



Hong Kong Institute of
Accredited Accounting Technicians
香港財務會計協會

Professional Bridging Examination

Pilot Examination Paper

Paper I PBE Financial Accounting

Questions & Answers Booklet

The suggested answers given in this booklet are purposely made to give more details for educational purpose.

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Professional Bridging Examination

Paper I PBE Financial Accounting

Pilot Paper (Questions)

Time Allowed	3 hours
Examination Assessment Allocation	
<ul style="list-style-type: none">• Section A – All TWO questions are compulsory	40 Marks
<ul style="list-style-type: none">• Section B – Answer 3 out of 4 questions	60 Marks

SECTION A (COMPULSORY) (Total: 40 marks)

Answer **ALL** questions in this section. Marks are indicated at the end of each question. Together they are worth 40% of the total marks for this examination.

CASE

Pretty Builders Limited (“PBL”), a listed public limited company, was founded in 1996. The following are the companies and their relationship status to PBL:

Name	Relationship to PBL	Activities
ABC	PBL purchases 80% of the shares of ABC on 1 January 2007	Equipment hire
XYZ	PBL owns 100% of the shares	Equipment manufacturing

ABC is a China-based company established 10 years ago, and has been a trading partner with PBL for most of the time. Mr. Chan, the founder of ABC and the director of PBL, holds the remaining 20% of the shares. His son also works for ABC.

The equipment hire business of ABC has a large client base, including state-owned enterprises. PBL paid RMB 66 million to acquire 80% shares in ABC. At the date of acquisition, the net asset value of ABC was RMB 52 million. The directors of PBL believed that the extra consideration they paid for the value of ABC’s market and technical knowledge will increase the group’s profits in the future. They intended to write off goodwill over this period using the straight-line method.

During 2007, XYZ lost a lawsuit for breach of a product it manufactured and sold in 2004. XYZ was required to pay a substantial amount of damages to the plaintiff. In order to finance the damage payment, XYZ decided to approach its bank for a \$200 million loan. The bank manager pointed out that XYZ is part of the PBL group and the group’s financial statement should be provided to support the loan application. The PBL directors were very unhappy about such a request and refused to do so.

PBL successfully sells a product called “ihook”. This product is bought in batches by PBL ready for sale, and no further processing is required. This product’s efficiency deteriorates with its age and accordingly its selling prices. As at 31 December 2007, there were four batches in the closing inventory:

Batch	Cost (\$'000)	Net Realisable Value (\$'000)
1	50,000	40,000
2	75,000	70,000
3	60,000	90,000
4	<u>85,000</u>	<u>110,000</u>
Total	<u>270,000</u>	<u>310,000</u>

The valuation of the closing inventory has been carried out by the production department and all the inventories have been counted, and the stated quantities verified. The production director reported the valuation of “ihook” as at 31 December 2007 to be \$270 million.

Assume that you are Peter Chung, the accounting manager of PBL. On 2 January 2008, you received an e-mail from Clement Wong, one of the directors of PBL, who is not a certified public accountant, in which he raised the following issues:

1. Mr. Chan, the founder of ABC, is Clement’s best friend and he does not want to disclose his family’s relationships and transactions with PBL in the financial statements;
2. after the purchase of the shares in ABC, Clement wanted to find out more about the accounting and reporting process of “goodwill arising on acquisition”. He had doubts about the amortisation policy suggested by other members of the board;
3. he questioned the usefulness of the consolidated financial statements in supporting XYZ’s loan application; and
4. he was not certain which method of valuation of “ihook” is in accordance with the requirements of standard accounting practice.

Required:

Question 1 (35 marks – approximately 63 minutes)

Prepare a memorandum in response to Clement’s e-mail. In your memorandum, you should:

- (a) Explain to Mr. Chan that his request cannot be fulfilled by setting out the reasons why it is important to disclose under HKAS 24 *Related Party Disclosures*:
 - (i) related party relationships; and (4 marks)
 - (ii) related party transactions. (4 marks)
- (b) Advise PBL on the appropriate accounting treatments in accordance with HKFRS 3 *Business Combinations*, paying special attention to:
 - (i) cost of business combination, initial and subsequent measurement on “goodwill arising on acquisition”;
 - (ii) recognition of pre-acquisition assets and liabilities; and
 - (iii) calculate the “goodwill arising on consolidation for PBL”. (9 marks)

(c) From the Bank's perspective, explain why they need the group financial statements for XYZ's loan application and the usefulness of consolidated financial statements.

(8 marks)

(d) Explain the basic rule for the valuation of inventories as laid down in HKAS 2 *Inventories* and recalculate the value of "ihook". Where the accounting valuation differs from that of the production director, explain why and evaluate the impact on the reported profit.

(10 marks)

Question 2 (5 marks – approximately 9 minutes)

Mr. Chan's personal assistant, Fiona, who is a certified public accountant, in a casual conversation with her boss, discovered that ABC is going to be spun off in another stock exchange for listing. Fiona tells her boyfriend, Paul about the plan. The following day, Paul instructs his stockbroker to purchase substantial number of shares of PBL in the market.

Comment on Fiona's action and its possible implications and damage to PBL and ABC.

(5 marks)

* * * END OF SECTION A * * *

SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)

Answer any **THREE** questions in this section. Each question carries 20 marks. Together they are worth 60% of the total marks for this examination.

Question 3 (20 marks – approximately 36 minutes)

On 1 January 2007, Table Limited, a newly established company, raised capital of \$3,000,000 from the issue of 3,000,000 \$1 ordinary shares issued at par. On the same date it acquired the following shareholdings:

Bowl Limited: 2,160,000 shares of \$1 each, fully paid, for \$2,140,000.
Plate Limited: 600,000 shares of \$1 each, fully paid, for \$860,000.

The following are the summarised draft statement of financial position as at 31 December 2007 of the companies in which shareholdings were acquired:

	Bowl Limited	Plate Limited
	\$'000	\$'000
Land	820	1,300
Plants	600	240
Inventories	580	420
Accounts receivable	220	500
Cash at bank	<u>40</u>	<u>70</u>
	<u>2,260</u>	<u>2,530</u>
Share capital: ordinary shares @\$1 each	2,400	2,000
Profit and loss account	(400)	390
Accounts payable	<u>260</u>	<u>140</u>
	<u>2,260</u>	<u>2,530</u>

Additional information:

1. No entries had been made in the books of Bowl Limited to reflect the fact that the fair value of one of the plants owned by that company, at 1 January 2007, was \$430,000; at that date its book value was \$350,000. Additional depreciation of \$20,000 for 2007 is needed to reflect this revaluation.

Save as disclosed above, the statement of financial position of the companies given reflect the fair values of all their assets and liabilities as at 1 January 2007.

2. On 31 December 2007, Plate Limited paid, in cash, a dividend of \$18,000 to Table Limited. Table Limited credited this amount in its statement of comprehensive income and the cash is in transit.
3. The balances of retained profits on 1 January 2007 (acquisition date) were:

	\$'000
Bowl Limited	300 (debit)
Plate Limited	350 (credit)

4. Table Limited does not take an active involvement in the operation of Bowl Limited but it can appoint the majority of the directors on the board. For Plate Limited, only one director appointed by Table Limited sits on the management board. The management board of Plate Limited comprises three directors.
5. It is the group's policy to account for goodwill arising on acquisition as an asset less any accumulated impairment losses. It was estimated that there is no foreseeable impairment on goodwill as at the year ended 31 December 2007.
6. Ignore taxation.

Required:

- (a) **Prepare the statement of financial position of Table Limited as at 31 December 2007.**
(3 marks)
- (b) **Prepare the consolidated statement of financial position of Table Group as at 31 December 2007.**
(12 marks)
- (c) **Explain the treatment of Plate Limited when preparing the group accounts.**
(5 marks)

Question 4 (20 marks – approximately 36 minutes)

At 31 December 2007, Knight Limited (“Knight”) had the following investments:

	Cost	Fair value at 31 December 2007
Fair value through profit or loss:		
Security A	\$700,000	\$725,000
Security B	<u>210,000</u>	<u>200,000</u>
Total	910,000	925,000
Available for sale:		
Security C	\$500,000	\$460,000
Security D	<u>850,000</u>	<u>865,000</u>
Total	1,350,000	1,325,000

No investments were sold during 2007. There was objective evidence that the decline in fair value of Security C is considered to be significant and prolonged.

Required:

- (a) What are “financial instruments”, and explain the difference between “financial instruments” and other assets and liabilities in accordance with HKAS 32 *Financial Instruments: Presentation* and HKAS 39 *Financial Instruments: Recognition and Measurement*. (5 marks)
- (b) Distinguish among the following categories of financial instruments:
- (i) Financial assets at fair value through profit or loss
 - (ii) Held-to-maturity investments
 - (iii) Loans and receivables
 - (iv) Available-for-sale financial assets
- (8 marks)
- (c) Explain why fair value reporting is applicable to (i) financial assets at fair value through profit or loss and (iv) available-for-sale financial assets, but not to (ii) held-to-maturity investments? (3 marks)
- (d) Prepare the journal entries for the year ended 31 December 2007 in respect of the change in value of the investments held by Knight. (4 marks)

Question 5 (20 marks – approximately 36 minutes)

(a) What is the purpose of the statement of cash flows? (4 marks)

(b) Investors and creditors are interested in an entity's future cash flows. However, historically the primary focus of financial reporting is information about earnings. What are the limitations associated with using cash flows to measure the performance of an entity? (5 marks)

(c) You are given the following information for the year ended 31 December 2007:

Increase in Notes Receivable	\$140,000
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During the year, \$30,000, 90-days 10% notes receivable were discounted at the bank without recourse. The note was held for 50 of its 90 days before discounting. The bank applies a 12% rate in discounting the note and 360 days as a year.

Calculate the proceeds received from the bank and explain how the transaction should be reported in the statement of cash flows? (5 marks)

(d) Explain how the following transactions should be disclosed in the company's statement of cash flows, stating the reasons and which headings (operating activities, investing activities and financing activities) the adjustments belong to:

- (i) a piece of land at its fair value of \$40 million was sold and recorded a gain of \$8 million;
- (ii) depreciation expenses for the current year; and
- (iii) issue shares to acquire a subsidiary.

(6 marks)

Question 6 (20 marks – approximately 36 minutes)

At the Chinese New Year dinner, one of the marketing staff who sits next to you, complains about the heavy work load in developing a new brand image of the company, which is now a leading brand in the market. In the casual conversation, you find out that he is disappointed that such a brand image was not included as an asset in the financial statements. He is then puzzled about the usefulness of the financial statements and why it is necessary to follow the accounting standards.

Required:

Explain to him:

- (a) The purpose and use of information presented in the financial statements. (5 marks)
- (b) The information needs of the shareholders and the company's employees. (5 marks)
- (c) The benefits of accounting standards to users of financial statements. (5 marks)
- (d) Reasons for not including internally generated brands as assets. (5 marks)

* * * END OF EXAMINATION PAPER * * *

Answers

Paper I
PBE Financial Accounting
(Pilot Paper)

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

To: Mr. Clement Wong, Director PBL
From: Peter Chung, Accounting Manager PBL
Date: dd/mm/yyyy

I refer to your e-mail dated 2 January 2008 regarding your queries about the accounting issues raised, my responses to your queries are as follows:

Answer 1(a)(i)

Related party relationships are part of the normal business process. Entities operate the separate parts of their business through subsidiaries and associates, and acquired interests in other enterprises for investment or commercial reasons. Thus control or significant influence can be exercised over the investee by the investing company. These relationships can have a significant effect on the financial position and operating results of the company and lead to transactions which would not normally be undertaken. Although a related party relationship may seem irrelevant if no related party transactions have occurred, Mr. Chan's son is working for ABC while his father is the director of PBL, this encourages the other companies to treat ABC more favorably than if the company is not part of the group. HKAS 24 requires the reporting entity to disclose the nature of the related party relationships to enable readers of financial statements to study such relationships carefully when assessing the performance of a group.

Answer 1(a)(ii)

It is assumed that the financial statements of an entity reflect transactions carried out on an arm's length basis and that the entity has independent discretionary power over its actions and pursues its activities independently. If these assumptions are not justified because of related party transactions, the disclosure of this fact should be made. For example, Mr. Chan may have instructed other members of the group to buy their supplies from ABC. This would be a normal commercial decision, as it would keep any profit on such trading with the group rather than going to an external party. However, if ABC were to be acquired on the basis of the reported results, any prospective purchasers would have to be aware that the intra-group trading that may have benefited ABC may no longer arise.

It can be seen that information about related parties can be an important element of any investment decision and regulatory authorities consider disclosure of such information to be important.

Mr. Chan is the director of PBL as well as the minority shareholder of ABC, PBL's subsidiary. Disclosure of the director's interest and share ownership should be made.

Answer 1(b)(i)

PBL should measure the cost of business combination as the aggregate of:

- the fair values, as at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by PBL, in exchange for control of the acquiree; plus
- any costs directly attributable to the business combination.

Goodwill arising on acquisition (or goodwill) is the excess of the cost of the acquisition over the acquirer's interest in the fair values of the identifiable assets and liabilities acquired as at the date of acquisition. Goodwill should be recognised as an asset and carried at cost less any accumulated impairment losses and should not be amortised.

The goodwill recorded on acquisition must be reviewed and evaluated for any possible impairment identified with the goodwill. To determine whether goodwill is impaired, an enterprise should apply HKAS 36 *Impairment of Assets*. HKAS 36 prescribes two ways, the "bottom up" and "top down" tests, to be applied for the review.

Answer 1(b)(ii)

The identifiable assets, liabilities and contingent liabilities of the acquiree recorded in an acquisition should be of those that existed as at the acquisition date at their fair values. In cases other than intangible assets, it is probable that any associated future economic benefits will flow to the entity, and its fair value can be measured reliably. In the case of liability other than contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably. In the case of intangible assets and contingent liability, its fair value can be measured reliably.

In this case, as the directors believe that goodwill was paid for the market shares and technical knowledge, we may have to consider whether ABC's intangible assets such as customer bases, technology, patents etc are identifiable before allocating the balance of acquisition costs as goodwill.

Answer 1(b)(iii)

At acquisition, RMB 24.4 million (66 - (52 x 80%)) should be recorded as goodwill arising on acquisition, and recognised as an asset in the consolidated statement of financial position. It assumes that there were no purchase costs allocated to intangible assets and there were no significant contingent liabilities.

Answer 1(c)

The objective of consolidated financial statements is to show the financial performance and position of the group as if it was a single economic entity. The entity financial statements of the parent company contain the investments in subsidiaries as non-current assets, but do not provide users with sufficient information about subsidiaries for them to make a reliable assessment of the performance of the group as a whole.

However, the consolidated financial statements are of little use in assessing the liquidity of any member of the group. It must be appreciated that the group does not exist as a legal entity. It is only an economic reporting entity. For example, it is not possible to sue the group; one would have to sue the relevant member of the group.

Even if the liquidity position shown by calculations using the group financial statements is favorable, it implies nothing about the individual members of the group. The reality is that only the assets of an individual member of the group are available to discharge the liabilities of that individual member. Sometimes a holding company may support a subsidiary that is in financial difficulties but it has no legal obligation to do so.

However, when assessing the lending decision, the bank may consider the performance and liquidity of the group as a whole and many demand corporate guarantees provided from the holding companies or fellow subsidiaries as security for granting the loan facility to XYZ.

Answer 1(d)

According to HKAS 2 *Inventories*, inventories should be measured at the lower of cost and net realisable value. This is a method of measurement for inventories if “cost” does not reflect the true value of the inventories. The standard requires that the comparison of cost and net realisable value needs to be done in respect of each item of inventory separately or by groups or categories of similar inventory items.

The production director reported the valuation of “ihook” as at 31 December 2007 at \$270 million by comparing the total cost to the total net realisable value of “ihook”. Such a comparison could result in an unacceptable setting off of unrealised losses against unrealised profits. The correct valuation should be:

Batch	Cost (\$'000)	Net Realisable Value (\$'000)	Lower of Cost or Net Realisable Value (\$'000)
1	50,000	40,000	40,000
2	75,000	70,000	70,000
3	60,000	90,000	60,000
4	<u>85,000</u>	<u>110,000</u>	<u>85,000</u>
Total	<u>270,000</u>	<u>310,000</u>	<u>255,000</u>

It may be more appropriate to value each batch separately at the lower of cost or net realisable value. Batches 1 and 2 should therefore be recorded at their net realisable values, while batches 3 and 4 can be recorded at cost.

The difference between the accounting valuation and the production director’s will reduce the reported profit by \$15 million.

I trust the above explanations have answered your queries. Please feel free to contact me should you have further queries.

Best regards

Peter Chung

Answer 2

As a professional accountant, Fiona should not disclose outside the firm any confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose. A professional accountant should maintain confidentiality even in a social environment. She should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving a long association with a business associate or a close or immediate family member. Consequently, Fiona and her boyfriend may be subject to investigation for insider dealings proceedings.

The irregular trading activity may also make PBL's share price volatile and the spin-off news may be considered as price-sensitive information and has to be disclosed in accordance with the Listing Rules. Therefore, the management may be subject to disciplinary action imposed by the Hong Kong Stock Exchange. Furthermore, the internal control system for releasing price-sensitive information may need to be revisited and tightened.

The advertent disclosure, may damage ABC's interests, including its public reputation which subsequently may be considered as risks and uncertainties for its future listing as integrity of the management is counted as an important criterion for listing.

* * * END OF SECTION A * * *

SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)

Answer 3(a)

Table Limited shares in: Bowl Limited 90% (Subsidiary)
Plate Limited 30% (Associate)

Statement of Financial Position of Table Limited as at 31 December 2007

	\$'000
Investments	
Investment in subsidiary - Bowl Limited	2,140
Investment in associate - Plate Limited	860
Cash at bank	<u>18</u>
	<u>3,018</u>
Share capital: ordinary share @\$1	3,000
Profit and loss account	<u>18</u>
	<u>3,018</u>

Answer 3(b)

Consolidated Statement of Financial Position of Table Group as at 31 December 2007

	\$'000	\$'000
Non-current Assets		
Goodwill arising on consolidation (W1)		178
Land		820
Plants (600 + 80 – 20)		660
Investment in associate (W4)		<u>872</u>
		2,530
Current Assets		
Inventories	580	
Account receivables	220	
Cash at bank	<u>58</u>	<u>858</u>
Total assets		<u>3,388</u>
Share capital: ordinary share @\$1		3,000
Profit and loss account (W3)		(78)
Minority interests (W2)		<u>206</u>
		3,128
Current Liabilities		
Account payables		<u>260</u>
Total equity and liabilities		<u>3,388</u>

(W1) Goodwill arising on consolidation

	\$'000	\$'000
Cost of investment		2,140
Less: net assets acquired		
Share capital (2,400 x 90%)	2,160	
Fair value adjustment (80 x 90%)	72	
Pre-acquisition losses (300 x 90%)	<u>(270)</u>	<u>(1,962)</u>
Goodwill		<u>178</u>

(W2) Minority interests

	\$'000
Share capital (2,400 x 10%)	240
Fair value adjustment (80 x 10%)	8
Retained losses (400 + 20(Depreciation)) x 10%	<u>(42)</u>
	<u>206</u>

(W3) Consolidated accumulated losses balance

	\$'000	\$'000
Table Limited		18
Bowl Limited		(400)
Less: Pre-acquisition losses (300 x 90%)	270	
Less: Depreciation adjustment building	(20)	
Dividend from Plate Limited	(18)	
Minority interests	<u>42</u>	274
Add: profit from Plate Limited		<u>30</u>
Retained losses		<u>(78)</u>

(W4) Investment in associate

	\$'000
Cost	860
Add: post acquisition profit	30
Less: Dividend received	<u>(18)</u>
	<u>872</u>

Answer 3(c)

Plate Limited is the associated company of Table Limited. Table Limited is able to exercise “significant influence” on Plate Limited because it has a representative on the management board and has 30% shareholdings. This means that Table Limited has the power to participate in the financial and operating policy decisions of Plate Limited. The investment would be included in the consolidated statement of financial position of Table Group using the equity method of accounting. The initial investment would be recognised at cost and the carrying amount is increased or decreased to recognise the investor’s share of profit or loss of the investee after the acquisition date. On acquisition of the investment any difference between the cost of the investment and the investor’s share of the fair values of the net identifiable assets or the associate is treated as goodwill. Goodwill relating to an associate is included in the carrying account of the investment. The investor’s share of profit or loss of the investee is recognised in the investor’s profit or loss. Distribution received from the associate reduces the carrying amount of the investment.

Answer 4(a)

HKASs 32 and 39 define a financial instrument as “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”.

A financial asset is any asset that is:

- (i) cash;
- (ii) an equity instrument of another entity;
- (iii) a contractual right to receive cash or another financial asset from another entity;
- (iv) a contractual right to exchange financial assets and liabilities with another entity under conditions that are potentially favorable to the entity.

A financial liability is any liability that is a contractual obligation:

- (i) to deliver cash or another financial asset to another entity;
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity.

From these definitions we can assert that a financial instrument is the contract, whether written or otherwise, not the asset or liability. A “contract” refers to an agreement between two or more parties that has economic consequences that the parties have little, if any, chance of avoiding, because generally the agreement is enforceable in law.

Answer 4(b)

- (i) Financial assets at fair value through profit or loss – it is acquired or incurred principally for the purpose of selling or repurchasing in the near future, in another words, it is for short-term profit taking or initially acquired for the purposes of generating a profit through short term fluctuations in price or dealer’s margin.
- (ii) Held-to-maturity investments – are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.

- (iii) Loans and receivables – are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They may be created by the entity by providing money, goods, or services directly to a debtor.
- (iv) Available-for-sale financial assets – are those non-derivative financial assets that are designated as available for sale or are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss.

Answer 4(c)

Fair value reporting applied to financial assets at fair value through profit or loss and available-for-sale financial assets is based on the intent and opportunity for “gain-trading”. Fair value reporting is not applicable to held-to-maturity investments because the fair value changes are not relevant in assessing, predicting, and evaluating cash flows associated with the investments.

Answer 4(d)

	Debit (\$'000)	Credit (\$'000)
Security A	25	
Security B		10
Profit and loss account		15
Security D	15	
Equity	25	
Security C		40
Impairment loss (P/L)	40	
Equity		40

Answer 5(a)

The purpose of a statement of cash flows is to provide relevant information about a company’s cash receipts and cash payments during the accounting period. When used in conjunction with the rest of the financial statements, it provides information that enable users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance between different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

Answer 5(b)

Candidates should emphasise the strengths and limitations associated with accrual and cash measures of a firm's performance. The following issues can be addressed:

- (i) While an investor's major objective might be to assess future cash flows, past cash flow is not necessarily the best measure for doing this. Because management may be able to manipulate the payment or receipt of cash over the short term, cash basis information may provide information that is not representationally faithful. As an example, suppose management is considering postponing the recording of an expense until payment is made in the next fiscal year. Using accrual accounting, the expense would be recorded when it is incurred, i.e., this year. However, a cash-basis earnings measure would recognise the expense in the year of payment, i.e., next year. Measuring a firm's performance using cash flows would allow management the opportunity to manipulate the measure of the company's performance.
- (ii) Accrual-based earnings figures reflected in the statement of comprehensive income measure revenues when they are earned and expenses when they are incurred. The receipt or payment of cash has no impact on revenue and expense recognition and, as a result, is not reflected on the statement of comprehensive income. While this alleviates the opportunity for income manipulation, it also negates the providing of information regarding a firm's sources and uses of cash. Many firms, particularly high growth firms, disclose positive net income while they, at the same time, experience cash shortages. Firms invest in inventory, expand production facilities, or grant liberal credit terms that tie up cash. This information is not reflected in an accrual-basis earnings statement. Only cash flow information can provide investors and creditors with an indication of a firm's sources and uses of cash.
- (iii) A combination of both accrual-basis information and cash flow information provides investors and creditors with the information they need to make decisions for allocating their resources. Accrual-basis information indicates how a firm generates revenues and incurs expenses, while cash flow information indicates where a firm's cash is coming from and where it is going.

Answer 5(c)

Cash proceeds from the bank:

Principal of the note	\$30,000
Add: interest from the note (30,000 x 10% x 90/360)	<u>750</u>
Maturity value of the note	30,750
Less: Bank discount (\$30,750 x 12% x 40/360)	<u>(410)</u>
Cash proceeds	30,340

The increase in notes receivable is considered as an increase in credit sales and should be deducted from operating profit before working capital changes. However, the collections made from notes receivable would be shown as an inflow of operating cash in the statement of cash flows.

The interest income and interest expenses on discounting of \$750 and \$410 respectively should be presented under the adjustments for profit before taxation to reduce and increase the profit before taxation to derive the cash generated from operations.

The interest received and interest paid from the notes receivable and discounting the notes receivable of \$750 and \$410 respectively should be presented under the net cash inflow from investing activities and net cash used in operating activities or financing activities.

Answer 5(d)(i)

Cash is only involved when the asset is acquired or sold. The gain and loss on disposal of non-current assets, assuming the effects of taxes are ignored, is a non-cash item. The gain should be deducted from profit from operations when calculating cash flow from operating activities. The cash proceeds would appear as an investing activity. Investing activities are cash flows related to the acquisition and disposal of assets for long-term or short-term purposes.

Answer 5(d)(ii)

Assuming no taxes effect, depreciation expense is the allocation of the cost of depreciable assets deductible as an expense in deriving net income. It should be added back to profit from operations when calculating cash flow from operating activities.

Answer 5(d)(iii)

No cash is involved in the transaction of the issuing of shares for a subsidiary. However, it should be reported in the notes to statement of cash flows when disclosing the acquisition of a subsidiary.

Answer 6(a)

The objectives of financial statements are to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. They have the role of financial accounting and reporting that are directed at general purpose financial reporting by business firms. Financial statements also show the results of management's stewardship of the resources entrusted to it. Financial statements comprise statement of financial position, statement of comprehensive income, statement of cash flows, statement of changes in equity and notes. It is worthwhile to note that providing information about the entity to users, particularly external users is important in helping to raise external finance and reduce the cost of capital.

Answer 6(b)

Shareholders need to make buy, sell or hold decisions about the company shares from time to time based on the company's performance and financial positions, industrial perspective, and other information. For a company's employees, they need information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the company to provide remuneration, retirement benefits and employment opportunities. Sometimes, the labour unions will use it to conduct collective bargaining with the management. Information regarding the firm's cash flows prospects is important too. The firm's ability to pay dividends and interest, as well as the market prices of the firm's securities, is affected by the firm's ability to generate favorable cash flows. Thus, financial statements information is helpful in assessing the amount, timing and uncertainty of prospects of cash flow related to the firm. In order to make these decisions, they need information about the company and the information provided should be of high quality. This then would reduce the risks associated with these decisions. Shareholders provide finance to a company and if the risk of providing that finance is reduced, then finance is more likely to be available, at a lower cost.

Answer 6(c)

One way of ensuring that financial statements are of high quality is to have "standards" which determine the recognition, measurement, presentation and disclosure of items in financial statements. Accounting standards can:

- (i) improve comparability;
- (ii) improve understandability;
- (iii) enhance credibility; and
- (iv) help to provide reliable information.

The application of "standards" can set forth the accounting and reporting practices, and procedures that should be followed in accumulating data and preparing financial statements. As a result, they will help to maintain users' confidence in, and the credibility of the reported financial data.

Answer 6(d)

Assets are defined as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”.

Internally developed brands can meet the definition of asset. Entities often exert control over them by having legal and trading rights for the protection of exclusive use. They also develop from past events and the brands help to contribute to the flow of future economic benefits. However, internally developed brands do not meet the recognition criteria as the cost of the asset cannot be ascertained and determined reliably. HKAS 38, *Intangible Assets* concurs with such a view that internally generated brands will not be recognised as assets.

* * * END OF EXAMINATION PAPER * * *