	100,000
Held-to-maturity securities	<u>36,900</u>
	<u>153,300</u>

3. Non-current liabilities consists of:

	\$
Debentures	33,000
Allowance for doubtful debts	1,400
Minority interest	2,600
Ordinary shares of \$5 par	<u>25,000</u>
	<u>62,000</u>

(Continued)

4. Shareholders' equity includes:

	\$
Accumulated depreciation:	
Building and equipment	40,000
Preference shares of \$100 par	12,000
Share premium	16,900
Retirement benefit obligations	6,500
Retained profits	38,700
Intangibles	<u>(1,300)</u>
	<u>112,800</u>

REQUIRED:

- (a) Based on your analysis, prepare a properly classified balance sheet as at 31 December 2003 for Hung Limited in accordance with HKSSAP1 "Presentation of Financial Statements". *(12 marks)*
- (b) A company must include a summary of its accounting policies in the notes to its financial statements.
- (i) Give four examples of accounting policies that are disclosed in the notes accompanying a company's financial statements. *(4 marks)*
- (ii) Why is this disclosure of accounting policies important? *(4 marks)*
- (Total: 20 marks)*

3. The following are various cash flow activities of Mode Limited for the year ended 31 December 2003:

- (i) Operating profits before tax, \$72,000
- (ii) Payment for purchase of equipment, \$5,000
- (iii) Increase in accounts receivable, \$4,400
- (iv) Depreciation expense, \$11,300
- (v) Tax paid, \$3,500
- (vi) Payment for purchase of land, \$9,700
- (vii) Decrease in accounts payable, \$2,900
- (viii) Increase in inventories, \$10,300
- (ix) Payment for purchase of building, \$65,000
- (x) Doubtful debts expense, \$2,700
- (xi) Proceeds from sale of long-term investments at cost, \$10,600.
- (xii) Opening cash balance, \$38,000; closing cash balance, \$41,600
- (xiii) Dividend paid, \$24,500
- (xiv) Proceeds from issue of ordinary shares, \$32,300

REQUIRED:

- (a) Prepare the Cash Flow Statement for Mode Limited in accordance with HKSSAP15 "Cash Flow Statements". *(16 marks)*

- (b) What are the benefits of including a cash flow statement in the published financial statements?

(4 marks)

(Total: 20 marks)

4. Bang Limited is a metal work manufacturing company with its headquarters in Hong Kong. To plan the growth of the firm for the next decade, the directors decided to diversify and invest overseas. On 1 January 2003, Bang Limited acquired 80% interest in a Singapore company (Werner Company) which specializes in producing special metal used in hi-tech airplanes. Bang Limited paid HK\$2,800,000 for the 80% interest in Werner, at which time the reserves of Werner were S\$ 5,000,000. No dividends were proposed on 1 January 2003, and no dividends have been paid during 2003. The local management retains the management control of Werner Company after acquisition.

The audited balance sheet as at 31 December 2003 is presented below:

	S\$'000
Plant (at cost)	14,800
Depreciation	(6,000)
Inventory	6,000
Accounts Receivable	9,500
Accounts Payable	(7,800)
Dividend Payable	(1,200)
Share Capital 930,000 shares of S\$10 each	(9,300)
Retained Profits at 1 January 2003	(5,000)
Profit for 2003	(1,000)

The exchange rates are as follows:

1 January, 2003	S\$ 4.875 per HK\$1
Average, 2003	S\$ 4.625 per HK\$1
31 December, 2003	S\$ 4.5 per HK\$1

REQUIRED:

- (a) Translate the balance sheet of Werner Company as at 31 December 2003 using the appropriate exchange rate. *(Calculate to the nearest dollar)* (10 marks)
- (b) Justify why the rates you have selected to translate the balance sheet are appropriate. (4 marks)
- (c) State how the exchange difference arising from the translation in (a) above should be accounted to comply with the requirements of HKSSAP11 "Foreign Currency Translation". (2 marks)
- (d) If the transfer of foreign currency is not permitted in the country where Werner Company is located and the investment is considered to be in serious jeopardy, how should the situation be recognized in the financial statement of Bang Limited? (4 marks)

(Total: 20 marks)

5. Party Limited, a wholesaler, purchased 80% of the issued shares of Sorry Limited, a retailer, on 31 December 1999, for \$120,000. On that date, Sorry Limited had only one class of 100,000 ordinary shares with nominal value of \$1 each and a retained earnings balance of \$30,000. No further shares were issued by Sorry after the date of acquisition.

The trial balances of both companies as at year ended 31 December 2003 is as follows:

	Party \$'000	Sorry \$'000
Patent (NBV)	-	42
Fixed Assets	123	97
Investment in Sorry Limited	120	-
Net Current Assets	<u>124</u>	<u>41</u>
	<u>367</u>	<u>180</u>
Ordinary Shares (\$1 each)	300	100
Retained Profits	<u>67</u>	<u>80</u>
	<u>367</u>	<u>180</u>

Party Limited purchased the shares of Sorry Limited to acquire control of a patent owned by Sorry. The patent leases will expire on 31 December 2006, and Party's executives estimated that these nonrenewable leases were worth at least \$10,000 more than their book value when the shares were purchased. Goodwill is being amortized over an 8-year period, until the patent expires.

The fair values of the assets and liabilities of Sorry Limited were the same as their book value at the date of acquisition, with the exception of patent leases.

REQUIRED:

- (a) Prepare the consolidated balance sheet of Party Limited and its subsidiary as of 31 December 2003, complying with the requirements in HKSSAP30 "Business Combinations". *(14 marks)*
- (b) Assuming that the Party's executives estimated the patent as worth at least \$25,000 more than their book value when the share was purchased, what will be the goodwill attributed to the acquisition? *(2 marks)*
- (c) Referring to (b), suggest possible accounting treatments for the calculated goodwill arising on consolidation. *(4 marks)*

(Total: 20 marks)

6. The separation of the ownership of companies from the management of companies made necessary the reporting on the financial state of the company to the shareholders. Consequently, it became necessary to regulate and determine what should be included in such reports and how they should be prepared.

REQUIRED:

- (a) What are the differences between public regulation and private regulation of accounting information? *(8 marks)*
- (b) State some of the advantages of private regulation by the accounting profession. *(5 marks)*
- (c) What is the main mechanism for regulation of Accounting Standards in Hong Kong? *(7 marks)*
- (Total: 20 marks)*