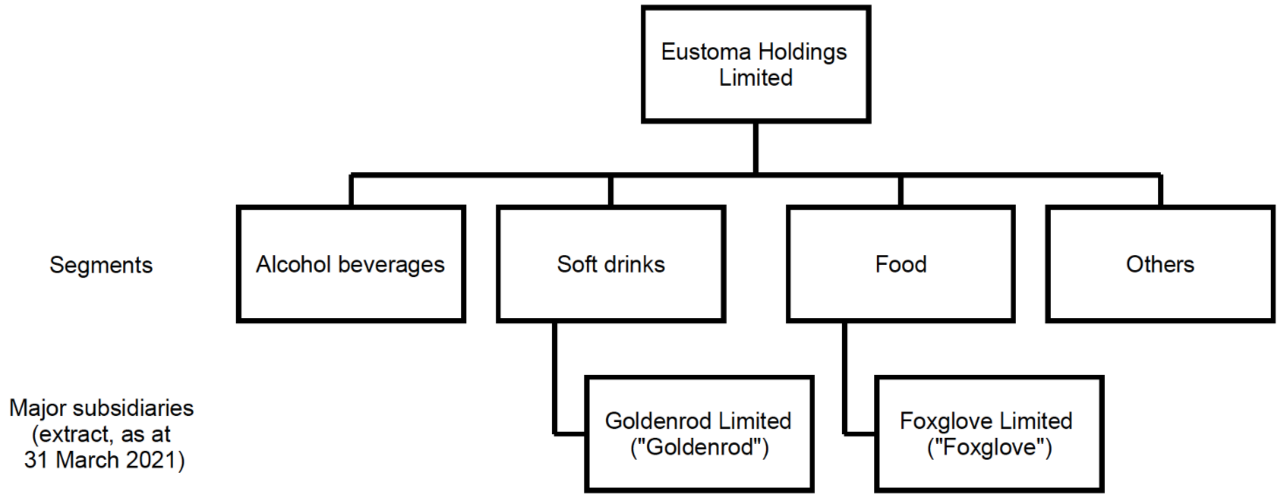
SECTION A – CASE QUESTIONS (TOTAL: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

CASE

Eustoma Holdings Limited ("Eustoma") is one of Hong Kong's leading beverage companies. Eustoma's shares have been listed on the Main Board of the Hong Kong Stock Exchange since June 2004. The principal activities of Eustoma and its subsidiaries (the "Eustoma Group") fall into several key segments which are depicted in the following diagram included in the interim report:



Companies in the Eustoma Group have a financial year end date of 30 September and apply Hong Kong Financial Reporting Standards in the preparation of financial statements. Taxation impact is ignored in this case.

Acquisition of Foxglove

On 1 January 2014, Eustoma paid HK$11,000 million to acquire 70% of the ordinary share capital of Foxglove (the "Acquisition"). Foxglove engages in the food manufacturing business and delivers value to customers leveraging core brands which focus on confectioneries, health food, and supplements. The financing and operating activities of Foxglove are directed through voting rights and Eustoma has obtained control over Foxglove since the Acquisition. Foxglove is the only entity in the food segment in the Eustoma Group. Foxglove is also the only non-wholly-owned subsidiary in the Eustoma Group.

On top of the abovementioned cash payment on 1 January 2014, Eustoma paid HK$60 million to professional firms to structure the Acquisition. Part of this amount was paid to an independent appraiser assisting with the identification and measurement of the fair values to be assigned to the assets and liabilities of Foxglove. The purchase price allocation exercise concluded that, on 1 January 2014, the fair values of Foxglove's net assets were equal to their carrying amounts with an exception of some machinery items which had a fair value greater than the carrying amount of HK$1,000 million. These machinery items were fully depreciated prior to 30 September 2020. Eustoma chose to measure the non-controlling interest in Foxglove at their fair value as at the acquisition date, which was measured at HK$4,700 million. Companies in the Eustoma Group measure their property, plant and equipment using the cost model in accordance with HKAS 16 *Property, Plant and Equipment*.

At the acquisition date, Foxglove had retained earnings of HK$7,000 million with no other reserve. Foxglove has not issued any share since the Acquisition and has not declared any dividends during the six months ended 31 March 2021.

Eustoma presents its investment in Foxglove at cost in its separate financial statements. Eustoma identified Foxglove as a cash-generating unit in accordance with HKAS 36 *Impairment of Assets* and it was assessed that the goodwill arising from the Acquisition has not been impaired since the acquisition date.

<u>Disposal of shares of Foxglove</u>

Although Foxglove has consistently contributed around 15% of the Eustoma Group's revenue and remained profitable, Eustoma devised a strategic plan in early 2021 to concentrate its resources refocussing on its beverage products, in particular the beer-type beverages. On 1 April 2021, Eustoma sold part of its investment in Foxglove, which was equivalent to 25% of Foxglove's share capital, to a few unrelated parties for a total of HK$5,200 million in cash (the "Disposal"). After the Disposal, Eustoma held 45% of the ordinary shares of Foxglove and was able to appoint directors of Foxglove. Eustoma measured the fair value of the remaining shareholdings of 45% of Foxglove on 1 April 2021 at HK$9,400 million.

The following dialogue was extracted from a recent meeting of the audit committee of Eustoma:

Edward: Mr Edward Poon, chairman of the audit committee of Eustoma
Fanny: Ms Fanny Chan, member of the audit committee of Eustoma

Fanny: After the disposal of Foxglove's shares, Eustoma's shareholdings dropped to only 45%. We are holding less than half of the ordinary shares of Foxglove. Foxglove is not our subsidiary anymore and will leave the Eustoma Group.

Edward: We cannot jump to this conclusion. We need to seek help from our Finance Department to provide further information before we conclude that Eustoma will not have power over Foxglove after the disposal, thereby losing control.

The financial statements of Foxglove and the Eustoma Group excluding Foxglove for the six months ended 31 March 2021 are shown below:

Statements of profit or loss and other comprehensive income for the six months ended 31 March 2021

	Eustoma Group excluding Foxglove HK$ million	Foxglove HK$ million
Revenue and other income	294,000	52,200
Expenses and other loss	(267,000)	(50,000)
Profit for the period	27,000	2,200

Statements of financial position as at 31 March 2021

	Eustoma Group excluding Foxglove HK$ million	Foxglove HK$ million
ASSETS		
Property, plant equipment and other non-current assets	256,000	14,700
Investments	27,000	-
Cash	15,000	1,300
Other current assets	44,000	3,900
Total assets	342,000	19,900
EQUITY AND LIABILITIES		
Share capital	70,000	5,000
Retained earnings, 1 October 2020	193,000	9,500
Add: Profit for the six months	27,000	2,200
Retained earnings, 31 March 2021	220,000	11,700
Total liabilities	52,000	3,200
Total equity and liabilities	342,000	19,900

On 1 April 2021, the difference between the fair values of Foxglove's recorded net assets and their carrying amounts was attributable to a number of brands which were internally generated subsequent to the acquisition date (i.e. 1 January 2014). These brands had indefinite useful life and were not impaired during the six months ended 30 September 2021. As at 30 September 2021, Foxglove recorded a net asset value of HK$18,500 million on its statement of financial position, with profit of HK$1,800 million earned during the six months ended 30 September 2021.

<u>Incentive to senior executives of Goldenrod</u>

Goldenrod is a wholly-owned subsidiary in the Eustoma Group and is engaged in the manufacture of non-alcoholic beverages under the soft drinks segment. The remuneration packages of the senior executives of Goldenrod have been very simple, comprising basic salary and annual bonus.

After the Disposal, Eustoma decided to use share-based payment to incentivise the senior executives of Goldenrod. On 30 September 2021, Eustoma granted a right, free of charge, to each of the four senior executives of Goldenrod to receive a remuneration that was pegged to the price of Eustoma's shares (the "Rights"). The Rights were immediately vested on 30 September 2021. The Rights will only be settled and paid in cash two years after the grant date. Eustoma does not require Goldenrod to pay the value of the Rights upon its settlement.

<u>Question 1</u> (18 marks – approximately 32 minutes)

You are the Finance Manager of Eustoma.

<u>Required:</u>

(a) **Prepare the consolidation adjustment journal entries to include Foxglove in the Eustoma Group's interim consolidated statement of profit or loss and other comprehensive income for the six months ended 31 March 2021 and interim consolidated statement of financial position as at 31 March 2021.**

(6 marks)

(b) **Analyse what additional information you need to gather before reaching a conclusion as to whether Eustoma has power over Foxglove after the Disposal and how such information may affect your assessment.**

(12 marks)

<u>Question 2</u> (21 marks – approximately 38 minutes)

Following further assessment, Eustoma confirmed that control over Foxglove has been lost since 1 April 2021 upon the Disposal and Eustoma has not exhibited joint control over Foxglove after the Disposal. Eustoma also confirmed that the investment in Foxglove qualified as a discontinued operation.

<u>Required:</u>

(a) **Advise on the accounting impacts to the Eustoma Group's consolidated financial statements (including consolidated statement of financial position, statement of profit or loss and other comprehensive income as well as statement of cash flows) relating to the Disposal on 1 April 2021. Furthermore, advise on how the investment in Foxglove should be accounted for after the Disposal in the consolidated financial statements for the year ended 30 September 2021.**

Note: You must show supporting calculations in addressing this question.

(12 marks)

(b) **Explain why the investment in Foxglove qualified as a discontinued operation.**

(3 marks)

(c) (i) **Describe how such discontinued operation should be presented in the consolidated financial statements for the year ended 30 September 2021.**

(ii) **Prepare the relevant extracts, with figures, for the <u>discontinued operation</u> in relation to the presentation requirements for the consolidated statement of profit or loss and other comprehensive income, based on the case information and your answers in Questions 1(a) and 2(a).**

Note: In preparing the extracts, you are neither required to prepare the illustrations with figures relating to the continuing operations of the Eustoma Group nor present the comparative figures.

(6 marks)

<u>Question 3</u> **(11 marks – approximately 20 minutes)**

Analyse the appropriate accounting treatments for the Rights to the senior executives of Goldenrod in each of the following financial statements for the year ended 30 September 2021:

(a) **the financial statements of Goldenrod;**
(b) **the separate financial statements of Eustoma;**
(c) **the consolidated financial statements of the Eustoma Group.**

Note: You are required to discuss the classification of the share-based payment in each of the financial statements and demonstrate, without figures, the relevant journal entries and consolidated adjustment journal entries (if appropriate) in your answers. Answers without clear identification of which financial statements you are referring will not be awarded marks.

(11 marks)

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End of Section A

SECTION B – ESSAY / SHORT QUESTIONS **(TOTAL: 50 marks)**

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

Question 4 **(20 marks – approximately 36 minutes)**

Flow Space Limited ("FSL") leases a number of properties in Hong Kong under ten-year non-cancellable lease arrangements and converts them into a network of business centres to provide flexible workspace as well as related services. FSL has a financial year end date of 31 March.

Under FSL's business model, two service options that the company provides to its customers are:

- dedicated office suites – customers can have exclusive access to the designated areas, including their own reception, conference rooms and amenities. Monthly fixed fees include security and cleaning services. The contract term typically runs for five years at most.

- hot desk access in a co-working space area – free seating available in the co-work space with a printing quota of 150 pages per month, access to common areas and amenities shared with other users. The contract term is usually for one year.

Under each of the arrangements above, the customers are charged a fixed fee in advance on a monthly basis according to their chosen service option. In the case of early termination, three months' prior notice is required and no further penalty is imposed.

Management of FSL are divided in their views as to the financial reporting standards applicable to each of the arrangements. People from FSL's Operations Department consider that both arrangements should merely be straightforward operating leases to be accounted for under HKFRS 16 *Leases.* They believed that the whole consideration should be spread over the respective contract terms when recognising revenue. However, Aiden Chow, Finance Director of FSL, thinks HKFRS 15 *Revenue from Contracts with Customers* should be applicable instead.

Sophie Ng, an accounting consultant, is being engaged to look into the accounting treatment of the fees above.

Required:

Assuming you are Sophie, draft an email to be sent to Aiden to advise on the accounting treatment of the fees derived from each of the above service options.

Your answer should include the following:

- **an analysis of which financial reporting standard(s) would be applicable; and**
- **an explanation of the resulting accounting treatment and timing of recognition of the fees identified.**

(20 marks)

Note: A maximum of 2 marks for communication skill and 2 marks for analytical skill will be awarded.

<u>Question 5</u> **(17 marks – approximately 31 minutes)**

Shining Stars Limited ("SSL") is a company listed on the Hong Kong Stock Exchange with a financial year end date of 31 March. The government of the HKSAR exercises significant influence over it.

During the year, SSL entered into a supplier agreement with Frozen Ground Limited ("FGL"), which is ultimately controlled by the government of the HKSAR. In 2021, SSL made one purchase with FGL to the amount of HK$ 20 million, which is material to the operations of the company.

Sarah So, Finance Manager of SSL, considers that given FGL is government-related, there is no need to provide any disclosures about FGL and transactions with them in SSL's financial statements.

On 20 February 2021, SSL issued preference shares with a face value of HK$ 1 billion. The preference shares are classified as equity and bear a dividend of HK$ 5 million for the year. On 4 April 2021, SSL also underwent a share split – for every ordinary share it was split into 4. The financial statements were authorised for issue on 30 April 2021.

<u>Required:</u>

(a) **Evaluate Sarah's comments in relation to the non-disclosure about FGL and the related transactions during the year. (*You are not required to prepare any draft disclosures. Ignore Listing Rules requirements.*)**

(7 marks)

(b) **Explain the impact of the following on the calculation of basic and diluted earnings per share for the year ended 31 March 2021. (*Calculations are not required.*)**

(i) **preference shares; and**
(ii) **share-split.**

(6 marks)

(c) **During the financial year, news broke out that the products SSL sold were being sourced from suppliers that use child slave labour. Describe the potential financial implications on SSL as a result of the news.**

(4 marks)

Question 6 **(13 marks – approximately 23 minutes)**

Healing Touch Limited ("HTL") is a biopharmaceutical company that specialises in manufacture, research and development of drugs and vaccines. It has a financial year end date of 31 March and applies the cost model in accounting for its intangible assets.

In recent years, on top of developing its own patented formula HTL has also been acquiring formulas from other research laboratories. Each formula is unique although some of them might share similar healing properties.

Helena To, Finance Director of HTL, is looking to apply revaluation model to the acquired formulas after initial recognition. She is of the view that it would give more relevant information to the users of the financial statements as fair value is involved. She intends to propose an accounting policy change to the financial statements for the year ended 31 March 2021.

On 1 April 2021, news appeared in the media reporting that one of HTL's newly launched vaccines causes severe side effects. The vaccine was described as causing hospitalization and even death amongst affected individuals. The company faces a number of major lawsuits and is ready to defend its position. Based on past experience, HTL's lawyers roughly estimate that the exposure could be as high as HK$ 30 million, although the loss would be covered by insurance to a certain extent. Helena considers that given this is something that happened after the reporting date and that HTL has bought insurance to cover such kind of risk, the company would only need to disclose the matter in its 31 March 2021 financial statements and no provision was necessary.

Required:

(a) **Evaluate Helena's proposal to account for the formula using the revaluation model instead of the cost model.**

(5 marks)

(b) **Advise and explain if you agree with Helena's approach to the 31 March 2021 financial statements in reaction to the news on 1 April 2021. Also, explain what further evidence you would expect to obtain, if any, in order to support/ disprove your view point and the consequential accounting impact(s) on the financial statements.**

(8 marks)

* * * END OF EXAMINATION PAPER * * *