Examination Panelist's Report

Paper I
PBE Financial Accounting

(June 2018 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 2018 session was quite extreme. Some candidates demonstrated sufficient preparation while some did not prepare for the examination. This was reflected in the alarming performance in Section B. Quite a number of candidates simply ignored Section B or wrote some brief answers for one to two questions only. Candidates also had difficulty in understanding the mechanics of the transactions and were unable to produce sensible calculations and journal entries. For example, candidates mixed up interest expense and interest income as well as financial assets and financial liabilities which are considered fundamental yet critical. Candidates were still weak in expressing their thoughts in a logical manner in discursive questions.

Specific Comments

Section A – Compulsory Question

Question 1 – 40 marks

Part (a) assessed candidates' ability to integrate concepts in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and HKAS 10 *Events after the Reporting Period* in the context of a discovery of fraud after the reporting period. In the same part, candidates are required to prepare the statement of profit or loss and other comprehensive income as well as the statement of changes in equity.

Although HKAS 8 and HKAS 10 have been repeatedly assessed in various sessions, candidates could not apply the concepts well in this case. This may be attributable to the fact that the accounting issues were not explicitly identified in this question. Some outstanding candidates were able to logically present the accounting requirements in the two accounting standards (e.g. identifying that this discovery of fraud was an adjusting event and this should be dealt with as a correction of error). Candidates were expected to at least identify simple accounting issues in a case setting.

Not many candidates could make a proper application relating to retrospective adjustment in HKAS 8. Quite a number of candidates mistakenly adjusted the total amount of the fraud in the current year based on the rationale that the discovery of fraud occurred in the current year. Further, the preparation of the statement of changes in equity was not up to standard.

Part (b) 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, downstream intra-group transfer of machinery items, impairment of goodwill as well as the application of the equity method for the investment in an associate acquired in the middle of the year.

Candidates' performance was not satisfactory. The following mistakes were commonly observed:

(i) It is very pleasing to see that more candidates were able to deal with the contingent consideration by using its fair value as at the acquisition date. Yet, quite a few candidates made careless mistakes by ignoring the share capital amount in the computation of goodwill in this consolidation exercise.

(ii) Although the fair value differential relating to the inventories was considered by most of the candidates in computing the goodwill amount, nearly all candidates ignored the subsequent effects when the items were sold. The subsequent sale would: (1) generate excess cost of goods sold in the consolidated statement of profit or loss and other comprehensive income and (2) lead to a sharing of such extra cost of goods sold to the non-controlling interest.

(iii) As with the previous session, candidates demonstrated insufficient understanding of how a transfer of machinery items should be accounted for. It was pleasing to see that some candidates demonstrated awareness of (1) eliminating the unrealised gain arising from this intra-group transaction and (2) realising it through a reduced depreciation expense throughout the remaining useful life of the machinery items. Yet, the situation in this question (a downstream transfer) was different from that in the previous session (an upstream transfer). Candidates found it difficult to decide whether such impacts should be shared with the non-controlling interest. The mechanics of the intra-group transfer of property, plant and equipment are summarised here once again: (1) eliminating the unrealised gain upon transfer; (2) realising the unrealised gain 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 gain (in (1)) and the realisation of the unrealised gain (in (2)), if it is an upstream transfer. This is based on the rationale that, in an upstream transfer, the unrealised gain was recognised in the books of the subsidiary and the reduction in the annual depreciation expense, which is in fact realising such an unrealised gain, also affects the books of the subsidiary.

(iv) Candidates had difficulty in deciding whether the impairment loss of goodwill should be shared with the non-controlling interest. Candidates should understand that if the non-controlling interest in the subsidiary was measured at its fair value at the acquisition date, the impairment loss of goodwill would then be shared with the non-controlling interest (based on the ownership structure) since the goodwill was initially assigned to the non-controlling interest.

(v) Candidates were weak in the application of the equity method for the investment in an associate. Specifically, this acquisition occurred in the middle of the year and candidates could not handle a proper capitalisation of post-acquisition loss of the associate in the current year. Some candidates could not properly present their calculations on the consolidated statement of profit or loss and statement of financial position as a share of associate's loss and investment in associate respectively. Dealing with the reclassification of dividends distributed by the associate in the consolidated financial statements was still a problematic area.

Candidates should familiarise themselves with the rationales behind such a transaction:

a. dividends received should not be treated as a dividend income anymore under

equity accounting; and

b. it should be considered as a realisation of investments which reduces the investment of the associate's balance.

Section B – Optional Questions

Question 2 – 20 marks

This question required candidates to apply their knowledge regarding a number of liability-related items. The performance was average.

Part (a) required candidates to define liability in accordance with the *Conceptual Framework for Financial Reporting 2010* and was straightforward. Most of the candidates were able to at least demonstrate some knowledge of the definition.

Part (b) required candidates to apply the concepts in HKFRS 2 *Share-based Payments* to a given share appreciation rights ("SAR") scheme. Most of the candidates were able to correctly classify this SAR scheme as a cash-settled share-based payment. Yet, further elaborations and the journal entries provided in their solutions revealed that they did not understand the differences between an equity-settled share-based payment and a cash-settled share-based payment. The essence of a cash-settled share-based payment is the incurrence of liabilities for amounts based on the value of its own equity instrument. Quite a number of candidates stated that the cost of the SAR scheme was recognised as a reserve under the equity section of the statement of financial position which is in fact the treatment for an equity-settled share-based payment.

Some candidates demonstrated weaknesses in understanding the mechanics of the transaction by providing incorrect calculations or even misleading journal entries. It should be quite apparent that no remuneration expense should be made as at the grant date the employees have yet to provide services to the entity. Some candidates, however, simply used the information provided (i.e. the share price as at the grant date) and incorrectly recognised remuneration expense as at the initial grant date.

Part (c) assessed candidates' knowledge of amortised cost. Candidates did not demonstrate sufficient awareness as to what amortised cost is. The statement given in the question dealt with financial liabilities; however, some candidates discussed the business model test which in fact relates to financial assets. Candidates should make sure that they can differentiate a financial asset from a financial liability before trying to solve a problem.

Part (d) required candidates to apply the concepts of amortised cost to bonds issued with transaction costs. This is a traditional scenario yet the performance was quite disappointing. Candidates found it problematic to deal with the initial recognition of the bonds:

- Many candidates simply recognised the bonds at their par value, ignoring the fact that the bonds were actually issued at a discount.
- Candidates did not understand the treatment of the transaction costs for bonds measured at amortised cost and incorrectly recognised an expense when incurred.

Some candidates mixed up coupon interest rates and effective interest rates. It should be noted that the cash payment (based on coupon interest rate) was not the same as the interest expense recognised in the statement of profit or loss and other comprehensive

income (based on effective interest rate) when the bonds were not issued at their par value.

Question 3 – 20 marks

This question required candidates to first analyse a finance lease transaction in accordance with HKAS 17 *Leases* and prepare a statement of cash flows using the indirect method in accordance with HKAS 7 *Statement of Cash Flows*. This was the most popular question in Section B and the performance was satisfactory.

Part (a) assessed candidates' ability to deal with the accounting treatments of a finance lease from a lessee's perspective. Very few candidates were aware that the leased asset and the lease liability should be recognised at the lower of the fair value of the leased asset measured at the inception of the lease and the present value of the minimum lease payment. Nearly all candidates recognised initially the leased asset and finance lease obligation at the fair value provided without computing the present value of minimum lease payments which was actually lower than the fair value. Further, many candidates ignored the impact of depreciation expense for a leased asset under a finance lease.

Part (b) was an extension to part (a) which required candidates to comment on the presentation of the finance lease obligation on the statement of financial position. Quite a number of candidates were aware that the lease obligation should be presented under both current and non-current liabilities. Very few candidates, however, attempted to quantify the amounts.

Part (c) required candidates to prepare a statement of cash flows using the indirect method. The performance of candidates varied. Some weaknesses were identified below:

- Some candidates could not even properly classify the cash flows into the three categories: operating, investing and financing activities;
- Quite a number of candidates wrongly used the profit after tax figure (instead of profit before tax) as the starting point for cash flows from operating activities;
- While most of the candidates were able to correctly include the changes in working capital as part of the cash generated from operations, they demonstrated weaknesses in dealing with more complicated issues such as the adjustment relating to the loss on disposal of equipment and income tax paid;
- Quite a number of candidates incorrectly put the change in overdraft as part of the cash flows from operating activities, implying that they had difficulty in understanding what constitutes cash and cash equivalents in HKAS 7;
- Many candidates put the acquisition of the plant in part (a) as a cash outflow under investing activities. An acquisition of assets by means of a finance lease does not have, in fact, a direct impact on current cash flows;
- Candidates were weak in dealing with cash flows from financing activities, especially in quantifying the dividends paid and repayment of finance lease obligations calculated in part (a) above.

Question 4 – 20 marks

This question required candidates to apply their knowledge relating to a number of asset-related items. The performance was not satisfactory.

Part (a) assessed candidates' ability to deal with impairment losses in a cash-generating unit under HKAS 36 *Impairment of Assets*. Candidates did not demonstrate sufficient understanding of what a cash-generating unit is.

Although quite a number of candidates were able to quantify the total impairment loss to be recognised in the cash-generating unit in question, they were not able to describe their thinking logically. Candidates failed to demonstrate the two important concepts involved:

- The order/sequence of allocating impairment loss to different assets in a cash-generating unit; and
- The "floor" when allocating impairment loss to an asset in a cash-generating unit.

Many candidates simply calculated the impairment loss allocated to property, plant and equipment by comparing its carrying amount and recoverable amount provided in the question. Candidates should first calculate the impairment losses allocated to property, plant and equipment as well as other intangible assets (after exhausting the balance of goodwill) based on a pro rata basis of their carrying amounts. It is not a must to reduce the carrying amount of the assets to their recoverable amounts in all circumstances. Some candidates made the following mistakes revealing that they were weak in some fundamental concepts:

- Allocating impairment losses to inventories, trade receivables and cash which were inappropriate;
- Accounting for the decrease in the value of property, plant and equipment in revaluation reserve, which was only appropriate when (i) the entity measures its non-current assets using the revaluation model in accordance with HKAS 16 *Property, Plant and Equipment* and HKAS 38 *Intangible Assets* and (ii) there was a previous revaluation increment generating the revaluation reserve.

Part (b) required candidates to explain the accounting treatments of borrowing costs on loans financing the construction of a factory under HKAS 23 (Revised) *Borrowing Costs*. Not many candidates could identify that the loans in question should be considered as general borrowings (but not specific borrowings); therefore, they simply calculated the interests incurred and capitalised the amount accordingly. Candidates should familiarise themselves with the computation of the capitalisation rate for general borrowings by applying the concept of the "weighted average" of the borrowing costs.

Further, candidates were weak in the concept of qualifying assets as revealed in the poor performance in the extended question requiring candidates to explain whether there would be any difference(s) if the loans were used to finance the manufacturing of inventories.

<u>Question 5 – 20 marks</u>

This question required candidates to discuss the revenue recognition concepts in HKFRS 15 *Revenue from Contracts with Customers* and apply them to two straightforward scenarios. This was the least popular question in Section B and the performance was the worst.

Part (a) related to the conceptual discussions of the two terms "income" and "revenue" and is straightforward. Yet, candidates were not able to define the two concepts properly in accordance with the *Conceptual Framework for Financial Reporting 2010* and HKFRS 15.

Part (b) assessed candidates' understanding of the concept relating to performance

obligation in HKFRS 15. As with the performance in the June 2017 session, candidates demonstrated limited awareness on the basic concepts in HKFRS 15. Some candidates who performed better could correctly link the concept of performance obligation to "promise" and "distinct"; yet they could not elaborate further as to how multiple performance obligations are to be determined in a contract with customers.

Part (c) required candidates to apply how a significant financing component affects the determination of the transaction price. This is not an entirely new concept but the performance was disappointing. First, candidates were not able to justify that the sales contract in question contained a significant financing component because of the long period of time (two years) between cash payment and the date of passing control of the good. Second, a number of candidates messed up whether the transaction would lead to a recognition of interest income or interest expense. This decision depends on whether the cash was received in advance (providing financing to the entity and therefore incurring interest expense) or it was a deferred payment (providing financing to the customer and therefore generating interest income). This demonstrated that candidates were, in general, weak in understanding the mechanics of the transactions and therefore could not produce proper journal entries.

Part (d) assessed candidates' ability to allocate the transaction price to three separate performance obligations. It was gratifying that most of the candidates could calculate correctly the allocated transaction prices and performed satisfactorily in this part.

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. Consistent with the performance in previous sessions, the performance in this session still revealed that candidates did not prepare sufficiently. Candidates are advised to:

(i) Understand the mechanics of the transactions instead of reciting the journal entries to avoid producing journal entries which do not make much sense from the accounting perspective;

(ii) Further describe logically their thinking in solving an accounting problem instead of merely producing the journal entries;

(iii) 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 prior years; and

(iv) 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.

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