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Accounting Technician Examinations

Pilot Examination Paper

Level II

Paper 7
Advanced Accounting

Questions
Suggested Answers
and
Marking Scheme

The Suggested Answers given in this Booklet are purposely made to give more details for educational purpose.

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Accounting Technician Examinations

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Level II

Paper 7
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Time allowed – 3 hours

Section A – 20 Multiple Choice Questions (compulsory)

Section B – 1 Question (compulsory)

Section C – 4 Questions (attempt any 2)

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INSTRUCTED TO DO SO BY THE SUPERVISOR

SECTION A (MULTIPLE CHOICE QUESTIONS) (20 marks)

Answer **ALL** questions in this section. Choose the best answer for each question.
Marks will not be deducted for incorrect answers. Each question carries 1 mark.

1. A company issues shares in exchange for the shares in another company. This transaction would be reported on the statement of cash flows in

A the cash flows from investing activities section.
B the cash flows from operating activities section.
C the notes.
D the cash flows from financing activities section.

2. The partnership agreement for Chan & Lee provides that Chan is to receive a bonus of 20% of net income (after bonus) and that the remaining net income is to be divided equally. If the partnership income before the bonus for the year is $115,200, Chan's share of the net income is:

A $57,600
B $67,200
C $69,120
D $86,400

3. When fixed-price construction contracts require more than one accounting period for completion and the contract costs can be reasonably estimated, revenue should be recognised

A when cash is received from the buyer.
B at the completion of production.
C when title to the project is transferred to the buyer.
D during production.

4. In which of the following examples of real estate transactions would the seller NOT transfer the usual risks and rewards of ownership?

(1) The buyer can compel the seller to repurchase the property
(2) The seller guarantees the return of the buyer's investment
(3) The seller is required to support operations of the buyer and will be reimbursed on a cost plus 10% basis

A (1) and (2)
B (1) and (3)
C (2) and (3)
D All of the above

5. Which of the following statement(s) is (are) correct about the carrying amount of a long-lived asset after an impairment loss has been recognised? Assume the long-lived asset is being held for use in the business and that the asset is depreciable.

(1) The reduced carrying amount of the asset may be increased in subsequent years by means of a prior period adjustment if the impairment loss has been recovered
(2) The reduced carrying amount of the asset represents the amount that should be depreciated over the asset's remaining useful life

A (1) only
B (2) only
C (1) and (2)
D Neither (1) nor (2)

6. Times Ltd prepares its statement of cash flows using the direct method. Times sold equipment with a book value of $60,000 at a gain of $8,000. The amount to be reported on the statement of cash flows under operating activities is

A nil
B ($8,000)
C $8,000
D $68,000

7. Which of the following items would be a violation of materiality?

A A company did not separately report an unusual gain of $10,000. Its income from operations was $1,000,000.
B $6,000 expenditure to improve a building that originally cost $800,000 was expensed.
C A company expensed the purchase of pencil sharpeners that have estimated useful life of three years.
D A $100,000 illegal bribe to a foreign official was not separately disclosed in the annual report.

8. On 1 September 2000, King Ltd paid $20 a share for all 60,000 shares of Prince Ltd. The carrying amounts of Prince's identifiable assets and liabilities on 1 September 2000 are

Cash	$120,000
Inventories	$360,000
Plant assets (net)	$720,000
Liabilities	$(270,000)

On 1 September 2000, the inventories of Prince Ltd had a current fair value of $285,000, and the plant assets (net) had a current fair value of $840,000.

The amount recognised as goodwill as a result of the business combination is:

A nil
B $75,000
C $225,000
D $270,000

9. Which of the following is the best theoretical justification for consolidated financial statements?

A In form the constituent companies are one economic entity; in substance they are separate.
B In form the constituent companies are separate, in substance they are one economic entity.
C In form and substance the constituent companies are separate.
D In form and substance the constituent companies are one economic entity.

10. Beta Ltd has a current ratio of 1.5 and working capital of $50,000. Total current liabilities are equal to

A $75,000
B $100,000
C $150,000
D Cannot be determined with the information given

11. An extremely high debtor turnover might indicate that

A the company is unsuccessful in its efforts to collect cash from customers.
B net credit sales for the year have been understated.
C debtor balances have been overstated.
D policies for extending credit to customers are too tight.

12. Which one of the following best describes the reason for allocating a fixed asset's cost over its useful life?

A To provide a better measure of the market value of the asset on the balance sheet
B To match the cost of the asset with the revenue it is used to produce
C To gradually bring the cost of the asset into income rather than having to expense it all in the year of acquisition
D To reduce income to take advantage of the tax benefits of owning fixed assets

13. All of the following items are classified as accounting assumptions and conventions EXCEPT for

A going concern
B entity
C monetary unit
D timeliness

14. According to the recognition criteria established for revenue, revenue is normally recognised

A during production.
B at the completion of production.
C when cash is received from the customer.
D at the point of sale.

15. Using the straight-line method to amortise goodwill is an application of expense recognition using

A the percentage-of-completion method.
B association of cause and effect.
C immediate recognition.
D a systematic and rational allocation method.

16. Current liabilities are defined as

A obligations that will be paid using existing resources, regardless of their classification.
B obligations that will be paid by refinancing through issuing new long-term liabilities.
C obligations that will be paid using existing resources properly classified as current assets.
D obligations that will be paid out of a fund classified as a long-term investment.

17. A contingent liability should be accrued if it is

A reasonably possible and measurable.
B probable and certain in measurement.
C certain.
D probable and reasonably estimated.

18. Great Eagle Ltd incurred the following costs during the year in the development and production of a new product:

$475,000	in the design, construction, and testing of a preproduction prototype and model
$45,000	in trouble-shooting in connection with breakdowns during commercial production
$38,000	in legal fees to obtain a patent
$310,000	in engineering activity required to advance the design of the product to the point that it was ready for manufacture

How much should be included in research and development cost for the year?

A $475,000
B $785,000
C $830,000
D $868,000

19. Where, as a result of past events, there is a possible asset whose 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 enterprise, and the inflow of economic benefits is not probable

(1) the asset is not contingent
(2) no asset is recognised
(3) disclosures are required
(4) no disclosure is required

A (1) and (3)
B (1) and (4)
C (2) and (3)
D (2) and (4)

20. On 1 January 2000, Alpha Ltd had issued share capital comprising 103,800 ordinary shares of $3 each. On 1 August 2000, it issued 60,000 ordinary shares at a market price of $5 each. During the year, dividends of $28,000 and $560,000 were declared and paid on the ordinary and preference shares respectively. Net income for the year was $2,400,000. The earnings per share for the year were

A $10.56
B $11.23
C $14.29
D $18.63

(Total 20 marks)

[END OF SECTION A]

SECTION B (COMPULSORY) (30 marks)

1. The draft balance sheets of Spring Ltd, Summer Ltd and Winter Ltd as at 31 October 2000 were as follows:

	Spring Ltd		Summer Ltd		Winter Ltd	
	$	$	$	$	$	$
Fixed assets						
Leasehold building at cost	200,000		240,000		80,000	
Accumulated depreciation	(72,000)	128,000	(80,000)	160,000	(32,800)	47,200
Plant and equipment at cost	205,800		340,000		184,000	
Accumulated depreciation	(139,800)	66,000	(172,000)	168,000	(96,400)	87,600
		194,000		328,000		134,800
Investments						
Shares in Summer Ltd at cost		270,000		-		-
Shares in Winter Ltd at cost		310,000		-		-
Current assets						
Stock	347,000		211,000		266,800	
Debtors	131,400		341,600		167,000	
Bank	50,400	528,800	-	552,600	50,800	484,600
		1,302,800		880,600		619,400
Current liabilities						
Creditors	320,000		155,400		118,400	
Profits tax	114,800		94,400		49,000	
Proposed dividends	160,000		96,000		24,000	
Bank overdraft	-	(594,800)	74,800	(420,600)	-	(191,400)
		708,000		460,000		428,000
Capital and reserves						
Ordinary shares of $1 each		400,000		240,000		200,000
10% Preference shares of $0.5 each		-		-		80,000
Share premium		-		50,000		-
Accumulated profits		308,000		170,000		148,000
		708,000		460,000		428,000

The following additional information is also given:

(a) On 31 October 1990 Spring Ltd bought 80% of the ordinary share capital of Summer Ltd.

(b) On 1 May 2000 Spring Ltd bought 75% of the ordinary share capital and 50% of the preference share capital of Winter Ltd.

(c) All ordinary shares are $1 each, fully paid.

(d) Preference shares in Winter Ltd are 50 cents each, fully paid.

(e) Proposed dividends in Winter Ltd are:

ordinary shares	$20,000
preference shares	$ 4,000

All dividends receivable are not accounted for until they are received. There has been no change in the ordinary and preference share capital during the year ended 31 October 2000.

(f) Goods purchased by Winter Ltd from Spring Ltd and remaining in stock at 31 October 2000 amounted to $50,000. The profit element is 20% of selling price for Spring Ltd.

(g) Intra group balances are included in debtors and creditors as follows:

				$
Spring Ltd	Creditors	-	Summer Ltd	91,200
	Creditors	-	Winter Ltd	57,800
Summer Ltd	Debtors	-	Spring Ltd	113,800
Winter Ltd	Debtors	-	Spring Ltd	57,800

(h) A cheque drawn by Spring Ltd for $22,600 on 28 October 2000 was received by Summer Ltd on 3 November 2000.

(i) At 31 October 1990, the balance of the profit and loss account in Summer Ltd was $56,000 credit.
At 31 October 1999, the balance of the profit and loss account in Winter Ltd was $124,000 credit.

(j) Goodwill arising on consolidation should be written off immediately through reserves.

REQUIRED:

Prepare a consolidated balance sheet as at 31 October 2000 for Spring Ltd and its subsidiaries.

(30 marks)

[END OF SECTION B]

SECTION C (ANSWER TWO QUESTIONS ONLY) (50 marks)

Answer any **TWO** questions in this section. Each question carries 25 marks

2. Chan and Tai were in partnership sharing profits and losses in the ratio of 2:1 (Chan : Tai). The partnership's accounts as at 31 December 2000 were as follows:

	$'000	$'000
Fixed assets, net book value		
Land and building	1,000	
Plant and machinery	600	1,600
Current assets		
Stock	2,860	
Debtors	5,580	
Provision for doubtful debts	(112)	
Bank	2,572	
	10,900	
Current liabilities	(9,410)	1,490
		3,090
Capital account		
Chan	1,500	
Tai	900	2,400
Current account		
Chan	510	
Tai	180	690
		3,090

On the same day, they agreed to admit Man into the partnership. Man introduced $2,000,000 cash as his share of capital. The new profit and loss sharing ratio was 2:1:1 (Chan : Tai : Man).

The partners further agreed that:

(i) Goodwill should be valued at two times the average profits of the last three years. Goodwill was not maintained in the books; adjusting entries for goodwill between the partners were made in their capital accounts. Profits for the last three years were:

1998	$1,550,000
1999	$1,650,000
2000	$1,750,000

(ii) Land and buildings, and plant and machinery were revalued at $3,000,000 and $400,000 respectively.

(iii) Provision for doubtful debts should be increased by $200,000.

(iv) The value of stock should be reduced by $1,000,000.

(v) The fixed capital of the business should be $4,800,000 contributed by the partners in their profit sharing ratio. Any surplus or deficit should be transferred to their current accounts.

REQUIRED:

(a) **Prepare the revaluation account, partners' capital accounts and current accounts (in columnar form) reflecting the changes in the partnership. Show all workings.**

(15 marks)

(b) **Prepare the balance sheet of the partnership as at 1 January 2001.**

(5 marks)

(c) **Give five reasons why goodwill exists in a business.**

(5 marks)

(Total 25 marks)

3. H Ltd is a manufacturing company with a subsidiary, S Ltd, and an associate, A Ltd. During the year ended 31 March 2001, the following transactions took place:

(i) H Ltd sold goods for $800,000 to S Ltd.

(ii) A Ltd paid a management fee of $500,000 to H Ltd.

(iii) H Ltd rented office premises from Mr Leung, the managing director and shareholder of the company, and paid rental of $1,200,000.

(iv) H Ltd purchased raw materials for $1,000,000 from B Ltd. The entire share capital of B Ltd was held by a close relative of the managing director of H Ltd.

The above transactions were conducted on arm's length terms.

REQUIRED:

(a) Explain the following terms in accordance with SSAP 2.120 "Related Party Disclosures":

(i) related party (3 marks)

(ii) related party transaction (1 mark)

(iii) control (2 marks)

(iv) significant influence (2 marks)

(b) Describe two possible pricing methods for related party transactions. (5 marks)

(c) Discuss whether the parties involved in the transactions listed above are related parties, and whether the transactions need to be disclosed in the consolidated financial statements of H Ltd for the year under review. (12 marks)

(Total 25 marks)

4. (a) Answer the following questions with reference to SSAP 2.113 "Accounting for Investment Properties" and SSAP 2.117 "Property, Plant and Equipment".

(i) It is generally agreed that an increase in the value of a depreciable asset does not remove the necessity to charge depreciation to reflect on a systematic basis the consumption of the asset. Discuss the need for charging depreciation on "investment properties".

(4 marks)

(ii) Under SSAP 2.117, enterprises continue to have the option to carry fixed assets at valuation or at depreciated original cost. If enterprises take the option to revalue assets, explain the accounting practice with respect to revaluation requirements and the related depreciation charge and revaluation surplus/deficit.

(8 marks)

(b) Solar Estate Ltd owned the following properties at 31 December 2000:

	Purchase date	Cost	First let	Market value at 31 Dec 2000
		$'000		$'000
Sun House	1 Oct 1999	10,000	1 Nov 1999	11,500
Earth House	2 Oct 1999	15,000	1 Dec 1999	14,500
Moon House	1 Oct 1997	25,000	15 Nov 1997	15,000
Star House	1 Oct 1999	35,000		38,000

The company uses Star House as its office. All other properties are let at full market rental, and Moon House is let to a wholly owned subsidiary. All current values are estimated based on the directors' past experience in the property market.

The company's policy is to provide annual depreciation on buildings at 2% on cost. A full year's depreciation is to be provided in the year of acquisition.

REQUIRED:

(i) Explain which, if any, of these properties is/are likely to be an investment property, and what additional information you may require before reaching a final conclusion.

(4 marks)

(ii) Explain how these properties would be dealt with in the financial statements of Solar Estate Ltd for the year ended 31 December 2000.

(7 marks)

(iii) If Star House were only partially occupied by Solar Estate Ltd as an office and the rest were rented out to outsiders, what would the accounting treatment be?

(2 marks)

(Total 25 marks)

5. Answer the following questions with reference to SSAP 2.109 "Events after the Balance Sheet Date" and SSAP 2.128 "Provisions, Contingent Liabilities and Contingent Assets".

(a) Define the following terms:

(i) events after the balance sheet date (3 marks)

(ii) a contingent liability (3 marks)

(iii) a contingent asset (2 marks)

(b) SSAP 2.109 states that "financial statements should be prepared on the basis of events occurring up to the balance sheet date and conditions existing at that date". In some cases, conditions existing at the balance sheet date can only be ascertained after that date.

REQUIRED:

Comment on whether the standard succeeds in ensuring that:

(i) financial accounts are prepared in accordance with this rule

(ii) financial accounts prepared in accordance with this rule are not misleading.

(8 marks)

(c) The draft accounts of Olympic Ltd for the year ended 31 January 2001 show a pre-tax profit of $888,000**.** Before the company's directors meet to approve the accounts, the following additional information is presented:

(i) In November 2000, the company received a complaint from a US chain store that one of the beds produced by it on display had collapsed when lain on by an overweight customer. The chain store was sued by the customer for damages amounting to US$30,000. Olympic had been advised by its lawyer not to take any action until the US chain store took an action against the company.

(ii) In February 2001, the company entered into a contract to purchase machinery costing $2 million.

(iii) In March 2001, the company's entire stock of material XYZ (which had been damaged by water in an accident in February 2001) was sold for $180,000. The book value of the stock was $380,000.

REQUIRED:

Discuss how the above items should be dealt with in the financial statements of Olympic Ltd for the year ended 31 January 2001.

(9 marks)

(Total 25 marks)

[END OF PILOT EXAMINATION PAPER]

Accounting Technician Examinations

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Level II

Paper 7
Advanced Accounting

Suggested Answers
and
Marking Scheme

SECTION A (MULTIPLE CHOICE QUESTIONS) (20 marks)

1. C
2. B
3. D
4. A
5. B
6. A
7. D
8. C
9. B
10. B
11. D
12. B
13. D
14. D
15. D
16. C
17. B
18. B
19. D
20. C

(Total 20 marks)

SECTION B (COMPULSORY) (30 marks)

1. **Spring Ltd and its subsidiaries**

Consolidated balance sheet as at 31 October 2000

		Marks		Marks		Marks
	$		$		$	
Fixed assets						
Leasehold building at cost			520,000	[1]		
Less: Depreciation			184,800	[1]	335,200	
Plant and equipment at cost			729,800	[1]		
Less: Depreciation			408,200	[1]	321,600	
					656,800	
Current assets						
Stock (347,000+211,000+266,800–10,000)			814,800	[2]		
Debtors (131,400+341,600+167,000–171,600)			468,400	[2]		
Bank (50,400+50,800+22,600)			123,800	[2]		
			1,407,000			
Less: Current liabilities						
Creditors (320,000+155,400+118,400–149,000)	444,800	[2]				
Profits tax	258,200	[1]				
Proposed dividend	160,000	[2]				
Proposed dividend payable to MI (96,000 × 20% + 20,000 × 25% + 4,000 × 50%)	26,200	[2]				
Bank overdraft	74,800	[1]	964,000		443,000	
					1,099,800	
Capital and reserves						
Ordinary shares					400,000	[1]
Consolidated profit and loss					480,800	[1]
					880,800	
Minority Interest					219,000	[1]
					1,099,800	

(21 marks)

Cost of control – Summer

Cost of shares	270,000	Share capital	192,000
Capital reserve on consolidation	6,800	Profit and loss	44,800
		Share premium (50,000 × 80%)	40,000
	276,800		276,800

(1 mark)

Cost of control – Winter

Cost of shares	310,000	Share capital – ordinary	150,000
		– preference	40,000
		Profit and loss	102,000
		Pre-acquisition dividend – ordinary (20,000 × 75% × ½)	7,500
		Pre-acquisition dividend – preference (4,000 × 50% × ½)	1,000
		Goodwill	9,500
	310,000		310,000

(2 marks)

Profit and loss – Summer

Cost of control (56,000 × 80%)	44,800	Bal b/d	170,000
Consolidated profit and loss (114,000 × 80%)	91,200		
Minority interest (170,000 × 20%)	34,000		
	170,000		170,000

(1 mark)

Profit and loss – Winter

Cost of control (124,000 + 24,000 × ½) × 75%	102,000	Bal b/d	148,000
Consolidated profit and loss (24,000 × ½ × 75%)	9,000		
Minority interest (148,000 × 25%)	37,000		
	148,000		148,000

(1 mark)

Consolidated profit and loss

Goodwill w/o (9,500 – 6,800)	2,700	Profit and loss – Spring	308,000
Unrealised profit in stock		– Summer	91,200
(50,000 × 20%)	10,000	– Winter	9,000
Bal c/d	480,800	Dividend receivable from Winter	
		– Ordinary (20,000 × 75% × ½)	7,500
		– Preference (4,000 × 50% × ½)	1,000
		Dividend receivable from Summer (96,000 × 80%)	76,800
	493,500		493,500

(2 marks)

Minority interest

Bal c/d	219,000	Summer	
		– Ordinary shares	48,000
		– Share premium	10,000
		– Profit and loss	34,000
		Winter	
		– Ordinary shares	50,000
		– Preference shares	40,000
		– Profit and loss	37,000
	219,000		219,000

(2 marks)

Intra-company account

Bal b/d	113,800	Bal b/d	91,200
Bal b/d	57,800	Bal b/d	57,800
		Cash in transit	22,600
	171,600		171,600

(Total 30 marks)

SECTION C (ANSWER TWO QUESTIONS ONLY) (50 marks)

2. (a)

Revaluation account

	Marks	$'000		Marks	$'000
Plant and machinery	**[0.5]**	200	Land and buildings	**[0.5]**	2,000
Stock	**[0.5]**	1,000			
Provision for doubtful debts	**[0.5]**	200			
Capital – Chan	**[0.5]**	400			
– Tai	**[0.5]**	200			
		2,000			2,000

Capital account

	Chan	Tai	Man		Chan	Tai	Man
	$'000	$'000	$'000		$'000	$'000	$'000
Goodwill w/o	1,650	825	825	Bal b/d	1,500	900	
	[0.5]	**[0.5]**	**[0.5]**		**[0.25]**	**[0.25]**	
Current	50	175		Revaluation	400	200	
	[0.5]	**[0.5]**			**[0.75]**	**[0.75]**	
Bal c/d	2,400	1,200	1,200	Goodwill	2,200	1,100	
	[0.5]	**[0.5]**	**[0.5]**		**[0.5]**	**[0.5]**	
				Bank			2,000
							[0.5]
				Current			25
							[0.5]
	4,100	2,200	2,025		4,100	2,200	2,025

Current account

	Chan	Tai	Man		Chan	Tai	Man
	$'000	$'000	$'000		$'000	$'000	$'000
Capital			25	Bal b/d	510	180	
			[0.25]		**[0.25]**	**[0.25]**	
Bal c/d	560	355		Capital	50	175	
	[0.25]	**[0.25]**			**[0.25]**	**[0.25]**	
				Bal c/d			25
							[0.25]
	560	355	25		560	355	25

Calculation of goodwill

Profits for 1998	$1,550,000
1999	1,650,000
2000	1,750,000
	4,950,000

Marks

Average profits for last three years = $4,950,000/3 = 1,650,000

Goodwill = 2 × average profits
= $1,650,000 × 2
= $3,300,000 **[2]**

(15 marks)

(b)

Balance sheet as at 1 January 2001

	$'000	$'000	
Fixed assets			
Land and building	3,000		**[0.5]**
Plant and machinery	400	3,400	**[0.5]**
Current assets			
Stock	1,860		**[0.5]**
Debtors	5,580		**[0.5]**
Provision for bad debts	(312)		**[0.5]**
Bank (2,572 + 2,000)	4,572		**[0.5]**
	11,700		
Current liabilities	(9,410)	2,290	**[0.5]**
		5,690	
Capital			
Chan	2,400		**[0.25]**
Tai	1,200		**[0.25]**
Man	1,200	4,800	**[0.25]**
Current			
Chan	560		**[0.25]**
Tai	355		**[0.25]**
Man	(25)	890	**[0.25]**
		5,690	

(5 marks)

(c) Reasons why goodwill exists in a business:

(i) Reputation of the partners and/or partnership
(ii) Quality of products/services sold
(iii) Site or other monopoly advantage
(iv) Valuable patents, trademarks or other form of licence
(v) Ability to generate above-average profits
(vi) Quality labour force and/or quality management
(vii) External factors favourable to the business

(1 mark for each, max 5 marks)

(Total 25 marks)

3. (a) (i) Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. **[2 marks]** Parties are also considered to be related if they are subject to common control or common significant influence. **[1 mark]**

(3 marks)

(ii) A related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. **[1 mark]**

(1 mark)

(iii) Control is defined as ownership, directly or indirectly, of more than one half of the voting power of an enterprise, **[1 mark]** or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of management of the enterprise. **[1 mark]**

(2 marks)

(iv) Significant influence is defined as participation in the financial and operating policy decisions of an enterprise, but not control of those policies. **[1 mark]** Significant influence may be exercised by representation on the board of directors, or by participation in the policy making process, material intercompany transactions, interchange of managerial personnel or dependence on technical information. **[1 mark]**

(2 marks)

(b) (i) Comparable uncontrolled price method

The price for a transaction between related parties is set by referring to the price in a comparable uncontrolled transaction – a transaction between unrelated parties where the products, markets and transaction terms are substantially similar to the related party transaction. This method is appropriate when both the characteristics of the products and the economic circumstances surrounding the related party transactions are substantially the same as those between independent parties.

(ii) Cost-plus method

The price for transactions between a manufacturer and a related purchaser is based on mark-ups over the cost achieved by a comparable manufacturer in unrelated transactions. The mark-ups are determined by referring to those earned for products of significant similarity. This method is appropriate when a manufacturer sells semi-finished products to related manufacturing companies for further processing.

(iii) Resale price method

The method determines the price for the sale of goods between a supplier and a related reseller (distributor, wholesaler or retailer) by subtracting an appropriate re-sale profit margin from the price at which the goods are re-sold by the related company to independent customers. The profit margin is determined by referring to the gross margin achieved by an independent reseller dealing with similar products under same general economic conditions. This method is appropriate where the reseller provides little value-added service for the products.

(Any 2 for 2.5 marks each, total 5 marks)

(c) (i) S Ltd is directly controlled by H Ltd, hence they are related parties. **[1.5 marks]** However, no disclosure is required for transactions between members of a group because consolidated financial statements present information about the holding company and subsidiaries as a single reporting enterprise. Any offset of transactions between members of the group is eliminated on consolidation. **[1.5 marks]**

(ii) Parties are considered to be related if one party has the ability to exercise significant influence over the other party. Since H Ltd and A Ltd are associated, they are related parties. **[1.5 marks]** Transactions between associates are not eliminated on consolidation, and therefore require separate disclosure as related party transactions. **[1.5 marks]**

(iii) Mr Leung is a key management personnel of H Ltd, hence they are related parties. **[1.5 marks]** The transaction between Mr Leung and H Ltd is a related party transaction and therefore must be disclosed in the consolidated financial statements of H Ltd. **[1.5 marks]**

(iv) Since B Ltd is owned by a close relative of the key management personnel of H Ltd, B Ltd and H Ltd are related parties. **[1.5 marks]** The transaction between B Ltd and H Ltd is a related party transaction and therefore must be disclosed in the consolidated financial statements of H Ltd. **[1.5 marks]**

(12 marks)

(Total 25 marks)

4. (a) (i) Since investment properties are not held for consumption in the business operations but as investment, their disposal would not materially affect any manufacturing or trading operations of a company. **[1 mark]** In such a case the current value of these investments, and changes in that current value, are of prime importance, rather than a calculation of systematic periodic depreciation. **[1 mark]** Consequently, for the proper appreciation of the financial position, investment properties are generally not required to be depreciated, but are included in the balance sheet at their open market value. **[1 mark]**

However, where the unexpired term of the lease is 20 years or less, the property should be depreciated. This is to avoid the situation whereby a short lease is amortised against the investment property revaluation reserve while the rentals are taken to the profit and loss account. **[1 mark]**

(4 marks)

(ii) Up-to-date valuations required at each balance sheet date

Where assets are carried at revalued amounts, the valuations must now be carried out with sufficient regularity such that the carrying value does not differ materially from the fair value at each balance sheet date. **[0.5 mark]** In volatile markets, such as the Hong Kong property market, this may require valuations be carried out every time accounts are prepared. In other more stable markets, less frequent valuations, for example every three years, may be acceptable provided the directors carry out a review of the carrying value at each balance sheet date. **[0.5 mark]**

It is important to note, however, that depreciation is required even when valuations are carried out every year. **[1 mark]** For example, if an asset is revalued on the last day of the year, the profit and loss account will be charged depreciation for the whole year, based on the brought forward carrying value; if it is revalued at the start of the year, the depreciation charge for the rest of the year will be based on the new valuation. **[1 mark]**

Whole class of assets to be revalued at the same time

Under SSAP 2.117, when an asset is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued. **[1 mark]** "Classes" are described as a grouping of assets of a similar nature and use in an enterprise's operations. Common classes include "land and buildings", "machinery" and "furniture and fixtures". **[0.5 mark]** In some circumstances, further sub-divisions may be acceptable; for example "land and buildings" could be sub-divided into factories, hotels and offices on the basis that these have dissimilar uses. However, it is doubtful that any further sub-division, for example between long-term and medium-term leases, would follow the spirit of the SSAP. **[0.5 mark]**

Even though the revaluation of assets is to be carried out on a class by class basis, this does not mean that it is acceptable to offset deficits arising on one asset with surpluses arising on another. **[1 mark]** Therefore deficits arising on revaluation must be charged to the profit and loss account unless the revaluation reserve holds an amount in respect of the same asset. **[1 mark]** Subsequent surpluses on revaluation can be credited to the profit and loss account to the extent that they reverse a deficit previously recognised with respect to the same asset. **[1 mark]**

(8 marks)

(b) (i) Star House is not an investment property since it is owned and occupied by the company for its own purposes. **[1 mark]**

Moon House is not an investment property as it is let to and occupied by another company in the group. **[1 mark]**

Sun House and Earth House would appear to be investment properties as the rental income for both is negotiated at arm's length. **[1 mark]** The additional information that may be relevant is whether these two properties are held as investments. If the properties are held as investments, they are investment properties. Otherwise, they are not investment properties. **[1 mark]**

(4 marks)

(ii) Assuming that Sun House and Earth House are held as investments, they should be classified as investment properties and included in the balance sheet at their open market value. **[1 mark]**

Investment properties	***Market value***	Surplus (Deficit) credited / charged to revaluation reserve	
	$	$	**Marks**
Sun House	11,500,000	1,500,000	**[1]**
Earth House	14,500,000	(500,000)	**[1]**
	26,000,000	1,000,000	

Balance sheet notes should disclose:

(a) The basis of valuation and the fact that the valuation is made by the company's officers. **[0.5 mark]**

(b) The balance on the investment property revaluation reserve ($1m) together with details of movements during the year. **[0.5 mark]**

Moon House and Star House are to be treated as depreciable assets and should be depreciated over their estimated useful life. These two fixed assets will therefore be reported in the balance sheet at the following figures: **[1 mark]**

Buildings	Cost	Accumulated deprecation	Net book value	
	$	$	$	
Moon House	25,000,000	2,000,000	23,000,000	**[0.5]**
Star House	35,000,000	1,400,000	33,600,000	**[0.5]**
	60,000,000	3,400,000	56,600,000	

Balance sheet notes should disclose the accounting policy, depreciation methods and depreciation rates adopted by the company. **[1 mark]**

(7 marks)

(iii) If only 15% or less by area or value of a property is occupied by the company or another company in the group, the property will normally be regarded as an investment property. **[1 mark]** If the part occupied by the owner is more than 15% by area or value, the occupied part of the property should be treated as a depreciable asset and SSAP 2.117 should be applied; the part held as an investment property should be identified separately in the accounts and included in the balance sheet at its open market value. **[1 mark]**

(2 marks)

(Total 25 marks)

5. (a) (i) "Events after the balance sheet date" are those events, both favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. **[1 mark]** Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); **[1 mark]**

(b) those that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date). **[1 mark]**

(3 marks)

(ii) "A contingent liability" is:

(a) a possible obligation that arises from past events and whose 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 enterprise; or **[1 mark]**

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or **[1 mark]**

(ii) the amount of the obligation cannot be measured with sufficient reliability. **[1 mark]**

(3 marks)

(iii) "A contingent asset" is a possible asset that arises from past events **[1 mark]** and whose 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 enterprise. **[1 mark]**

(2 marks)

(b) (i) The objective of a balance sheet is to show the state of affairs of a business as at a particular date. Many items included in a balance sheet will require estimates to be made as to the amount at which they should be stated. Events occurring after the balance sheet date may provide evidence as to the true value of a certain asset as at that date, or the full amount of a certain liability. **[1 mark]** It is appropriate, when preparing the balance sheet, that such evidence should be taken into account in deciding what amount to attribute to such assets and liabilities. SSAP 2.109 provides for this to happen by requiring figures in the accounts to be altered when "adjusting events" arise. Adjusting events are defined as "events after the balance sheet date which provide

evidence of conditions that existed at the balance sheet date". **[1 mark]** Adjustment to the accounts will also be appropriate when it becomes clear after the balance sheet date that the basis on which the accounts were prepared is unsound. **[1 mark]** Thus SSAP 2.109 requires adjustment to the accounts in the event that the going concern basis turns out to be inapplicable. In this way SSAP 2.109 seeks to ensure that financial statements reflect as fully as possible the conditions which exist at the year end. **[1 mark]**

(ii) Adjusting events should be consistent with the time interval concept: that financial statements are prepared for a period of time, and events occur in either one period or another. Any attempt to record transactions and events occurring after the year end in a particular year's accounts would remove the status of the balance sheet as a statement of assets and liabilities at that moment in time. **[1.5 marks]**

However, events can occur after the year end which may give rise to significant changes to a company's financial position after the year end. It would be inappropriate to reflect such events in the balance sheet and profit and loss account, and yet to omit them completely from the financial statements would prevent a reader from properly understanding the company's financial position. **[1 mark]** When these events occur before the accounts are authorised for issue, then the opportunity exists to disclose this new information by way of a note to the accounts. This is known as a non-adjusting event. **[0.5 mark]** The note should state the nature of the event and give an estimate of the financial effect (or a statement that an estimate is not practicable). **[0.5 mark]** SSAP 2.109 thus seeks to prevent the release of misleading accounts by requiring disclosure in a note of material non-adjusting events after the balance sheet date. **[0.5 mark]**

(8 marks)

(c) (i) At this stage, there is not enough information to indicate whether the company has any contingent liability. As no other information is available the degree of probability of the loss is indeterminable, although common sense would suggest that it might arise. **[1 mark]** The directors would probably prefer not to disclose the possibility of legal action, but they would not be justified in treating the possibility of loss as remote. **[1 mark]** It should be disclosed along with a statement that it is impracticable to estimate the financial effect – the US company being sued for US$30,000 does not limit the company's potential loss to that amount, it all depends on what the US company claims, if anything, as a result of the case. **[1 mark]**

(ii) The event has arisen after the balance sheet date. **[1 mark]** It is not an adjusting event as it concerns conditions (the machinery was purchased in February 2001) which did not exist at the balance sheet date. **[1 mark]** The nature and financial effects of the purchase should be disclosed as non-disclosure will affect the ability of the users of the financial statements to make proper evaluations and decisions. **[1 mark]**

(iii) The event has arisen after the balance sheet date. **[1 mark]** It is not an adjusting event as it concerns conditions (damage of stock in February 2001) which did not exist at the balance sheet date. **[1 mark]** The nature and financial effects of the site accident should be disclosed if non-disclosure will affect the ability of the users of the financial statements to make proper evaluations and decisions. **[1 mark]**

(9 marks)

(Total 25 marks)

– END –