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APERCU

CONTENTS

ENHANCING EFFECTIVENESS OF THE INTERNAL AUDIT FUNCTION

The internal audit's role in corporate governance

Following a number of recent corporate scandals, stakeholders of listed companies – especially public investors and regulators – are feeling concerned about the quality of their corporate governance practices. Although regulators have stressed the importance of due diligence by sponsors to identify risk factors and operational loopholes in IPO candidates throughout the listing process, much of the responsibility for establishing an effective internal control system rests with the organisation's management.

The internal audit function can be a useful "check and balance" tool for monitoring an organisation's operations and internal control system. Unlike in the United States, where such a function is mandatory for listed companies, the Code on Corporate Governance Practices promulgated by Hong Kong Exchanges and Clearing Limited only recommends it as a best practice for Hong Kong ones. It can help an audit committee discharge a number of its responsibilities under the listing rules, such as making sure the company's internal controls are operating effectively, overseeing the integrity of its financial reporting system, and ensuring compliance with corporate governance rules and regulations.

Challenges in setting up an effective internal audit function

It is not easy for a company to establish an effective internal audit function. A number of things have to be taken care of. They include defining its terms of reference, methodology, resources and performance evaluation. The measurement of an internal audit function's performance will be discussed later in this article.

Terms of reference (TORs) are of utmost importance for an effective internal audit function. Besides setting out the authority and responsibilities of an internal audit function, they also give it the status of an independent unit that reports directly to the audit committee (in a listed company) or the CEO (in a private company). Moreover, the TORs allow the function to access all the organisation's books and records in the course of conducting internal audit review activities.

Yet in reality, some organisations make their internal audit function part of their finance function, and it reports directly to the CFO for the sake of convenience or due to lack of resources. This kind of set up demonstrates that the internal audit function is on the organisation's operational level and that it supports the finance function in verifying the organisation's financial transactions. However, there is a risk of self-review, especially when finance personnel are assigned to check on the work they have done themselves. Therefore, the internal audit function's objectivity should be ensured by positioning it independently.

For methodology, some companies refer to the Institute of Internal Auditors (IIA) Standards when preparing their internal audit manual. The Standards provide a good framework for conducting internal audit activities and the factors that need to be considered throughout the entire process. Having said that, they are not as prescriptive as they could be, especially when an organisation is conducting specific business process reviews or industry-specific business risk assessments. The factors being considered may be incomplete, or they may represent only key features of the areas concerned. Consequently, the head of the internal audit function may have to take all local or business processes-related risk factors into account when planning and executing internal auditing activities.

Resources are another key element of an effective internal audit function. Some organisations may choose to reallocate staff members from other departments to fill internal audit vacancies. Though such people might have a good knowledge of the organisation's business, they may not be sufficiently well trained in conducting internal audit reviews; and they may lack the professional scepticism needed to identify loopholes. Organisations are advised to ensure that they have adequate resources, such as internal audit professionals who possess relevant qualifications (such as the IIA's Certified Internal Auditor) and experience to carry out the relevant activities.

Limited resources can also make it difficult to determine the scope of a review, especially in a multinational corporation (MNC). MNCs usually conduct annual or semi-annual risk assessments with specific evaluation criteria and weighting, in order to identify high-priority areas for the year under review. Some lower-priority ones are reviewed at a later stage. Co-sourcing may be required if more resources are needed to cover various locations. This approach ensures limited resources are used in a cost-effective manner.

Aligning performance with stakeholder expectations

Traditionally, internal audit functions were established to look for non-compliance with internal policies and procedures. Nowadays, the ever-increasing need to fulfil evolving corporate governance practices means the management of organisations expects their internal audit function to be more proactive and deliver much more than before.

In the past, management often used the following key performance indicators to measure an internal audit function's performance:

- the number of internal audit activities conducted per year;
- adherence to the internal audit plan;
- the average number of findings identified during reviews; and
- the time delay in issuing internal audit review reports.

The above tend to be quantitative rather than qualitative assessments. Their shortcoming is that they do not provide the management and audit committee with qualitative information about how internal audit reviews can lead to enhanced organisational performance and the achievement of goals and objectives.

Therefore, it is critical to define what is value-added from the perspective of stakeholders. As a major stakeholder, the audit committee should regularly assess the risk regime in which the organisation is operating, and determine the priority of issues from both operational and strategic points of view. According to observations, audit committees tend to operate in a reactive mode, meaning their members review information provided by the management or review reports provided by the internal audit function. To discharge their responsibilities effectively, audit committee members should proactively ask themselves: "What do we need from the internal audit function?" That means they should set out their expectations and information requirements.

For example:

- What are the key risks and controls in the revenue-recognition process?
- Are there any loopholes in the operational flow of the procurement process where fraud could take place?
- What internal controls has the management established to ensure the integrity of financial reporting and statements?
- What mechanisms are in place to ensure the sustainability of operating cash flow?
- How can we ensure that relevant risk factors are being considered and monitored during the strategy development and implementation stages?

With these directions, the internal audit function can become more focused in designing its planning and reviewing activities. They will also serve as yardsticks or goals that will help it measure its performance and achieve its goals. Other useful qualitative indicators for measuring the internal audit function's performance include:

- identified risk factors that have not been addressed by management;
- value-added recommendations that enhance the degree to which corporate goals are achieved;
- customer satisfaction surveys;
- increased buy-in from auditees about implementing changes; and
- findings that can lead to increased operating efficiencies, or enhanced performance or cost savings.

Growing with the organisation

Corporate governance practices represent the tone-at-the-top that is set by management. Different organisations may have different practices, and they depend on the stage of development of the organisation as a whole and the needs of its senior management. As an organisation matures, it will adopt many recommended best practices, and thus demonstrate its management's commitment to good governance. In the same way, there is no standard model for establishing an internal audit function, and practices vary between organisations. However, the common theme is that the function is an important pillar in corporate governance; one that provides assurance and comfort to an organisation's management as well as its stakeholders.

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APPOINTMENT OF PRINCIPAL

GABRIEL WONG
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Gabriel Wong joined BDO as Principal of Specialist Advisory Services in Aug 2012.

Gabriel Wong has in-depth professional experience advising clients on matters relating to regulatory investigations, fraud investigations, breach of contract and dispute resolution, anti-bribery and corruption, irregular rebates and kickbacks, misappropriation of assets, financial statement manipulation, employee/management conflicts of interests, review of internal controls, forensic risk reviews and due diligence, compliance, anti-money laundering compliance reviews, and Foreign Corrupt Practices Act related investigations and reviews. Prior to joining BDO, he was a director in the financial investigations practice of a global risk consultancy firm. He also managed and supervised various investigative projects when he was with the forensic and dispute services division of an international accountancy firm.

Gabriel also worked in a regulatory authority's enforcement division performing investigations into complaints regarding financial institutions.

In addition to his forensic accounting and litigation support experience, Gabriel is also well-versed in restructuring, liquidation, estate administration, financial due diligence, financial control/monitoring and insolvency procedures as he was previously with the reorganisation practice of an international accountancy firm.

Gabriel has served leading companies in various industries including property development, technology, telecommunications, electronics, advertising, healthcare, chemicals, metals, retail, banking, quality assurance and textile in the Asian region with a focus on PRC. He has advised multinational companies having significant presence in Asia which include private institutions and public companies listed in various stock exchanges worldwide.

Gabriel speaks fluent English, Cantonese, Mandarin and basic Japanese.

Gabriel is a Certified Public Accountant in Hong Kong, a professional member of the Association of Certified Anti-Money Laundering Specialists, a founding member of the Hong Kong Chapter of ACAMS, a member of The Association of Certified Fraud Examiners' Hong Kong Chapter and a member of the Association of Chartered Certified Accountants.

IS AN ENTITY A PRINCIPAL OR AN AGENT WHEN IT REPORTS REVENUE?

Revenue is generally one of the important elements in an entity's financial statements. It enables investors and analysts to assess an entity's operation scale; and it is also a key factor in financial ratios, such as profit margins and asset turnover. Whether the reporting entity is a principal or an agent will impact what should be its revenue. This article will discuss the key considerations on how to determine if the reporting entity is a principal or an agent for financial reporting purpose.

Relevant accounting concepts

Hong Kong Accounting Standard (HKAS) 18 "Revenue" states that revenue includes only gross inflows of economic benefits received and receivable by an entity on its own account. Amounts collected on behalf of third parties – such as sales taxes, goods and services taxes and value added taxes – are not regarded as economic benefits flowing to the entity, and they do not result in an increase in equity. Therefore, they are not revenue. Similarly, in an agency relationship, gross inflows of economic benefits include amounts collected on behalf of a principal, and they do not result in an increase in equity for the entity. The amounts collected on behalf of a principal are not revenue. Instead, revenue is the amount of commission.

HKAS 18 also points out that judgement and consideration of all the relevant facts and circumstances are required when determining whether an entity is acting as a principal or as an agent. An entity acts as a principal when it is exposed to significant risks and rewards associated with the sale of goods or rendering of services. The features that indicate whether an entity is acting as a principal include:

(a) the entity has the primary responsibility for providing goods or services to customers, or for fulfilling orders, for example by being responsible for the acceptability of the products or services ordered or purchased by customers;
(b) the entity has an inventory risk before or after the customers place orders, during shipping or on return;
(c) the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and
(d) the entity bears the customers' credit risk for the amount receivable from them.

The standard does not indicate which of the above features shall be dominant over the others. Therefore, all factual patterns should be taken into account in the decision-making process.

On the other hand, an entity acts as an agent when it is not exposed to significant risks and rewards associated with the sale of goods or rendering of services. The standard states that one feature which indicates an entity is acting as an agent is that the amount the entity earns is predetermined, either as a fixed fee per transaction or as a stated percentage of the amount billed to the customer.

Below are some examples that demonstrate how the determination of an entity acting as a principal or an agent works in practice.

Example 1: an internet platform for online trading

Nowadays, entrepreneurs often start their own online businesses using platforms such as taobao.com and ebay.com. Millions of online transactions are made on these platforms every day. They provide all the support services needed to facilitate trading, including receiving orders and proceeding bills settlement online. Let's suppose the company providing online platform and the online business owner enter into an agreement under which the online platform provider, by providing the support services as mentioned above, receives a fixed service fee income and a certain percentage of transaction amounts as service income from the online business owner. Stipulating in the agreement is that the online platform provider does not take title to the products the online business owner sells, nor accepts any risk or responsibility associated with the products delivered. When applying the accounting concepts based on the above facts and circumstances, the online platform provider meets the definition of "agent" because: the business owner (1) has the primary responsibility for providing goods, (2) sets the prices for its own products, and bears both (3) inventory risk and (4) credit risk, while the online platform provider earns a fixed fee and a percentage of transaction amounts for support services it provides.

Example 2: a toy trading company

It is generally agreed that a trading company in, say, the toy industry, should record its sales to customers as revenue, and its inventory costs as the costs of sales. Normally, buyers and sellers of a toy trading company enter into separate sales and purchase contracts with the company that govern the risks and rewards of each party. Contracts are usually arranged in such a way that the toy trading company acts as a principal who is primarily responsible for delivering the goods to the buyer. The trading company sets the selling price itself and it bears the inventory risk if the stocks cannot be sold, as well as the credit risk if its customers default on payments.

Assuming that a toy company, on top of general contractual arrangements stated above, makes the following arrangements to further protect itself from exposure to business risks:

- it can use an indent trading arrangement, under which purchase orders are made only when sales orders are received from buyers. All inventories sourced from sellers are delivered directly to buyers and the trading company does not keep any stocks at all, in essence it avoids inventory risk; and
- adding a fixed mark-up to the purchase price it sets for customers, to ensure it receives a profit margin.

Following the same way we look at in the previous example, we go through the accounting concepts again one by one to see if any conclusion can be drawn.

Based on the facts and circumstances we have here: (1) the toy trading company still retains primary responsibility for the acceptability of the goods; (2) receiving a fixed mark-up does not indicate the toy trading company is an agent in this case as the company itself alone determines the mark-up, ie it still retains latitude in setting prices and determining its profit margin; (3) though it does not have general inventory risk (risk of obsolescence or not being able to sell inventory which arises from holding inventory prior to sale) as it now has a business model (ie indent trading arrangement) which mitigates this, it still has inventory loss risk (risk that goods are lost or damaged once sale has been agreed and goods need to be delivered to customer) despite the fact that this may or may not be significant and (4) the credit risk still lies with the toy company in case of default payments from its customers. The above indicators appear the toy company is still a principal and the gross inflow of economic benefits (ie the invoiced amount to the customer) is its revenue.

The above analysis does not take into account the shipping arrangements between the toy trading company and its customers, and consideration of which might lead to different results. For example, if DDP (Delivered Duty Paid) is used as the shipping term, the trading company is responsible for delivering goods to the named place in the country of the customers. The inventory risk lies with the toy company, and the above analysis still applies. On the contrary, if EXW (Ex-work) is used, the toy company does not have any obligation when the toys are ready for customers' collection at its premises, and in this case inventory risk would basically be eliminated. Now not all facts and circumstances are in favour for the toy company as principal and certain level of judgement is needed to assess if the toy company remains as a principal.

Example 3: consignment sales of electronic appliances

It is not unusual for electronic appliance manufacturers in the Mainland China to distribute their products via nationwide chains of department stores under a consignment arrangement. That means the department stores become consignees who undertake to sell the goods to customers on behalf of the manufacturers (consignors), while the former have an unconditional contractual right to return unsold goods to the latter. To ensure the prices of the products are consistent throughout the country, the consignors specify a retail price range for them. In these circumstances, the consignees have the primary responsibility for delivering the goods, and they bear the credit risk; yet they do not have absolute discretion about setting the selling price and they do not bear the ultimate inventory risk entirely on the other hand. Again, a degree of judgement here is required when determining whether the consignees act as principals or agents. No straightforward solution is offered here, and more information should be assessed before any conclusion is drawn. For example, understanding the history of returning unsold goods would help us assess whether the consignors bear significant inventory risk, an indicator that they, not the consignees, are the principal. It is also helpful, for the sake of determination of revenue basis, by understanding whether the consignors in substance still retain significant responsibility for the acceptability of the goods to the final customers.

Conclusion

As the above examples show, the decision whether the reporting entity acts as a principal or an agent is relatively clear-cut in some instances; yet certain degree of judgement is required in others. The dividing line between them is often very fine. Please also note that the above analysis and conclusion are made based on the facts and circumstances stated above and may not be indicative for all other situations. Different facts and circumstances and the weightings assigned to the factors may lead to different results, and readers are advised to be mindful in examining all facts and circumstances on a case-by-case basis.

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HONG KONG VISAS

Awareness of immigration rules and regulations is increasingly essential as global mobility becomes more common in multinational companies, and more important as part of their business strategy and development. In particular, they would not wish to gain a bad reputation for non-compliance, or to become the target of official investigations.

It should be noted that, apart from Hong Kong permanent residents, individuals who wish to work in Hong Kong are required to have an employment visa with their employer as its sponsor. They are not allowed to commence work until one has been granted. The employer should apply for an Employment as Professional Visa to the Hong Kong Immigration Department and, once it has been granted, the employee concerned is required to register and apply to the Department for a Hong Kong Identity Card within 30 days. The employee may already possess a Hong Kong Identity Card, but this in itself does not grant the right to work if his or her employment visa has expired. It is therefore essential for the employer to monitor closely the expiry date of any existing employment visa and apply to renew it as necessary. This should be done one month before the existing visa expires. If an employee is required to travel frequently and will not be in Hong Kong to submit a renewal application at that time, the employer may submit a renewal application earlier, providing reasons for doing so. The employee must be in Hong Kong when the application is submitted.

When it reviews an application for an employment visa, the Immigration Department usually considers how beneficial the expatriate's relevant experience is for the employer, the industry and the Hong Kong economy as a whole, whether this expertise cannot be provided by the local workforce, etc. Other factors it will take into account include the employee's educational background and salary level. A new application normally takes four to six weeks to process, and the employee is not allowed to work in Hong Kong until the employment visa is granted. In some situations, the Immigration Department makes spot checks on companies to see whether individuals are working there illegally. So it is important to comply with the immigration rules.

Apart from Professional Visas, individuals can also work in Hong Kong under the Quality Migrant Admission Scheme or the Capital Investment Entrant Scheme. These schemes are more stringent than Professional Visa applications, because applicants are required to satisfy criteria set out by the Immigration Department before their application is submitted. Unlike an employment visa, the Quality Migrant Admission Scheme aims to attract talented and skilled persons to settle in Hong Kong in order to enhance its competitiveness. Applicants are assessed on a General Points Test or an Achievement-based Points Test to determine whether they satisfy the Immigration Department's requirements. Basically, five factors are considered: age, academic qualifications, work experience, language proficiency and family background.

The Capital Investment Entrant Scheme is another method that allows individuals to settle in Hong Kong. To satisfy its requirements, they must first demonstrate they have had net assets or net equity with a market value of at least HK$10 million to which they are absolutely beneficially entitled throughout the two years preceding the date on which they lodge an application. The investment could be any combination of financial assets, including equities, debt securities, deposits and subordinated debts. Since the scheme involves investing in Hong Kong, there are other investment requirements the applicants will need to satisfy in order to fulfil the Immigration Department's criteria.

In conclusion, the most common type of visa application is under the Employment as Professionals category, and the criteria for such an application are less complicated than those for the other two schemes mentioned above. Expatriates who have stayed in Hong Kong for seven consecutive years can also apply to the Immigration Department for the Right of Abode. Once this has been granted, they become permanent residents of Hong Kong, and they have the right to stay and work there without any constraints.

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BE MINDFUL OF MINING ACCOUNTING

The Hong Kong capital market has attracted the listings of a number of high-profile natural resources giants in recent years, particularly those in the mining industry.

The downturn in the US and EU markets and China's dramatic economic growth – which has greatly boosted the country's demand for natural resources, especially coal and precious metals – have made China the main driver of the global economy.

Meanwhile, the strong liquidity of Hong Kong's capital market, its status as a world-class international financial centre in an Asian time zone, its pre-eminent market position in the region and – most importantly – its proximity to one of the major buyers of the commodities have resulted in the city becoming recognised by many of the world's miners as an ideal location for floating their companies. The recent acquisition by Hong Kong Exchanges and Clearing Limited of the 135-year-old London Metal Exchange, the world's largest base metals futures market with an 80%* share of all base metals forward and options contracts, will further increase Hong Kong's attractiveness as a leading financial centre for commodity-based stocks and related financial products.

However, investors are becoming more and more concerned about the financial reporting of the growing number of mining IPOs and listed companies in Hong Kong. In fact, the mining industry's accounting standards are different from those for other sectors in some aspects, because the financial reporting needs to address the exposure of the mining companies to a unique set of risks and rewards.

Before going into detail about these accounting matters, we first need to consider the usual phases of mining industry operations:

(1) **prospecting and searching** is the preliminary phase; it usually involves searching for an area of interest or carrying out preliminary geological tests before more detailed exploration;

(2) **exploration and evaluation** consists of acquiring legal rights to explore for a mineral property; more detailed examination of the geographical area of the identified mineral property; core drilling; and studies of the technical feasibility and commercial viability of conducting mining activities there;

(3) **development and construction** precedes the start of mass production; it includes the mine's design and engineering; permanent excavations; building infrastructure, such as roads, tunnels and buildings; and making other surface improvements for the forthcoming production phase;

(4) **production and maintenance**, the crucial phase that turns the potential (resources and reserves) into performance (mineral products), when the minerals are extracted from the ore body and other directly-related production activities take place; and

(5) **close-down and restoration**, the last but not the least phase, which includes activities to cease the production, demolition of mining facilities, and remediating the production site to an appropriate condition after mining ceases.

Every mining project is unique, but most will undergo some although not all the above phases. For instance, after taking cores for analysis, geological mapping and even removing the overburden in some areas, a team of technical experts might conclude there are only a few probable and proven reserves of coal at a site in a country. If its owners or management then decide not to proceed, the project will end at Phase (2), the exploration stage. However, a state-owned mining enterprise in China that gets promising results from a potential precious metal mine could go all the way from Phase (1) to Phase (5).

On the other hand, the five phases may take place simultaneously, and they can also be sub-divided into more specific stages in which mining activities can be identified more precisely. Even so, they can form a basis for discussing the common assets and liabilities of mining companies, and how they should be initially recognised and subsequently measured in accordance with the relevant Hong Kong Financial Reporting Standards (HKFRSs).

It is also worth mentioning that the mining industry's unique and dynamic characteristics mean that a number of key estimates and judgements are involved in its accounting. The considerations mentioned in the following paragraphs are therefore not meant to be exhaustive, and we will discuss initial recognition and subsequent measurement issues in the mining industry in greater depth in future publications.

(1) Initial recognition

(A) Exploration and evaluation assets (E&E Assets)

Generally speaking, most of the costs spent during Phase (1) are expensed, whilst some exploration and evaluation costs (especially those incurred during Phase (2)) may qualify for capitalisation to become part of E&E Assets. HKFRS 6 "Exploration for and Evaluation of Mineral Resources" (HKFRS 6) states that an entity shall determine an accounting policy that specifies which expenditures are recognised as E&E Assets, and apply that policy consistently.

When making this determination, an entity should consider the degree to which expenditures can be associated with finding specific mineral resources. HKFRS 6 gives examples of expenditures that might be included in the initial measurement of E&E Assets. They include, but are not limited to, costs related to activities during Phase (2), such as acquisition of exploration rights; topographical, geological, geochemical and geophysical studies; exploratory drilling; and activities related to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

However, HKFRS 6 also clearly states that no E&E Assets should be recognised (i) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area, which is the situation in Phase (1) (notwithstanding expenditures incurred in the pre-license prospecting phase such as purchase of data and analysis from consultants and other activities giving rise to the proprietary information that the entity can control may qualify for recognition as an asset of the miners); and (ii) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable, like activities conducted during Phase (3). E&E Assets shall be initially like recognised at cost.

(B) Mining rights

Once a miner commences Phase (3) and Phase (4) activities, the E&E Assets shall no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. In practice, costs of the E&E Assets are usually transferred to mining rights once mining licences have been approved (usually by local governments) or to the respective tangible assets (for example, drilling equipment that could be used during the production phase) where appropriate. Mining rights are treated as intangible assets under Hong Kong Accounting Standard 38 "Intangible Assets", and they should be recognised at cost.

(C) Provision for close-down and restoration

Subsidence caused by the resettlement of land at mining sites is an unavoidable risk in the mining industry. Depending on the circumstances, miners may relocate the inhabitants of a mining site prior to conducting mining activities, or else they may compensate them for losses or damage during the close-down and land subsidence after the site has been mined. Miners may also be required to pay for the restoration, rehabilitation or environmental protection of the sites after it has been mined. Governments usually require such compensation and reclamation under administrative measures or legislation.

Close-down and restoration costs include the dismantling and demolition of infrastructure and the removal of residual materials and remediation of disturbed areas.

Many mining companies start studying local practices and regulations concerning close-down and restoration requirements at an early stage, such as Phase (1), because the associated costs can seriously affect the value of a mine's development. That is unsurprising. Just imagine if a miner were to discover a coal reserve underneath the HSBC Hong Kong headquarters in Central, or if a gold-silver-copper reserve were found beneath the New York Stock Exchange on Wall Street. The miners concerned might not be enthusiastic about developing mines in those prime locations because the close-down and restoration costs would be astronomical, far outweighing the benefits.

If the damage to the land and environment is made and the related close-down and restoration obligation is identified during early stages such as Phases (1) and (2), provision for it should initially be recognised during such phases, and additional amounts may be gradually accumulated during subsequent phases. A provision for close-down and restoration is treated as a liability and recognised at cost, and it should be accounted for in accordance with Hong Kong Accounting Standard HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets" (HKAS 37).

(2) Subsequent measurement

(A) E&E Assets

E&E Assets are stated at cost less impairment.

Impairment of assets is generally dealt with in accordance with Hong Kong Accounting Standard 36 "Impairment of Assets" (HKAS 36), which requires an entity to assess whether there is any indication that an asset may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of such losses.

Where it is not possible to estimate the recoverable amount of an individual asset, the enterprise will estimate the recoverable amount of the smallest cash-generating unit (CGU) to which the asset belongs. The recoverable amount is the higher of fair value less costs to sell and value in use. To assess value in use, estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which estimates of future cash flows have not been adjusted.

Nevertheless, given the unique nature of E&E Assets, two important modifications are made in HKFRS 6 for the purposes of assessing impairment of E&E Assets. They are (i) separate impairment indicators for E&E Assets and (ii) an allowance for grouping CGUs for the purpose of impairment testing.

(i) In some cases, particularly exploration-only entities, the E&E Assets do not generate cash flows, and there is insufficient information about the mineral resources in a specific area for an entity to make reasonable estimates about the amount E&E assets may recover. That is because exploration for and evaluation of the mineral resources have not reached a stage at which the entity has sufficient information to estimate future cash flows. Without such information, it is impossible to estimate either fair value less costs to sell or value in use, the two measures of the recoverable amount under HKAS 36.

Therefore the approach to assessing impairment on E&E Assets is different from the requirements of HKAS 36 such that the assessment of impairment should be triggered by changes in facts and circumstances.

E&E Assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of the E&E Assets may exceed their recoverable amount. For the purposes of E&E Assets only, the following facts and circumstances (the list is not exhaustive) instead of those suggested in HKAS 36 should be considered as impairment indicators when identifying the E&E Assets that may be impaired.

(a) The period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.
(b) Substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.
(c) Exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.
(d) Sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the E&E Assets is unlikely to be recovered in full from successful development or by sale.

(ii) HKFRS 6 specifies that, in such cases, or similar ones, the entity shall still perform an impairment test of E&E Assets in accordance with HKAS 36, except that it shall determine an accounting policy for allocating the E&E Assets to CGUs or groups of CGUs for the purpose of assessing such assets for impairment instead of the "smallest" CGU as required under HKAS 36. Each CGU or group of CGUs to which the E&E Assets are allocated shall not be larger than an operating segment determined in accordance with HKFRS 8 "Operating Segments". Any impairment loss or reversal of impairment loss is still recognised in the profit or loss in accordance with HKAS 36.

(B) Mining rights
Mining rights are stated at cost less amortisation and impairment.

Amortisation of mining rights should be made to reflect the expected pattern of consumption of the expected future economic benefits embodied in the assets (eg the mines) over their useful lives. While mining companies are allowed to select the most appropriate amortisation method for their mining rights, the units of production method is most commonly used. The units of production method results in a charge based on the expected use or output. A number of different formulae are applied in the units of production method, but the most commonly used one is as follows:

$$\textbf{Amortisation charge for the reporting period} = \frac{\text{Cost of the mining asset at the end of the reporting period} - \text{Cumulative depreciation and impairment at the beginning of the reporting period}}{\text{Closing reserves estimated at the end of the reporting period} + \text{Current period's production}} \times \text{Current period's production}$$

This formula for the amortisation of mining rights involves estimating the closing reserves at the end of the reporting period. Reserve estimates can change for a variety of reasons, such as further drilling and examination of the reserves and fluctuations in the commodity price which affect the commercial viability of specific mining activities. Changes in reserve estimates, as long as they are not due to errors, should constitute changes in accounting estimates, and they should be accounted for prospectively. Moreover, while the reserve base used in the units of production method has not been specified in the accounting standards, it is most commonly based on proved and probable reserves.

Impairment on mining rights should be measured and accounted for in accordance with HKAS 36.

(C) Provision for close-down and restoration
The subsequent measurement of provision for close-down and restoration should also follow HKAS 37 such that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This best estimate is the amount an entity would rationally pay to settle its obligation at the end of the reporting period, or to transfer it to a third party at that time.

A miner should consider a number of factors when it evaluates the amount of provision for close-down and restoration. These include changes in the environmental damage entailed by the development of the mine, ever-changing environmental regulations imposed by local and central governments and regulators, changes in estimates of the actual close-down and restoration costs due to inflation, and changes in the timing of the close-down and restoration activities in Phase (5) due to changes in production plans and commodity prices.

The estimation of the provision for close-down and restoration is obviously subject to many uncertainties and judgements, and it is sometimes difficult. One solution is to consult lawyers. Since a miner's close-down and restoration obligations are usually governed by local laws and regulations, the professional opinion of local legal counsel on the interpretation of relevant legislation is very useful in many cases, particularly where mineral resources and mines in developing countries are concerned. Like changes in reserve estimates mentioned above, changes in the provision for close-down and restoration (as long as they are not due to errors) should constitute changes in accounting estimates, which should be accounted for prospectively.

* *Extracted from Media and Analyst Presentation of Hong Kong Exchanges and Clearing Limited dated 15 June 2012.*

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REGULATORY REFORMS OF THE FINANCIAL SERVICES INDUSTRY AND THEIR IMPACT ON INTERNAL AUDIT

Regulatory reform

Following the recent near-collapse of the global financial system, there have been widespread calls for changes to regulatory frameworks.

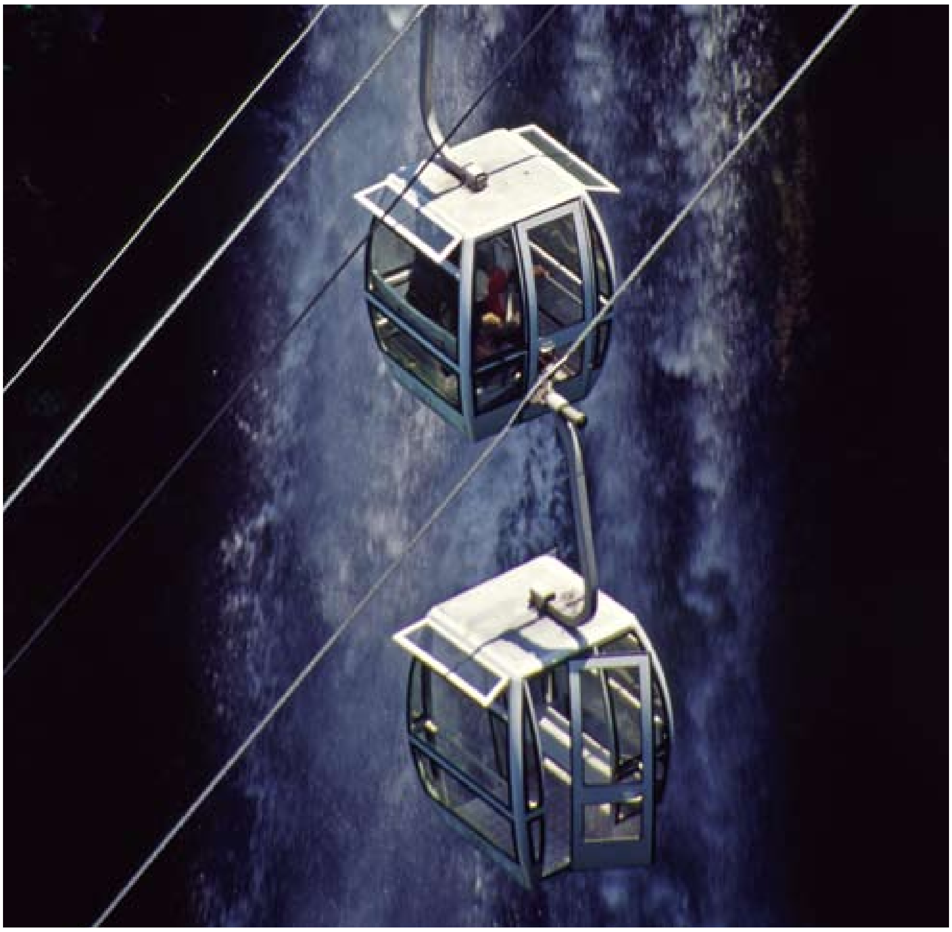
The Dodd-Frank Act was passed in the US in July 2010. Its 16 provisions have expanded the Federal Government's role in the financial markets and created powerful new agencies, including the Consumer Financial Protection Bureau and the Financial Stability Oversight Council. The key goals of this new legislation are to promote financial stability by improving accountability and transparency within the financial system, to eliminate the "too big to fail" concept, to protect the American taxpayer by ending bailouts, and to safeguard consumers from abusive financial services practices.

Two elements of the Dodd-Frank Act is a sharper focus on mitigating systemic risk and maintaining financial stability through the use of macro / micro supervision tools, and heightened scrutiny of large, complex financial institutions. It has designated 29 major financial institutions as global systemically important financial institutions (G-SIFIs). The identity of non-bank SIFIs has yet to be determined. The Act imposes new requirements, including higher capital and liquidity buffers, recovery and resolution plans, and prudent risk-management standards.

It aims to enhance governance, transparency and consumer protection. It reinforces accountability at board and executive management levels to ensure risk and reward are appropriately balanced. It raises reporting requirements on risk monitoring, and it ensures an emphasis on consumers' interests. It also calls for the enhancement of co-ordination between global supervisors.

Implementation of the Dodd-Frank Act is still in progress. Fewer than 30% of the rules it requires have been finalised. It is estimated that regulators need to conduct 67 studies and create 243 such rules. They have never had to undergo such an intensive period of rulemaking! The new rules apply to areas such as OTC derivatives, including such changes as centralised clearing, business contract requirements, compliance programmes and counterparty fund protection; as well as the Volcker Rule covering changes to propriety trading, covered fund activities and record keeping.

SIFIs are required to prepare recovery and resolutions plans. A realistic recovery plan will help ensure a SIFI restores its capital and liquidity rapidly in the event of unexpected losses or withdrawals. Each SIFI is also required to put in place a resolution plan to ensure that it can, if necessary, rapidly restructure and / or wind down, while at the same time preserving its critical economic functions.



Basel III is a new global regulatory standard that requires banks to strengthen their capital and liquidity by holding 4.5% of common equity and 6% of tier-I capital of risk-weighted assets. It also calls for a mandatory capital buffer of 2.5% and introduces a minimum 3% leverage ratio and two liquidity ratios: the coverage ratio and the net stable funding ratio.

The Solvency II EU Directive is a fundamental review of the capital adequacy regime for the European insurance industry. It requires insurance companies to perform and report on risk and solvency assessments covering overall solvency needs, compliance with regulatory capital requirements, and reserve requirements.

Challenges for financial institutions

The enactment of such complex new regulations requires financial institutions to devote considerable resources to ensuring they comply with the rapid changes entailed. Of course, institutions face many challenges about deciding how some of these rules should be interpreted, and they need to work with regulators on some of their shortcomings. They also need to assess the impact of the changes on their institutional strategies and business models, and they need to ensure they allocate appropriate resources to implement them within the regulatory timelines.

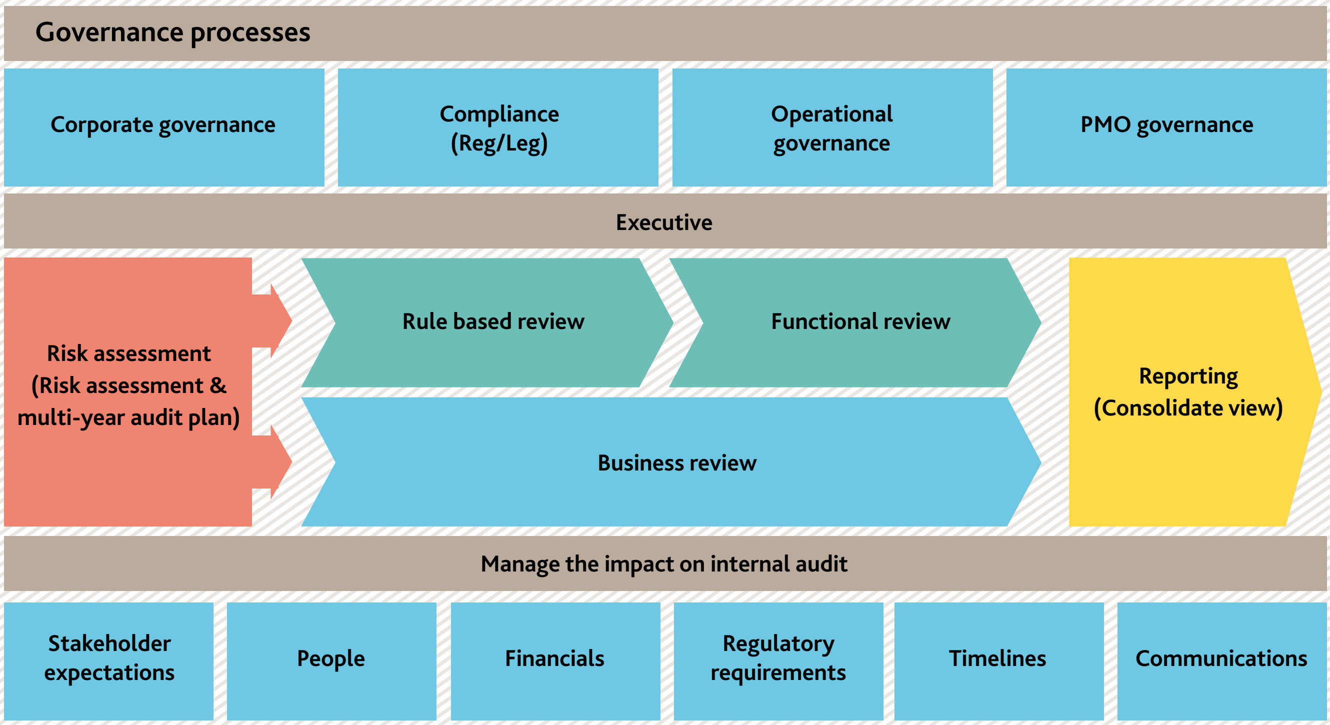
Internal audit

As financial institutions adapt to the evolving regulatory landscape, so too must their internal audit function. Internal audit is the board's eyes and ears; it provides directors with independent assurance that regulatory reforms are being implemented methodically and appropriately. Internal audit can play a significant role in ensuring that the strategy and execution of regulatory reforms are being managed effectively throughout an institution. The following is a framework to help it provide such assurance.

Understand stakeholders' expectations

A financial institution's internal audit function first needs to recognise the expectations of its stakeholders and to establish a regulatory reform team that understands the institution's reform strategy and approach. It also needs to set up liaison teams to communicate with each of its business and functional areas.

INTERNAL AUDIT FRAMEWORK



A risk-based internal audit plan
The implementation of regulatory reforms will alter the risk universe for institutions. It will impact on their products and services, support functions, statutory and compliance requirements and significant systems. Internal audit needs to revisit the institution's risk-assessment framework in order to determine the scope of its functions and which areas it particularly needs to focus on.

Governance and PMO reviews
Internal audit can ensure that an institution has a governance structure that can identify, assess, interpret and implement regulatory reforms. It must make certain that the institution can align its regulatory reform with its business strategy and direction, and that it has established processes that can track and assess the proposed new rules, in order to formulate responses and implement changes that align with them.

Internal audit must review the effectiveness of the reform programme's management, including its sponsorship by the board, and the clear roles and responsibilities of its steering committee, programme management office (PMO) and working groups. Internal audit can help ensure the PMO has processes in place to validate the changes linked to applicable rules and regulations; that such changes are integrated into cross-functional areas; and that an effective mechanism is in place to report on the programme's status.

Rule-based reviews
Internal audit can ensure that regulatory reforms are being implemented thoroughly and accurately by conducting pre-implementation, parallel and post-implementation reviews which focus on assessment of the completeness and accuracy of their implementation, in terms of processes and systems that address the new rules and requirements. It should particularly emphasise priority areas, such as OTC derivatives, the Volcker Rule, and recovery and resolution planning.

Functional reviews
These will assess the impact of various regulatory reforms on a specific function, such as IT governance, compliance, new product development and regulatory reporting, to ensure it is ready to implement the necessary changes, and that it does so effectively.

Business reviews
This is a horizontal approach that assesses the impact of various regulatory reforms across the functional areas of a specific business. Such reviews assess their impact on key processes, risks and controls, technologies, the responsibilities of personnel and their approach to addressing interdependencies

Effective reporting
As part of its effort to ensure the success of an institution's regulatory reform programme, internal audit should compile a consolidated review based on the entire coverage and results of all its individual reviews. It should establish good procedures for the sharing of best practices by various business functions, reporting any issues noted, and following up on the implementation of the management action plan. Internal audit must maintain adequate documentation to make regulators confident about its work, and it must regularly report to the audit committee about its progress and assessment of the regulatory reform programme.

Managing the impact on internal audit methodologies and resources
Implementation of regulatory reforms will have a significant impact on the internal audit function and its resources. Internal audit needs to revisit its risk-assessment processes in order to make changes to the organisation's risk profile. It will also need to update the audit universe and risk and control libraries. Moreover, internal audit will face a particularly strong demand for support, particularly from the corporate and capital markets teams. It will need to assess skill-set gaps and develop plans to acquire those it needs.

In a period of wide-ranging and complex regulatory reforms, internal audit needs to develop knowledge-management programmes to stay abreast of the institution's regulatory reform programme and its progress, and it will need to ensure that its internal auditors are adequately trained about the programme, so that they can add value to it.

Opportunities
Internal audit must take a proactive approach to determine and communicate its role in regulatory reform by taking advantage of its access to an institution and its unique horizontal perspective of it. Internal audit has an opportunity to add significant value by guiding its management as it works towards the successful implementation of regulatory changes.

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GLOBAL NETWORK DEVELOPMENT AT A GLANCE

BDO Germany focuses on legal services

BDO Germany is continuing to broaden the scope of its advisory services in order to cope with the market's growing demand. Through close cooperation with BDO Legal Rechtsanwaltsgesellschaft mbH, BDO Germany now offers its clients a wide range of legal services that cover all important aspects of commercial law, thus making its advisory services fully comprehensive. The closer partnership between the two firms is demonstrated inter alia by the change of name of BDO's strategic legal partner from Dres. Lauter, Otte & Knorr to BDO Legal, and BDO Legal is now fully integrated into BDO's global high-performance network.

BDO is Germany's leading entrepreneur-driven provider of accountancy, tax and advisory services. Its close cooperation with BDO Legal strengthens BDO's integrated consultancy approach. This responds to the market's need for competent interdisciplinary expertise in all economically important areas of advice – accountancy, advisory services, tax advice, and – now – commercial legal services.

Dr Holger Otte, CEO of BDO AG Wirtschaftsprüfungsgesellschaft, says: "The economy is undergoing a paradigm shift, and our clients increasingly prefer one-stop-shop consulting services. Our close cooperation with BDO Legal means we can continue tailoring the scope of our nationwide services to suit our clients' needs".

BDO Legal Rechtsanwaltsgesellschaft mbH has more than 40 lawyers working in five locations throughout Germany.

BDO wins global outsourcing award

BDO UK has won the 2012 "Outsourcing Service Provider of the Year" award. It received this honour at the Annual European Outsourcing Association Awards, the European sourcing industry's premier awards ceremony to celebrate pan-European outsourcing best practice, which was held at the prestigious Law Society in Central London on 27 June 2012.

This award recognises BDO's strategic investment in developing Finance & Accounting services for the very largest and very smallest clients in almost every country throughout Europe.

In clear contrast to other accountants and business process outsourcing providers, the award recognises the benefits BDO clients enjoy as a return on investment (ROI), such as:

- In-country service: BDO has avoided the temptation to consolidate into low-cost, high-volume shared service centres, knowing its clients place the utmost value on accurate application of accounting standards and intimate relationships with local regulators and client teams.
- Consistent quality: BDO has invested heavily for more than five years in people, processes and IT platforms in order to enhance its skills and harmonise outsourced accounting procedures across the BDO network. The ROI for clients eradicates variations in timeliness and quality, as well as reducing regulatory risk. The ROI for BDO is a dramatic reduction in rework and a steady rise in reputation.

A key performance indicator of this consistent quality is the reporting of completed tasks on BDO's global control platform, which schedules and tracks deliverables (most of which are complex accounting/tax compliance returns) from 500 separate in-country operations for 50 multi-national clients in 145 jurisdictions. During the first quarter of 2012, more than 99.98% of over 5,000 such deliverables were on time and right first time.

BDO RECENT PUBLICATIONS

CHINA TAX

Further guidance on determination of beneficial owner under tax treaty issued

BDO issued the "Further guidance on determination of beneficial owner under tax treaty issued" newsletter in July 2012. This newsletter highlights the salient points mentioned in the Announcement 30, which was issued by the China State Administration of Taxation on 29 June 2012.

HKFRS / IFRS UPDATES

Annual improvements to HKFRS 2009 – 2011 cycle

On 6 June 2012 the Hong Kong Institute of Certified Public Accountants (HKICPA) issued "Annual Improvements to HKFRS 2009 – 2011 Cycle" in response to the International Accounting Standards Board's (IASB) annual improvements project which deals with non-urgent but necessary improvements to IFRS. This update is also a summary of the key amendments to IFRS.

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

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