Examination Panelist's Report

Paper I
PBE Financial Accounting
(June 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 June 2017 session was not satisfactory. The performance in Section B was especially alarming. It was revealed that candidates did not prepare sufficiently for the examination and had difficulty in understanding some fundamental financial reporting concepts such as other comprehensive income items and inventory measurement principles. It was also noted that candidates generally could state some of the accounting concepts, yet they failed to apply such 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. It should be noted that 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 draft a memorandum to discuss three accounting issues. The first issue required candidates to explain the two different approaches in measuring non-controlling interest (NCI) under HKFRS 3 (Revised) *Business Combinations*. Most of the candidates stated the two approaches correctly. Some candidates were able to illustrate the differences through computations. However, not many candidates could describe the reasons behind such differences.

The second issue required candidates to first define fair value and then discuss the inputs in measuring fair value. Most of the candidates provided very brief answers by merely stating that fair value was the market value, but did not mention the levels of inputs to valuation technique used to measure such value. Candidates gave irrelevant answers such as how fair value changes for investment properties and how financial instruments should be dealt with. This highlighted that candidates had little awareness of the basic principles in HKFRS 13 *Fair Value Measurement*. It should be remembered that HKFRS 13 is in the syllabus of the PBE Paper I and is in fact closely related to a number of financial reporting standards. Candidates should refer to the competency map of the PBE Paper I and make themselves familiar with this topic.

The last issue in part (a) required candidates to apply the recognition principles in HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in the context of future costs. In general, candidates were able to state the three conditions for recognising a provision. However, most of the candidates could not draw a correct conclusion. Candidates were not aware that the cost to install the fire safety measures in the question was in fact a future cost with no obligation event having taken place at the end of the reporting period despite the fact that it was a legal requirement to do so. Candidates are strongly advised to understand how to apply the accounting concepts to real situation instead of simply reciting them.

Part (b) of Question 1 assessed candidates' ability to prepare consolidated financial statements. In this question, candidates were required to deal with the fair value differential adjustment, calculation of goodwill and NCI using the fair value method as well as renting a property within the group with intra-group balances.

Although this consolidation exercise was straightforward, the performance was not as satisfactory as in the previous sessions. The following list details some of the common mistakes:

(i) Candidates were not familiar with the calculation of goodwill and measurement of NCI using the fair value approach. Quite a number of them just ignored this fact and calculated the goodwill using the proportionate interest method which has been frequently assessed in the previous examinations.
(ii) Candidates capitalised the acquisition-related costs as part of the investment and eliminated the entire value in the consolidation adjustment process which was incorrect.
(iii) Instead of eliminating the dividends declared in full, candidates performed a partial elimination of the dividends payable to the parent only which led to an incorrect balance of NCI at the end of the reporting period.
(iv) Candidates mistreated the intra-group leasing transaction as involving unrealised profits which led to an incorrect profit attributable to NCI for the year.

The most challenging part in this consolidation exercise was the intra-group leasing transaction. Such a transaction triggered a reclassification of the nature of the property from an individual company perspective (i.e. investment property) to the group perspective (i.e. an owner-occupied property). This concept has been regularly assessed in previous examinations (e.g. the June 2016 and December 2014 sessions). However, candidates still failed to demonstrate competence in this area. First, rarely could candidates reclassify the property from investment property to property, plant and equipment in the consolidated financial statements. Second, though most of the candidates calculated correctly the fair value decrease in the investment property, they did not realise that this should be a reversal of loss in the consolidation adjustment process. Such a fair value decrease had already been recognised in the separate financial statements. As the property in question was no longer classified as an investment property from the group perspective, the loss should have been reversed.

As highlighted in the previous Examination Panelist's report, some candidates still recited the skeleton of the workings provided in the solutions of past examination papers without demonstrating a proper understanding of the consolidation concepts and therefore produced incorrect calculations. Candidates are strongly advised to build a more concrete foundation of the consolidation techniques by understanding how the consolidation adjustment journal entries are prepared.

Section B – Optional Questions

Question 2 – 20 marks

This question required candidates to apply extensively various concepts relating to HKAS 21 *The Effects of Changes in Foreign Exchange Rates*. This was the most popular question in Section B.

Part (a) assessed candidates' ability to deal with foreign currency transactions in the context of trade receivables. Candidates' performance was good in the computational part but it was rare that candidates could explain the rationale of the transaction correctly. Candidates could not describe properly the rates (i.e. the spot exchange rate as at the date of the transaction and closing rate) used in their computations. Further, candidates were not aware of the significance of whether an item should be classified as monetary or non-monetary which led to different accounting treatments.

Part (b) assessed another aspect of HKAS 21 which related to the determination of functional currency of a foreign operation. Although most of the candidates were able to reach the correct conclusion, candidates failed to present their arguments logically. Some candidates mixed up presentation currency and functional currency while some simply argued that the company in question was a UK company and therefore the functional currency should be British pounds. Further, candidates could not utilise the additional considerations in HKAS 21 to support their arguments for a foreign operation.

The last part of this question required candidates to translate the financial statements of a foreign operation. Seldom has this concept been assessed in the previous examinations. Candidates could apply the correct exchange rates for profit or loss items as well as assets and liabilities on the statement of financial position. However, candidates found it difficult to deal with the translation of share capital and retained earnings, in particular segregating the retained earnings into pre-acquisition and post-acquisition reserves. Further, candidates could not describe correctly how the translation difference should be recognised. This highlighted that candidates were generally weak in the concepts relating to other comprehensive income which was further evidenced in Question 3 below.

Question 3 – 20 marks

This question required candidates to deal with a number of accounting issues relating to properties, namely, (i) transfer from an owner-occupied property to an investment property, (ii) classification of non-current assets held for sale and (ii) income taxes.

Part (a) assessed candidates' ability to deal with the principles in HKAS 16 *Property, Plant and Equipment* as well as HKAS 40 *Investment Property* in the context of a change in use of a building. It was pleasing that most of the candidates were able to identify such an accounting issue and apply the relevant definitions under the two accounting standards to justify the nature of the building before and after the transfer. It was, however, disappointing that candidates still failed to distinguish the different treatments between a revaluation increase under HKAS 16 and a fair value change under HKAS 40, despite the fact that such concepts have been repeatedly assessed in previous examinations. Many candidates recognised the revaluation increase upon transfer in the profit or loss (either as a fair value gain or a gain on disposal) which was incorrect. This may again highlight

candidates' weakness in distinguishing between profit or loss and other comprehensive income items. Candidates are strongly recommended to master such concepts as they are fundamental in financial reporting.

Part (b) required candidates to make a decision on whether a property should be classified as a non-current asset held for sale. Although quite a number of candidates were able to state the conditions for classifying a non-current asset as "held for sale", only a few of them reached a correct conclusion. This may indicate that candidates prepared for the examination through rote learning without really understand how to apply the financial reporting standards to real situations. Further, candidates should pay attention to the "key words" in the financial reporting standards. Using this part as an illustration, in order to classify a non-current asset as "held for sale", the asset must be available for "immediate" sale and the sale must be "highly" probable. The delay in timing of the transfer due to the completion of renovations in fact demonstrated that the property was not available for immediate sale. Ignoring such key terms would definitely lead to a wrong conclusion. Candidates are therefore recommended to grab the essence of the financial reporting standards and be prepared to apply them correctly.

Part (c) assessed candidates' knowledge of HKAS 12 *Income Taxes*. This part was very similar to the question in the December 2016 session. The performance was very extreme. Quite a number of candidates left this part blank while those who attempted it could calculate most of the deferred tax implications correctly which demonstrated a significant improvement from the previous examination session. Candidates could determine the tax base of the property, calculate the temporary difference and correctly drew the conclusion that the transactions gave rise to a deferred tax liability. Those who could not get full marks ignored the movement of deferred tax liability in the second year when preparing the journal entries. Candidates are strongly advised to master the accounting concepts relating to income taxes because this area remains a key part in both practice and the examination.

<u>Question 4 – 20 marks</u>

This question required candidates to apply concepts relating to HKFRS 15 *Revenue from Contracts with Customers* and HKAS 2 *Inventories*. This question was the least popular question in Section B.

Parts (a) and (b) assessed candidates' understanding of the new revenue financial reporting standard. Candidates demonstrated very limited awareness of this standard despite the straightforward nature in the requirements such as identifying the steps in the five-step model and defining performance obligations. Many candidates left these parts blank. Some of those who attempted to answer framed their answers using the previous version of the revenue accounting standard which was no longer examinable. It should be noted that HKFRS 15 has shifted from the "risk and reward" approach to the "control" approach. Further, candidates were very weak in the application of performance obligations to a real situation. Candidates should equip themselves with such knowledge as performance obligation forms a significant part of the revenue recognition process under HKFRS 15.

Part (c) assessed candidates' understanding of the inventory measurement principles which were very straightforward and should have been covered in the introductory financial reporting course. The performance was worse than expected. Candidates demonstrated a number of misconceptions about inventory measurement, especially the calculation of net

realisable value. Many of the candidates incorrectly treated the estimated costs to sell as a cost or an expense already incurred and recognised such amount in the profit or loss accordingly. It should be noted that such an estimation was only used to determine the net realisable value which is then compared to the inventory cost to decide whether a write-down is necessary.

Question 5 – 20 marks

This question required candidates to (i) apply the concepts in HKFRS 2 *Share-based Payment*; (ii) compile a statement of changes in equity, and (iii) outline some disclosure items relating to directors' remunerations.

Parts (a) and (b) assessed candidates' understanding of some basic principles of HKFRS 2. It was disappointing that candidates were not aware of the key terms in HKFRS 2 such as service condition and performance condition. Seldom could candidates correctly describe such vesting conditions in the question. Further, candidates failed to demonstrate sufficient competence in how to calculate the employee benefits expense throughout the vesting period. Common mistakes included failure to (i) "lock" the measurement of the transaction using the fair value of share option as at the grant date for an equity-settled share based payment transaction and (ii) "apportion" the recognition of such expense in the first year of the two-year vesting period. Many candidates ignored the transaction regarding the conversion of share option upon vesting. It is true that transactions involving share-based payment are inherently complicated. Candidates are still required to understand how such transactions are recognised with reference to the competency map of the PBE Paper I.

Part (c) required candidates to compile a statement of changes in equity taking into consideration the share-based payment transaction in part (b) and profits for the year. Weakness in preparing such a statement was highlighted in the previous Examination Panelist's Report. In this session, some candidates were able to demonstrate their awareness of such a statement; however, most of them were not able to draft the statement in an appropriate format in accordance with HKAS 1 (Revised) *Presentation of Financial Statements*.

Part (d) of this question assessed candidates' awareness of how financial items are disclosed in financial reports. Most of the candidates were able to give some reasonable examples and the performance was satisfactory.

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. Candidates are advised to:

(i) master such difficult topics as deferred tax and share-based payment and at the same time learn the fundamental financial reporting concepts such as other comprehensive income items and the preparation of financial statements;
(ii) be aware of such updated accounting standards as revenue recognition; 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. This observation has been repeatedly highlighted in this report. 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 * * *