

APERCU



WHAT YOU NEED TO KNOW ABOUT STATUTORY PATERNITY LEAVE PROVISIONS OF HONG KONG

Good news to all new working fathers in Hong Kong! The long-awaited paternity leave law was finally passed by the Legislative Council in December 2014. The Employment (Amendment) Ordinance 2014 (Latest Amendment) on statutory paternity leave took effect on 27 February 2015.

Under the Latest Amendment, a male employee with a child born on or after 27 February 2015, is entitled to three days of statutory paternity leave (SPL) with pay at 80% of his daily average wage, provided that he satisfies the requirements under the norms of SPL.

Paternity leave is not something new in Hong Kong. The Government of Hong Kong SAR and some private organisations have already offered paternity leave to their employees voluntarily long before the mandatory paternity leave law was passed. The paternity leave benefits they offered were even better than those now offered under the norms of SPL. During the debates on the provisions, some legislative council members had criticised the government proposal declaring it not good enough and they had proposed to provide eligible employees with seven days of paternity leave with full pay. However, this proposal was considered to be too costly for employers and was not endorsed by the Labour Advisory Board.

The following paragraphs lay out the norms of the SPL to be implemented and the points that must be considered both by employers and employees.

Eligibility of SPL and SPL pay

According to the Latest Amendment, the eligibility for SPL, for SPL pay and all requirements to be fulfilled by employees are shown in Table 1.

CONTENTS

- 01** What you need to know about statutory paternity leave provisions of Hong Kong
- 04** Establishing an effective internal audit function
- 06** Currency swap valuations
- 09** Suspicion is central to AML System
- 11** BDO supports The Chamber of Hong Kong Listed Companies (CHKLC) Director Training Series 2015

BDO international tax webinar series
- 12** Upcoming amendment to the statutory minimum wage rate in 2015

Recent BDO publications

Table 1

Eligibility	Requirements to be fulfilled by employees	Entitlement to SPL	Entitlement to SPL pay
1) Being the child's father		✓	✓
2) Employed by the same employer under a continuous contract (see note) and	i) for a period of not less than 40 weeks immediately prior to the day of beginning his paternity leave or	✓	✓
	ii) for a period of less than 40 weeks immediately prior to the day of beginning his paternity leave	✓	✗
3) Complied with all 'notification requirements' ie The employee has to notify the employer of his intention of taking paternity leave by either item i) or ii) listed on the right	i) three months before the expected birth date of the child and his intended paternity leave date or	✓	✓
	ii) at least five days before each intended date of his paternity leave	✓	✓
4) If required by the employer, the employee must provide a written statement with details per items i) to iv) listed on the right	i) the employee's signature	✓	✓
	ii) indicating that he is the father of the child	✓	✓
	iii) the name of the mother of the child	✓	✓
	iv) the expected date of the child's birth, or the actual date of birth if the child has already been born	✓	✓
5) The employee would also need to provide the requisite documents within specified timelines as stated in Tables 2 & 3 below		✓	✓

(Note: according to the Employment Ordinance, an employee who has been employed continuously by the same employer for four weeks or more and has been working for not less than 18 hours a week is regarded as being employed under a continuous contract).

Table 2

Requisite documents to be provided by employee to employer

For a child born in Hong Kong	For a child born outside Hong Kong
Birth certificate of the child issued by the Registrar under the Births and Deaths Registration Ordinance, on which the employee's name is entered as the child's father.	Birth certificate issued by the overseas authorities on which the employee's name is entered as the child's father. If no birth certificate is issued in the place of birth, another document issued by the overseas authorities that could reasonably prove that the employee is the child's father.
If unfortunately, the child is born dead or dies after birth and the employee is unable to provide his employer with the relevant birth certificate	
<ul style="list-style-type: none"> The employee is required to submit a medical certificate or other document issued by the authorities to prove the delivery of the child. A written statement signed by the employee stating that: <ol style="list-style-type: none"> he is the father of the child delivered by the woman named in the medical certificate; and the child is born dead or dies after birth. 	Employee is required to submit a medical certificate or other document issued by the authorities of the place and a written statement signed by the employee with all requirements same as those as stated on the left.

Table 3

Timelines for provision of requisite documents to employer

Employee continues to work with the employer	Employee has ceased to be employed by the employer
Within 12 months after the first day on which the employee takes the paternity leave.	Within 12 months after the first day on which the employee takes the paternity leave or within six months after the cessation of employment, whichever is earlier.

Other points to note regarding the entitlement of SPL

- Multiple births in one pregnancy are taken as one confinement and the employee is only entitled to a maximum of three days of paternity leave while fulfilling all the requirements.
- The entitlement of paternity leave does not apply to a miscarriage.
- Unlike maternity leave, no statutory protection is expressly indicated in the Latest Amendment against termination of employment during the period when a male employee is on paternity leave.

Table 4

Requisite documents provided on or before taking paternity leave	Requisite documents provided after taking paternity leave
<ul style="list-style-type: none"> • The employer must pay the employee not later than the day on which his next wages are due after the leave day; or • If the employee has ceased to be employed on or before taking the paternity leave day, the employer must pay him not later than seven days after his cessation of employment. 	<ul style="list-style-type: none"> • The employer must pay paternity leave pay to the employee in respect of the leave day not later than the day on which his next wages are due after the requisite documents are provided to the employer; or • If the employee has ceased to be employed by the employer, not later than seven days after the requisite documents are provided to the employer. <p>When the employer has paid paternity leave pay to employee before the requisite documents are provided, the employer may deduct from the employee's wages an amount equivalent to the paid paternity leave pay, if:</p> <ol style="list-style-type: none"> a) the employee fails to provide the employer with the requisite documents within three months after the first day on which the paternity leave is taken; or b) the employee has ceased to be employed by the employer and fails to provide the employer with the requisite documents before the cessation.

Note: Please note that if after the deduction the employee has subsequently provided the employer with the requisite documents by the due dates as specified above, the employer must again, pay the paternity leave pay to the employee.

Financial implications for employers when SPL is in force

Tables 1 to 3 illustrate the norms of SPL but, what are the financial implications for employers when SPL comes into effect? The below paragraphs show the details:

1. Basis of computation of paternity leave pay per day:

$$\text{Daily paternity leave pay} = 4/5 \times \text{Employee's daily average wages}^*$$

*Note: * computation of the daily average wage of paternity leave day is similar to the computation of average daily wages of the other statutory entitlements as specified in the Employment Ordinance.*

2. Timing when paternity leave pay has to be made by employer to employee

Payment of paternity leave pay must be made following the timeframe listed in Table 4, if the employee taking paternity leave provides the requisite documents.

The introduction of SPL will inevitably increase the running costs of employers as the costs of SPL for employees are fully borne by employers. It will have a negative effect on the profitability of businesses, in particular, small and medium businesses, as rents and wages eat up a large part of their profits.

Whilst the government said that the proposal is a prudent and reasonable one and has already taken into consideration balancing employees' benefits and affordability of employers before enactment, a government official said that the estimated cost increment to employers for the SPL benefits would be in the region of 0.02% to 0.04% of the total employment costs, which appears to be affordable while providing a more family-friendly working environment to its employees.

Possible challenges for employers

While some employers are preparing to adopt the new SPL benefits for the male employees, grey areas are looming as a result of certain not clearly defined terms in the Latest Amendment. Below are those grey areas pending for clarifications by Labour Department:

1. Potential difficulties in proving paternity

An employer cannot require an employee applying for SPL to provide:

- Proof of paternity;
- Further information concerning the mother (such as her address, or personal details as showed on her Hong Kong identity card);
- Proof of the mother's pregnancy (such as certificate of pregnancy issued by a registered medical practitioner); and
- Birth Certificate of the child unless the employee claims paternity leave pay.

As a result, it is expected that the number of employees who get paternity leave will increase after the implementation of SPL. Employers will need to be careful in approving employees' application for SPL and will also need to be cautious on staff planning and take into consideration the shortage of manpower.

2. Potential increase of cost of paternity leave

For employers who have already provided better maternity leave pay to female employees (such as, 100% pay for maternity leave instead of the statutory maternity leave pay at 80% of employee's daily average wages), they may need to provide also 100% pay on paternity leave for eligible male employees in order to avoid any potential labour dispute. As a result, the cost on paternity leave benefits would be further increased.

Immediate actions to be taken by employers to deal with the potential obstacles to the administration of SPL

In view of the potential difficulty on obtaining proof of paternity, the employers should review or update the following:

- Revision of company policies and staff handbook to cover the relevant procedures and requirements for application of SPL and SPL pay for employees' reference and adherence.
- Creation of standard forms and statements for employees' completion when applying for SPL and SPL pay.
- If paternity leave benefits have already been offered to employees before the implementation of SPL, employers should ensure the said benefits are not worse than the new provisions.

Employers may seek legal advice on drafting the contents of the relevant SPL application forms and statement in order to comply with the Latest Amendment and other relevant ordinance.

Employers must pay attention to the effective date of the SPL provisions and should then comply with the provisions immediately by granting SPL to entitled employees and pay them paternity leave pay in accordance with SPL requirements. It is an offence if an employer fails to do so without reasonable cause. Under the current order, an employer could be liable on conviction up to a fine of HK\$ 50,000.

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ESTABLISHING AN EFFECTIVE INTERNAL AUDIT FUNCTION

In a world with increased emphasis on corporate responsibility and accountability, internal audit has increased participation in risk management to evaluate how well risks are being managed. Internal audit is also regarded as an extended arm of the Audit Committee (AC) to conduct ad hoc and routine internal control review in order to discharge AC's oversight responsibilities in risk management and internal control.

The need for internal audit

According to the Risk Management and Internal Control Consultation Conclusion issued by the Hong Kong Stock Exchange (HKEx) in December 2014, every listed company should establish an internal audit function from January 2016 onwards. Organisations face renewed corporate governance concerns, as well as intense internal and external scrutiny. Many are struggling to keep pace with the changing regulatory environment, with heightened stakeholders' expectations and with being able to identify the complex risks they face.

It is clear that boards are now far more aware of the importance of understanding risk. Unlike external auditors, internal audit looks beyond financial risks and statements to the wider issues that help businesses mitigate operational and strategic risks to which they are exposed. This means the strategic value of internal audit is greater than it ever has been.

A reactive approach to internal audit is no longer acceptable. There can be no surprises when it comes to dealing with the risks and opportunities in your business. Internal audit has always been one of the cornerstones of good governance. This relies heavily on whether the internal audit function has an audit methodology that can anticipate potential risks, risk assessment analysis of individual risk factors, etc.

For many organisations, the expectations placed upon internal audit have increased, with the function being relied upon to make significant contributions to the business. However, having an internal audit function may not be mandatory for your sector. Many companies still do not recognise the fact that an internal audit function could have a deterrent effect for those potential wrongdoers interested in assets misappropriation, conflict of interest, or fraudulent reporting.

Nevertheless, internal audit can play an important role in any organisation's governance processes, especially in the management of risk, as a third line of defence by providing assurance over fundamental internal controls, helping to detect and prevent fraud, and monitoring compliance with company policy and legislation. Internal audit is not just for larger organisations. Smaller companies simply cannot afford high profile financial or reputational loss, making internal audit even more important. For small companies, establishing an effective internal audit function is even more crucial, as there are a lot of internal control weaknesses inherent to the business such as inadequate segregation of duties due to lack of resources, insufficient independent review, and inadequate documentation of key control procedures, etc.

Areas where internal audit can add value

- Appraise and advise on corporate governance, risk management, compliance and internal controls frameworks



- Process and control improvement initiatives, including ensuring processes are not over-controlled
- Challenge assumptions over state of risks, processes and core controls
- Provide new insights from wider experiences of operations inside and outside of the sector
- Help benchmark performance
- Advise on cost reduction without eliminating control
- Educate and train on risk management, operational auditing and integrated assurance
- Project plan appraisals and programme governance evaluation
- Corporate risk assessments and annual risk register refresh
- Assess service organisations and third parties.

Questions to consider when assessing the need for internal audit

- Have you experienced any unpleasant surprises from your operations?
- Do you have a comprehensive picture of the effectiveness of your governance, risk and assurance framework?
- Do you know your total cost of control and assurance?
- How effective and resilient is your existing assurance operations?
- Are you confident that you know where your business is exposed?
- How are you handling risks in new markets, outsourced activities or business partnerships?
- How easy and how often have people circumvented controls?
- Are you comfortable that major change projects are being controlled?
- Have cost reduction programmes and structural changes affected the value of your control infrastructure?
- Do you have the right information to run your business and is it accurate?

EVALUATING WHAT YOU HAVE IN PLACE, PROVIDING BESPOKE SOLUTIONS AND COMPLEMENTARY SKILLS. THE SETUP OF AN INTERNAL AUDIT FUNCTION SHOULD BE TAILORED TO MEET YOUR CURRENT AND FUTURE NEEDS.

Choosing the right model

Internal audit can adopt many roles in organisations, from more traditional, financially focused teams to functions that position themselves as 'trusted advisors'. These teams' remit is to work alongside management to provide not only independent challenge and assurance but also commercial insights and advice to support business growth.

Whilst the latter model is more aligned to good practice, all models can work effectively and can provide value.

To help ensure the function does deliver real benefits for the business, it is critical that stakeholders define the type of assurance and support they require from the internal audit function.

There are four fundamental questions to answer when confirming your assurance requirements:

- What are our key risks?
- How do we currently receive assurance over these risk areas?
- Where are our gaps in assurance?
- Do we want internal audit to provide assurance in these areas?

Determine the right internal audit function model is important. Taking into account the company's structures and operations, the internal audit function should 'map' the company's risks and priorities to known sources of assurance, underlining potential shortfalls and areas of duplication in coverage.

The company should establish and resource the most suitable assurance model – one that is tailored to its size, sector, risk appetite and the regulatory requirements that apply to its organisation. This can range from an in-house function, to co-sourcing, or to a fully-outsourced service.

Establishing a successful internal audit function, one that meets the needs of your business and observes the legal and regulatory requirements of your industry, is greatly influenced by the team you choose and their respective skill sets.

The company would be responsible for ensuring that, within the internal audit function, there are skilled professionals experienced in establishing and working with risk and assurance services across a range of sectors.

For any enquiries concerning establishing an internal audit function or enhancing the effectiveness of an internal audit function, please contact Ricky Cheng, Director of Risk Advisory Services, at rickycheng@bdo.com.hk for more information.

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CURRENCY SWAP VALUATIONS

Introduction

In our November 2014 issue of APERCU, we introduced the interest rate swap and its valuation methodologies. In this edition we introduce another common type of swap "the **currency swap**" (CS).

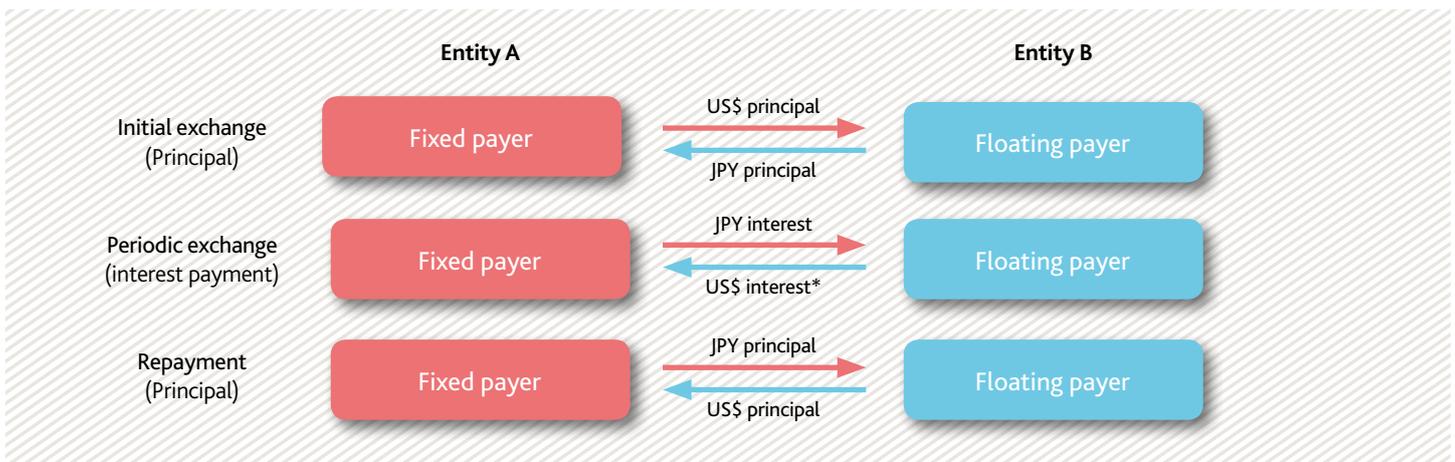
A CS is a contract between two entities to exchange the principal and interest of a specified notional amount denominated in one currency, for the principal and interest of an equivalent notional amount denominated in another currency. Since the cash flow streams are

denominated in two different currencies, a CS then has more complexity than an interest rate swap.

The three most common types of CS are as follows:

- **Fixed-for-fixed currency swap:** the interest rate being fixed on both sides;
- **Fixed-for-floating currency swap:** the interest rate fixed on one side and floating on the other; and
- **Floating-for-floating currency swap:** the interest rate floating on both sides.

At the initiation of a swap agreement, the notional principal (in two different currencies) will be exchanged between the two parties. During the life of the swap agreement, the interest based on the principal currency initially received is paid by the parties. At maturity, the notional principal is exchanged back; therefore each party will pay back the principal amount received from the other party at the initial exchange rate, effectively reversing the exchange at the origination of the swap agreement. Using a fixed-for-floating currency swap as an example, the cash flows under this agreement will be as follows:



*Libor is one of the most commonly used reference rates for floating rate interest payments

Entity A is able to borrow US dollars at a favourable interest rate (floating) but needs to make periodic payments of Japanese Yen. Entity A then enters into a swap with Entity B, which is able to borrow Japanese Yen at a lower interest rate than Entity A, but has difficulty raising US dollar funding itself.

Common reasons and benefits of using a CS include:

Purpose	Narrative
Lower borrowing costs	Entity A is a local United States company, while its subsidiaries are located in Japan. Entity A needs to finance these operations by borrowing Japanese Yen. Entity A finds it expensive to borrow foreign currency (JPY) in the domestic market or for its subsidiaries to borrow local currency (JPY) as foreign companies. Entity B is a local Japanese company, while its subsidiaries are located in the US. By taking advantage of borrowing in the home market and base currency, a CS offers a bridge for each of the parent companies to obtain foreign currency borrowings for their subsidiaries at lower interest costs, thus benefiting both parties.
Transform borrowing	Entity A needs to issue a US\$ 10m bond at 4%. As an alternative, Entity A can enter into a CS contract, under which Entity A borrows Japanese Yen instead, where the interest is only 3% and then exchanges into US dollars with the counterparty at the initiation of the CS contract. In this way, Entity A is able to transform the US-dollar-denominated fixed rate loan into a Japanese-Yen-denominated bond at only 3% interest.
Hedge exchange rate fluctuation	Entity A needs to pay its suppliers in Japanese Yen on a 90 day basis, however, its operating currency is US dollars. To hedge against exposure associated with exchange rate fluctuation, Entity A prefers to enter into a swap contract to ensure the exchange rate is fixed.
Speculation	If Entity A expects that market rates including exchange rates and interest rates will change, they can then enter into a specific CS contract to speculate that the market will move favourably for them. The markets may not move as anticipated, and as with any speculation, downside risk will exist.

CS valuation methodology

At the initiation of the CS, the value of the CS to both parties should be zero under an "arbitrage free" assumption. However, after the initiation date, when the market conditions change (ie, interest rates, exchange rates, etc), the value of the CS will deviate from its initial value with the result that one party gains at the other party's loss. A valuation of the CS is then needed to measure the gain or loss of either party during the life of the CS contract.

There are two main valuation methodologies applied for currency swap valuations.

Method 1: Valuing as two bonds

Here we define the V_{swap} as the value in US\$ of an outstanding swap, where US\$ interest is received and JPY interest is paid:

$$V_{swap} = BV_D - S_t BV_F$$

Where, V_{swap} = the value of the CS to the US\$ receiver; BV_D = the value of US\$ bond; BV_F = the value of JPY bond; S_t = the spot exchange rate of US\$/JPY at the valuation date

Method 2: Valuing as a portfolio of currency forward contracts

Method 2 treats the CS as a series of currency forward contracts. Forward exchange rates in future years are calculated using covered interest rate parity*:

Example illustration

Several years ago, a financial institution entered into a fixed-for-fixed currency swap in which it receives 4% interest per annum on 1.6 million US\$ and pays 5% interest per annum on 1 million pound sterling (GBP). The swap has five years remaining. The US\$ rate is 5% per annum and the GBP rate is 6% per annum (both continuous compounding). For simplicity, it is assumed that the LIBOR/swap interest rate curve will remain flat going forward for both the United States and the United Kingdom. As of the valuation date, the exchange rate of US\$/GBP is 1.6.

Valuation method 1: Valuing as two bonds, with the calculation shown in the table below (all amounts in thousands):

Year	C_D or N_D (cash flow receive)	Present value (US\$ receive)	C_F or N_F (cash flow pay)	Present value (GBP pay)
1	64	60.88	50	47.09
2	64	57.91	50	44.35
3	64	55.09	50	41.76
4	64	52.40	50	39.33
5	64	49.84	50	37.04
5	1,600	1,246.08	1,000	740.82
Total		1,522.20		950.39

BV_D (the value of US bond) = US\$ 1,522,000

BV_F (the value of GBP Bond) = GBP 950,390

V_{swap} (the value of the CS to the US\$ receiver)

$$= BV_D - S_t BV_F = US\$ 1,522,200 - GBP 950,390 * 1.6 (GBP/US\$) = US\$ 1,580$$

Valuing a fixed-for-floating swap or a floating-for-floating swap is even simpler using Method 1, as in every settlement date of the swap contract, the value of the floating leg is par value.

Valuation method 2: Valuing as a portfolio of currency forward contracts, with the calculation shown in the table below (all amounts in thousands):

Year	$Forward_1$	$Forward_2$	$Forward_3$	$Forward_4$	$Forward_5$	$Forward_{5(N)}$
C_D or N_D in US	64	64	64	64	64	1,600
C_F or N_F in GBP	50	50	50	50	50	1,000
F_i	1.58	1.57	1.55	1.54	1.52	1.52
C_F or N_F in US\$	79.20	78.42	77.64	76.86	76.10	1,521.97
$V_{forward i}$	-14.46	-13.04	-11.74	-10.53	-9.42	60.77

When we sum up all the forward contract values, we derive the value of the CS, which gives the same result as Method 1:

$$V_{swap} \text{ (the value of the CS to the US\$ receiver)} = \sum_{i=1}^T V_{forward i} + V_{forward T(N)} = -US\$ 14,460 - US\$ 13,040 - US\$ 11,740 - US\$ 10,530 - US\$ 9,420 + US\$ 60,770 = US\$ 1,580$$

Where, $V_{forward i}$ is the value of the respective currency forward contract.

The CS valuation under the two methods above is the same, and theoretically, the equations in the two valuation methods above should result in the same valuation. However, in reality, covered interest rate parity rarely works and will typically result in some variation between the two valuation methods.

* Covered interest rate parity: under no-arbitrage condition, the differential between the forward exchange rate and spot exchange rate is equal to the differential between the interest rate in the two countries.



Major risks in using a CS

The following risks may apply in the use of a CS

- **Market risk:** the risk that the market-to-market value of the swap moves against either of the swap parties. This can include movements in the LIBOR rate during the term of the swap contract or changes in exchange rate over the term to maturity that could be adverse or favourable. Market risk (also called "systematic risk"), can however be hedged. Any factors influencing the overall performance of the financial market, such as economic recession and monetary policies, can generate market risk.
- **Basis risk:** Basis risk arises when the price fluctuations of two offsetting hedging vehicles are not perfectly correlated. Since the two offsetting hedging vehicles are similar in nature but still different enough to cause differences between the spot price and future price, basis risk is then inevitable due to imperfect hedging.
- **Credit valuation adjustment and credit risk:** The significant default of major banks and financial institutions during the financial crisis in 2007/2008 raised market concerns about counterparty credit risk (CCR), which is the risk of a counterparty failing to meet its contractual obligations and the need for CCR to be incorporated into the pricing of derivative instruments. As a result, IFRS 13 Fair Value Measurement requires entities

to consider the effect of credit risk when measuring the fair value of derivatives by calculating a debit or credit valuation adjustment (CVA). A CVA is the difference between the value of a position traded with a default-free counterparty and the value of the same position when traded with a given counterparty. Put simply, CVA is the market value of CCR.

The most theoretically pure approach to calculate a CVA is called the 'Expected future exposure approach', which involves simulating scenarios of market parameters to generate the expected exposure profile. The CVA valuation methodologies are not standardised yet and are still dependent on market participants' judgment in assessing the appropriateness of the methodology used and their resources available to apply those methodologies in compliance with IFRS 13.

In some market literature, the mark-to-market feature of a CVA is also called potential credit risk (PCR). This credit risk depends on the portfolio exposure to the counterparty. In the case of a CS, the value of a CVA will depend on the assessment of future interest rates, exchange rates and the default possibility of the counterparty. On the other hand, there is Actual Credit Risk (ACR), which is caused by a counterparty's real default. Since CS is a "zero-sum" game, the ACR is unilateral and only one party could have positive ACR.

Conclusion

A CS is one of the most commonly used swap instruments in the global financial market. The valuation techniques for a CS with a simple structure are intuitive. Valuing as two bonds or valuing as a portfolio of forward contracts will theoretically give consistent results, although in reality this is not always the case.

There are risks to be considered when entering into a CS, including market risk and credit risk, the latter being less simple to hedge. The measurement of credit risk involves using sophisticated simulation modelling skills, especially for the calculation of a CVA, which can raise complications on valuation.

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SUSPICION IS CENTRAL TO AML SYSTEM

Money laundered around the world each year amounts to 2-3% of the global GDP, according to studies conducted by the International Monetary Fund. Considering the large scale and complexity of money laundering and terrorist financing (collectively "ML") activities, Governments and their enforcement units require intelligence about where to look for money launderers.

Legal requirements

Collecting intelligence is one of the reasons why the anti-money laundering (AML) related ordinance requires everyone, including you and me, to report to the authorities when they know of, or suspect, ML activity. Failing to report ML activities could be a **criminal offence**.

Financial institutions (FI), such as banks, securities firms and insurance companies, are highly vulnerable to ML risks. Therefore, they are subject to higher standards and must establish and maintain effective control systems in order to prevent and detect ML activities.

These requirements will be extended to non-designated professionals and businesses (NDPB), such as accountants, lawyers and money lenders in the near future.

An effective AML programme contains the following three major processes:

1. Customer due diligence (CDD)

CDD is a process of gathering, vetting, documenting and assessing your clients' background information for the purpose of anticipating their expected behaviour.

2. Transaction screening/monitoring

Transaction screening/monitoring is an alert system that is intended to identify unusual activities of clients.

3. Suspicious transaction reporting (STR)

This relates to evaluating whether unusual transactions are known or suspected to be ML activities and if so, reporting such transactions.

These processes are usually handled by the qualified Money Laundering Reporting Officer (MLRO) and the cases are submitted to the Joint Force Intelligence Unit (JFIU), a joint department made up of Police and Customs.

Doubt when things don't match or vet

"Suspicion" is the spirit of AML system.

From an evidence perspective, suspicion is more than mere speculation but less than solid proof. It arises when transactions are not consistent, justified and vetted with the nature, size, location and normal practice of the customer or same group of customers.

Financial institutions and professionals are required to exercise their judgment and due diligence reasonably, based on what information they have at a particular time, and determine if there is a likelihood of ML activities.

Case 1 outlines how suspicion plays a key role in the AML system.

Has Bank A breached the AML regulations?

YES, the decision of not filing a STR has breached the rule because the bank has not conducted sufficient due diligence to remove the suspicions substantially. It is clear that the \$2 million remittance does not match with the background of Mr B initially, from the perspective of the bank.

Based on transaction information and vetted documents available to the bank, it should see the fund movement as layering technique of money laundering.

The grounds of non-compliance include, at least:

- The MLRO has simply enquired, but **failed to verify** the identity of Mr B as the son of a billionaire.
- The MLRO has simply obtained the information of the father's business in Switzerland, but **failed to assess** if it has any connection to illegal activity or if it has complex and hidden beneficiary owners before he concludes that the funds are clean. Being rich doesn't necessarily mean being clean.
- The MLRO has **failed to evaluate** the second transaction, which is "apparently" a large third party transfer to the knowledge of Bank A on day 3.

The fact that the funds were subsequently deemed clean by the Authority is irrelevant to the effectiveness of the bank's compliance programme.

Case 1: Banking industry	
Day 1	Bank A has accepted Mr B as its client whose occupation is a clerk of a small-sized trading company and is salaried at \$20,000 per month.
Day 2	Bank A identifies that a large wire remittance of \$2 million is made to Mr B's bank account from Switzerland and the amount is immediately transferred to another account held by a third party, according to the results of transaction monitoring.
Day 3	<p>The MLRO of Bank A receives an exception report about the transaction. He enquires with the bank staff who admitted Mr B into the bank about further details of Mr B's background and the unusual transaction.</p> <p>The staff replies to the MLRO that Mr B has been a friend of his for a long time and Mr B is actually the son of a billionaire who has a legitimate business in Switzerland. The staff further provides the MLRO with the name, nature and background of the father's business.</p> <p>The MLRO is satisfied. He believes that the money is clean, therefore, decides not to file STR.</p>
Day 9	The MLRO receives a call from the Authority regarding the transactions and provides all CDD and transaction documents.
Day 100	The Authority finds out that the \$2 million transfer is, indeed, legitimate transaction from the billionaire father and the subsequent transfer is made to the sister of Mr B. Case closed.



Suspicious can co-exist

Another important concept is that one suspicion will not be removed simply because there are other possibilities available. They can co-exist.

Case 2: Securities industry

Client D of a securities firm is known to be an associate of a Director of listed company G. In a casual conversation, Client D claims that listed company G is about to win a major contract based on his analysis. A red flag is raised.

The next day, Client D purchases some shares of company G right before the Company's trading is temporarily suspended for an announcement, which turns out to be about being appointed as an exclusive distributor. Another red flag is raised again.

The MLRO pulls out the related CDD file and transaction history. He observes that Client D has a long history of buying a combination of securities, including but not limited to company G shares regularly for a similar amount and within the trade credit. There were gains and losses in these trades.

The MLRO is not sure if Client D is insider trading or simply being a good investor.

Note: Insider trading is a predicate offence to money laundering.

It is a typical dilemma any MLRO would encounter. In practice, there are always different interpretations of an unusual transaction. The MLROs always struggle with which side they should take. Indeed, they should not.

A daily life story may explain this concept:

"You are on your way home by bus that has a reputation for pick-pocket thefts (CDD result). When you get off, you learn that your wallet is missing (an unusual event). You would reasonably believe that your wallet might have been stolen or accidentally dropped when you took it out to pay the fare, but you are not sure as your memory is blurred (information available).

Practically, you would not eliminate the doubt of being pick-pocketed because you might just have been careless. Rather, you would go to police station, report the case and let the police investigate."

From this perspective, the MLRO should file a STR in **Case 2**.

Wilful Blindness

While AML system should be built around to "correct" the sense of suspicion, some financial institutions are taking the end of the two extremes intentionally.

"Wilful blindness" is the deliberate avoidance of knowledge of ML activities. It is the most significant deficiency found in AML system, particularly in the transaction screen/monitoring process. The commonly seen deficiencies are:

- There are no efficient automated system to normalise, extract and identify data regarding red flagged transactions
- Extraction logics and thresholds are rigid
- No ML typology scenario testing
- Insufficient data (ie product price information) for identifying trade based ML

Practically, for decent players, these deficiencies are usually the result of insufficient budget and resources, but not deliberate avoidance. However, continuously ignoring the regulators' reminder about devoting sufficient budget and resource is opening the door to non-compliance.

Defensive filing

On the other hand, some financial institutions and professionals are taking another extreme approach in order to play safe. They would simply file any unusual transactions without further assessment and investigation. Naturally, there would be a large number of filings. Technically, they can do it. However, this approach will definitely dilute the value of STR.

This approach is safe, but not highly recommended. Besides, once you slow down your filing, you would fall into a trap of having no consistent judgment.

Financial institutions and professionals are never expected and required to prove whether ML activities have actually occurred. In practice, a few funny transactions on the exception report are probably part of a much larger ML plan. They might get your attentions of doubts, but it is not likely that you can find hard evidence, that goes beyond reasonable doubt, to nail down the fraudsters. However, it is not your job. That responsibility lies with the legal authorities.

All we need to do is be aware and give the authorities a **heads up**.

For further enquiries about building a proper AML system, please contact our Director and Head of Risk Advisory Services, Mr Patrick Rozario on (852) 2218 3118 or patrickrozario@bdo.com.hk

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BDO SUPPORTS THE CHAMBER OF HONG KONG LISTED COMPANIES (CHKLC) DIRECTOR TRAINING SERIES 2015

BDO supports the CHKLC Director Training Series for the fifth consecutive year.

Running from April to November, the programme comprises six sessions dealing with the important aspects of directorship for a listed company, ranging from corporate governance, risk management to the latest updates in various applicable rules and laws. The programme will also address common issues faced by directors.

BDO Director & Head of Risk Advisory Services **Patrick Rozario** & Principal of Specialist Advisory Services **Gabriel Wong** are invited to speak on some of the important aspects of directorship for a listed company

The first session, "Addressing Challenges and Issues Faced by Internal Audit In Integrated Governance, Risk & Compliance (GRC)" by Patrick Rozario will take place at BDO's premises on 21 April 2015. The sixth session, "Quick guide to knowing fraud" by Gabriel Wong will be on 17 November 2015.

The schedule and topics for the forthcoming sessions are shown below.



Dates	Topics
21 April (Tue)	Addressing Challenges and Issues Faced by Internal Audit In Integrated Governance, Risk & Compliance (GRC)
19 May (Tue)	Competition Law in Hong Kong
23 June (Tue)	Annual Regulatory Update 2015
8 September (Tue)	Global M&A Overview and the Relevance to Valuations
13 October (Tue)	New Connected Transaction Rules
17 November (Tue)	Quick guide to knowing fraud

If you are interested in attending, please enroll with CHKLC directly. For more information, visit their website www.chkclc.org

BDO INTERNATIONAL TAX WEBINAR SERIES



Throughout 2015 BDO will be hosting a series of webinars on international tax. The webinars will be presented by BDO tax specialists from around the world and will cover a range of topics of relevance to businesses operating internationally.

Upcoming webinars are listed below. The webinars are free to attend, but numbers are limited so please sign up early to ensure a place.

For further information, please visit <http://www.bdointernational.com/Services/Tax/tax-webinars/Pages/Tax-webinars---2015.aspx>

Webinars schedule

Tuesday 2 June

Transfer Pricing update – looking at the OECD's work on intangibles and documentation as well as other transfer pricing news from around the world

Tuesday 25 August

Compliance Traps – common problems in tax compliance encountered by groups expanding into new territories

Tuesday 24 November

Base Erosion and Profit Shifting – an overview of the most recent releases from the OECD on their 15 point action plan

All the webinars will last one hour and will start at 16.00 GMT.

UPCOMING AMENDMENT TO THE STATUTORY MINIMUM WAGE RATE IN 2015

The Chief Executive in Council has adopted the recommendation of the Minimum Wage Commission to increase the statutory minimum wage (SMW) rate from the prevailing level of HK\$30 per hour to HK\$32.50 per hour. Subject to

the approval of the Legislative Council, the revised SMW rate will come into force on 1 May 2015.

The SMW rates before and after the amendments are summarised in Table 1.

For further enquiries about statutory minimum wage, please contact Director and Head of Payroll & HR Outsourcing Department Joseph Hong at josephhong@bdo.com.hk

Table 1

Details	Upcoming amendment to statutory minimum wage rate in 2015	
	Prevailing level of statutory minimum wage before amendment since 1 May 2013	Would come into force from 1 May 2015 (subject to the approval of the Legislative Council)
Minimum hourly wage rate	HK\$30 per hour	HK\$32.50 per hour
Monetary cap on keeping records of hours worked by employees	HK\$12,300 per month	HK\$13,300 per month

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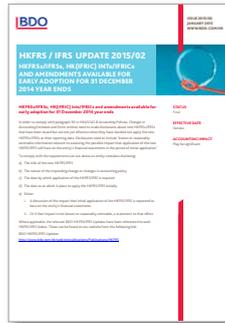


RECENT BDO PUBLICATIONS

HKFRS/IFRS UPDATES



HKFRS/IFRS Update 2015/01
HKFRSs/IFRSs, HK(IFRIC) Ints/IFRICs and amendments that are mandatory for the first time for 31 December 2014 year ends



HKFRS/IFRS Update 2015/02
HKFRSs/IFRSs, HK(IFRIC) Ints/IFRICs and amendments available for early adoption for 31 December 2014 year ends



HKFRS/IFRS Update 2015/03
IFRS interpretations committee – agenda rejections (November 2014)



HKFRS/IFRS Update 2015/04
Investment entities: Applying the consolidation exception (amendments to HKFRS/IFRS 10, HKFRS/IFRS 12 and HKAS/IAS 28)



HKFRS/IFRS Update 2015/05
Disclosure initiative (amendments to HKAS/IAS 1)



HKFRS/IFRS Update 2015/06
IFRS interpretations committee – agenda rejections (January 2015)

Legislation Updates



Capital investment entrant scheme suspended without warning - February 2015



Compensation levels increased under the employees' compensation ordinance - February 2015

If you wish to obtain a copy of these publications, please visit www.bdo.com.hk

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