Examination Panelist's Report

Paper I
PBE Financial Accounting
(December 2017 Session)

(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)

General Comments

The overall performance in the December 2017 session was disappointing. The performance in Section B was consistently alarming. Quite a number of candidates only attempted two questions in Section B. Candidates did not prepare sufficiently for the examination and had difficulty in understanding some commonly-assessed financial reporting concepts such as provisions, fair value less cost of disposal and measurement of financial instruments. It was also noted that candidates were weak in applying accounting concepts to reach a correct conclusion in solving problems from an accounting perspective. As highlighted in the previous Examination Panelist's report, candidates were still weak in expressing their thoughts in a logical manner in discursive questions. Ignoring the discursive questions risks not getting a pass for the examination.

Specific Comments

Section A – Compulsory Question

Question 1 – 40 marks

Part (a) of Question 1 assessed candidates' ability to prepare consolidated financial statements. In this part, candidates were required to deal with the fair value differential adjustment, calculation of goodwill and non-controlling interest using the fair value method, upstream intra-group transfer of machinery items as well as the application of the equity method for an investment in an associate.

Although consolidation techniques have been consistently assessed in the PBE Paper I and this consolidation exercise was relatively straightforward, candidates' performance was less satisfactory than expected. The following mistakes were commonly observed:

(i) Candidates did not perform satisfactorily in the computation of goodwill in this consolidation exercise. This revealed that candidates did not master the fair value method in HKFRS 3 (Revised) *Business Combinations*, although this weakness has already been highlighted repeatedly in recent Examination Panelist's reports. Quite a number of candidates ignored this requirement and still computed the goodwill using the proportionate interest method. This would definitely lead to the wrong balance of non-controlling interest at the end of the reporting period.

(ii) Candidates could, in general, deal with the fair value differential arising from Property Y, including the extra depreciation expense and the sharing of such expense to the non-controlling interest, correctly. Yet, they demonstrated insufficient understanding of how an upstream transfer of machinery items should be accounted for. Quite a number of candidates treated this transaction as the same as an inventory sale and eliminated "sales" and "cost of sales" correspondingly which was incorrect. They failed to eliminate the unrealised gain arising from this intra-group transaction. Further,

candidates failed to demonstrate an understanding that such an unrealised gain would be realised through a reduced depreciation expense throughout the remaining useful life of the machinery items. Lastly, quite a number of candidates did not share such realisation of unrealised profit in this intra-group transaction with the non-controlling interest. Candidates should familiarise themselves with the mechanics of the intra-group transfer of property, plant and equipment which are summarised as follows: (1) eliminating the unrealised profit upon transfer; (2) realising the unrealised profit throughout the remaining useful life by a reduction in the annual depreciation expense; and (3) sharing with the non-controlling interest regarding the elimination of unrealised profit (in (1)) and the realisation of the unrealised profit (in (2)), if the transfer is an upstream transaction. This is based on the rationale that, in an upstream transfer, the unrealised profit was recognised in the books of the subsidiary and the reduction in the annual depreciation expense, which is in fact realising such unrealised profit, also affects the books of the subsidiary.

(iii) Still, candidates did not account for the elimination of dividends properly. Candidates wrongly performed a partial elimination of the dividends to the parent which led to an incorrect balance of non-controlling interest at the end of the reporting period. This mistake has been repeatedly highlighted in recent Examination Panelist's reports and candidates should understand the elimination process in accordance with HKFRS 10 *Consolidated Financial Statements*.

(iv) Candidates were weaker in the application of the equity method for the investment in an associate. In general, they were able to handle the capitalisation of profits of the associate in the current year. Candidates also demonstrated an improvement in presenting such calculations on the consolidated statement of profit or loss and statement of financial position as a share of associate's profits and investment in associate respectively. Yet, they still had difficulty in dealing with the reclassification of dividends distributed by the associate in the consolidated financial statements. Quite a number of candidates mistakenly included the effect of such a reclassification in the share of associate's profit in the consolidated statement of profit or loss. Candidates should note that investment in an associate is very common in practice and they should be equipped with the fundamental mechanics of equity accounting in the consolidation process.

Part (b) required candidates to identify related parties in accordance with HKAS 24 (Revised) *Related Party Disclosures*. The performance was average. Candidates could reach correct conclusions to relatively straightforward situations (such as whether the parent and associate of the parent are related parties) in this scenario. Yet, candidates are advised to demonstrate a better understanding of some terminologies in HKAS 24 (Revised) such as "key management personnel" and "close member of the family". Further, quite a number of candidates demonstrated a very weak understanding with regard to entities having a common director in the context of HKAS 24 (Revised).

Part (c) assessed candidates' knowledge in a business combination transaction. Candidates correctly included cash consideration and share consideration as part of the total consideration. Yet, candidates were weak in explaining the accounting treatment of the acquisition-related costs. Disappointingly, a number of candidates still wrongly capitalised the acquisition-related costs as part of the investment cost. This mistake was highlighted in the Examination Panelist's report of the June 2017 diet. Further, candidates could not

describe the accounting treatment of a gain on a bargain purchase. Some could not even use the correct terminology for this in accordance with HKFRS 3 (Revised) despite the fact that such weakness has been highlighted in the Examination Panelist's report in the December 2016 diet.

Section B – Optional Questions

Question 2 – 20 marks

This question required candidates to apply the measurement principles of HKFRS 9 (2014) *Financial Instruments* to various financial assets.

Part (a) assessed candidates' knowledge of the general measurement principles of financial assets. Not many candidates could state clearly the two conditions for measuring a financial asset at amortised cost, which are the business model test and the contractual cash flows characteristics test. Those who could state the conditions failed to apply them properly to the case. This demonstrated that candidates were generally weak when it came to application. Candidates should note that merely copying the facts in the questions was not considered an application. Candidates are advised to link the principles in the accounting standard to the facts stated in the case for a good demonstration of their knowledge.

Part (b) assessed extensively the two measurement options of investment in equity instruments. This part was straightforward. Although these concepts have been repeatedly assessed, the performance was not as good as expected. Only some candidates were able to state clearly the two measurement options which are fair value through profit or loss (FVTPL) and fair value through other comprehensive income (FVTOCI). Similar to the performance in the December 2016 diet, candidates were weak in dealing with transaction costs. Candidates are advised to master these basic concepts in HKFRS 9 (2014).

Part (c) assessed candidates' awareness of the three valuation approaches in HKFRS 13 *Fair Value Measurement*. The performance in this part was very poor. Nearly all candidates could not address this question. Most of them mistakenly described the three levels of input for fair value measurement which were assessed in the previous diet. Candidates should refer to the competency map of the PBE Paper I regarding fair value measurement as this relates to a number of topics throughout the syllabus.

Question 3 – 20 marks

This question required candidates to apply various accounting concepts to three scenarios relating to future losses. Candidates were expected to identify the issues in the case, state the general requirements of the relevant accounting standards and draw the conclusions accordingly. This was the most popular question in Section B; yet, the performance was the worst in this section.
The performance in part (a) was satisfactory as it simply required candidates to define and state the recognition criteria of provision in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This part was straightforward.

The first scenario in part (b) required candidates to apply the accounting concepts in HKAS 10 *Events after the Reporting Period* and HKAS 2 *Inventories* to a situation relating to sales of obsolete inventories right after the reporting period. Very few candidates identified both of the two relevant accounting standards. As a result, they failed to provide a comprehensive analysis of the scenario.

The second scenario in part (b) required candidates to apply the accounting concepts in HKAS 37 to a situation relating to restructuring costs. The performance in this part was very poor. Many candidates were not aware of the specific guidance in HKAS 37 regarding when restructuring costs could be recognised. They therefore simply concluded that a provision was to be recognised in this case given that (i) the board has already made a decision to restructure and (ii) the amount could be reliably estimated. In accordance with the competency map of the PBE Paper I, candidates were expected to demonstrate an ability to apply comprehensive knowledge and a broad range of skills in a business setting to solve problems relating to this area. Obviously, candidates' preparation was insufficient.

The last scenario in part (b) required candidates to apply the measurement principles in HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* in a relatively simple setting. Yet, candidates' performance revealed a number of weaknesses. Some candidates wrongly applied the accounting principles in HKAS 37 to this scenario which were irrelevant. More alarmingly, candidates were very weak when it came to the concept of fair value less cost to sell. Quite a number of them treated this accounting issue as a "real" disposal at the current moment. Similar weakness was in fact revealed in the previous diet relating to the concept of net realisable value in inventory measurement. Candidates should try to familiarise themselves with the concepts regarding fair value less cost to sell because these relate to a number of accounting standards within the syllabus of PBE Paper I such as impairment.

<u>Question 4 – 20 marks</u>

This question required candidates to demonstrate a comprehensive understanding with regard to HKAS 12 *Income Taxes* and an awareness of (i) the Hong Kong Small and Medium-sized Entity Financial Reporting Framework and Standard (the HK SME-FRF and HK SME-FRS) as well as (ii) the Conceptual Framework for Financial Reporting. The performance was poor.

Part (a) was related to income taxes. Although this topic has been consistently assessed in recent diets, candidates still failed to demonstrate the competency level needed for the requirements of PBE Paper I. A majority of the candidates failed to identify both the current tax and deferred tax issues arising from the scenario. Regarding the current tax issue, quite a number of candidates could not reconcile the accounting profit to taxable profit before applying the tax rate for computing the current tax payable by the entity. Regarding the deferred tax issue, candidates were weak at recognising the deferred tax movement in subsequent years. Worse still, candidates applied the wrong approach (i.e. the income statement approach) in dealing with deferred taxes by comparing the depreciation expenses and the tax allowances granted. This is not the proper approach stipulated in HKAS 12. Candidates are reminded, once again, to familiarise themselves with the concepts of a tax base in HKAS 12.

Parts (b) and (c) related to HK SME-FRF and HK SME-FRS. Generally, candidates could give a correct account of the advantages of adopting the HK SME-FRF and HK SME-FRS. Yet, they failed to link this to deferred taxes as an illustration. It is encouraging to see that a number of candidates could identify the conditions for adopting the HK SME-FRF and HK SME-FRS.

The last part required candidates to explain two fundamental qualitative characteristics of financial information under the Conceptual Framework for Financial Reporting. The performance was unsatisfactory. Candidates either omitted this part or wrote some accounting terminologies they knew such as true and fair view, materiality, reliability which were not addressing the question.

Question 5 – 20 marks

This question required candidates to first explain some concepts of corporate governance in the context of financial reporting and then evaluate the accounting treatments relating to research and development costs in accordance with HKAS 38 *Intangible Assets*.

Part (a) related to corporate governance concepts. Although candidates were weak in defining what corporate governance is, they could suggest some valid recommendations to enhance the corporate governance from the financial reporting perspective. The performance was satisfactory.

The performance in part (b) was fair. Candidates could distinguish the two phases (research and development) in the project. Yet, they could not explain the rationale behind the accounting treatments of research costs and development costs. Candidates are expected to appreciate the reasons leading to the accounting treatments instead of merely reciting them. Further, candidates failed to demonstrate a proper understanding of development costs. Quite a number of them simply stated that development costs could be capitalised without referring to the six criteria for capitalisation in HKAS 38. Some candidates who could mention the criteria for capitalisation failed to apply such concepts to the scenario and therefore could not draw a proper conclusion.

Conclusion and Recommendation

Candidates should note that the PBE Paper I covers a broad range of topics and therefore candidates should not be too selective when preparing for the examination. The performance in this diet revealed that candidates did not prepare sufficiently. Candidates are advised to:

(i) polish their skills in the consolidation process by understanding the mechanics of consolidation, as well as the consolidation adjustment journal entries, in a group structure. Candidates should also be prepared to deal with more advanced topics in a consolidation exercise such as acquisition in the middle of the year or in prior years;

(ii) polish their application techniques in a case setting to solve accounting problems. Candidates should not merely copy the facts in the case in their answers. They are advised to link the principles in the accounting standard to the relevant facts stated in the case for a good demonstration of their knowledge; and

(iii) read the Examination Panelist's reports of the previous examinations after trying the past examination papers and take note of those common mistakes made by previous candidates.

Most importantly, candidates are strongly advised to fully understand the concepts and principles covered in the PBE Paper I instead of simply memorising them. Rote learning is definitely not the way to success particularly in discursive questions which require the application of concepts and principles to specific accounting issues.

* * * END OF EXAMINATION PANELIST'S REPORT * * *