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APERCU

TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS

Preparing financial statements can be challenging these days owing to the growing complexity of accounting standards. Being aware of some of the problems that could trip you up should make things a little easier. This article looks at ten common accounting issues which are often overlooked by preparers. It briefly highlights the relevant requirements of Hong Kong Financial Reporting Standards and provides some simple examples to illustrate each issue.

Transactions with owners – income or capital?

Income and expenses exclude contributions from or distributions to owners. Rather, such transactions are recognised in equity. An owner may also enter into transactions with the entity in another capacity, for example, as a lender, a supplier or a customer. The substance of these transactions should be carefully considered to determine whether they include an element of an equity transaction.

Example 1

An entity transfers a loan receivable to a shareholder at consideration equal to the outstanding principal amount. There is objective evidence the loan was impaired at the date of transfer.

Any consideration received in excess of the fair value of the loan represents a capital contribution and should be recognised in equity.

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Business combinations – determining the acquisition date

The acquisition date is the date that the acquirer obtains control of an acquiree. The purchase agreement may state that the acquisition is effective on a specified date. However, the date on which control is obtained will be a matter of fact.

Example 2

Entity A completes the acquisition of entity B on 28 February 2013. A appoints directors to replace the existing board of B on that date. The acquisition agreement states the acquisition is effective from 1 January 2013 and all profits earned after that date will go to A. The purchase price is determined based on the net asset position of B at 31 December 2012.

A will consolidate B from 28 February 2013 as this is the date from which A obtains control of B.

Fair value and impairment losses

Where the fair value less costs to sell (FVLCS) of an individual asset is less than its carrying amount an impairment loss is not automatically recognised. It is also necessary to consider whether the asset's value in use can be determined. If the entity plans to sell the asset in the near future then cash flows from its continuing use may be negligible and the asset's value in use will approximate its net disposal proceeds. In most other cases it will not be possible to estimate the value in use of a single asset as the asset will not generate cash inflows independently of other assets or groups of assets. Rather, the recoverable amount of the cash generating unit (CGU) to which the asset belongs will be tested for impairment. No impairment loss will be recognised for the asset if the related CGU is not impaired notwithstanding that the asset's FVLCS is less than its carrying amount.

Example 3

An entity considers that the carrying amount of its technical know-how and patents may be impaired due to a decline in sales of related products. It determines that their FVLCS is less than their respective carrying amounts based on a professional valuation report.

The entity will also need to determine the recoverable amount of the CGU to which the technical know-how and patents belong as these assets do not generate independent cash inflows. Any CGU impairment loss allocated to the assets should not reduce their carrying amounts below their FVLCS. If the CGU is not impaired no impairment loss will be recognised for the assets. However, it may be necessary to reassess their amortisation period and amortisation method to better reflect their remaining useful life and the pattern of consumption of their economic benefits by the entity.

Impairment – selecting a discount rate

Projected cash flows are discounted at a pre-tax rate that reflects the risks specific to the asset or CGU being tested for impairment when calculating value in use. The entity's weighted average cost of capital (WACC) will often provide an appropriate starting point when selecting a discount rate. Using a single entity level discount rate will not be appropriate however where the entity has multiple CGUs that are subject to different business risks. Adjustments to the entity's WACC will be necessary in this situation to estimate an appropriate discount rate for each CGU.

Example 4

An entity operates property development, investment and consultancy businesses. Each business is identified as a separate CGU for impairment testing. Historically, the growth rates and financial performance of each of the CGUs has varied significantly from one another. The property investment and consultancy businesses focus on the Hong Kong market while the property development business operates in Mainland China. The entity uses its WACC when calculating the value in use of each CGU.

The entity's WACC should be adjusted to reflect the unique risk factors of each CGU. Although all of the CGUs operate in the property sector, they each provide different products or services and generate different returns. In addition, the property development CGU operates in a different economic environment and generates cash flows in a different currency.

General borrowing costs – when to capitalise?

Borrowing costs to be capitalised are those that would have been avoided if the expenditure on the qualifying asset had not been made. General borrowings are all borrowings except those used specifically to finance qualifying assets. Where qualifying assets are funded out of general borrowings, the amount of borrowing costs to be capitalised is calculated by applying a capitalisation rate to the expenditures on the asset.

Example 5

An entity has taken out loans for working capital purposes and for a business acquisition. It constructs a production plant which is considered a qualifying asset. The plant is partly funded by a new loan and partly out of operating cash flows. The entity has capitalised the borrowing costs of the new loan.

The working capital and acquisition loans are general borrowings as neither was used to finance a qualifying asset. The cash used to fund the production plant could have been used to repay the general borrowings. The interest costs on those borrowings could therefore have been avoided had the plant not been built. The entity should capitalise part of the general borrowing costs.

Share-based payment – cancellation or forfeiture of awards?

If a service condition or a non-market performance condition is not met an award will be considered forfeited. This might occur, for example, if the employee resigns or the Company fails to complete an IPO. No expense is recognised where an unvested award is forfeited. On the other hand if an unvested award is cancelled other than as a result of forfeiture this is treated as an acceleration of vesting. The entity recognises immediately the amount that would otherwise have been recognised over the remaining vesting period. Where an unvested award is cancelled it is therefore necessary to determine whether this is a consequence of forfeiture or not.

Example 6

A director of Company X voluntarily cancels unvested share options.

This cancellation is not accounted for as a forfeiture even though it was at the choice of the director as it does not result from failure to meet a vesting condition.

Convertible notes – anti-dilution clauses

Conversion rights which result in the exchange of a fixed amount of cash for a fixed number of shares are classified as equity. If this test is not met they are accounted for as a derivative financial liability. Convertible notes may include anti-dilution clauses to protect the note holder when one or more dilutive events occur, for example, bonus issues, share splits or rights issues. Although such clauses result in a variable number of shares being issued they are not considered to fail the fixed for fixed test provided the effect is to maintain the relative rights of the note holders and equity shareholders before and after the dilutive event. The terms of anti-dilution clauses need to be considered carefully therefore to determine the substance of any adjustments.

Example 7

An entity issues a convertible note with a conversion price of HK$1. The note contains an anti-dilution clause which resets the conversion price to the lower of HK$1 and the price of any new shares which are issued at full market value.

This adjustment fails the fixed for fixed test as it compensates the note holders if new shares are issued at a market price which is lower than the conversion price. Other equity shareholders do not enjoy a similar benefit.

Current liabilities – classification of convertible notes

Where a convertible note is accounted for as a compound financial instrument the debt and equity components are presented separately. The debt component is classified as a current or non-current liability depending on the terms of the note. Any terms that could, at the option of the counterparty, result in settlement of the note by the issue of equity instruments do not affect this classification. The possibility of conversion is ignored therefore and only the repayment terms of the debt component are considered. Convertible notes may often contain embedded put options. Irrespective of whether these embedded derivatives are accounted for separately or as part of the debt component they are always relevant to the current or non-current classification of the note.

Example 8

Entity Y issued a five year convertible note on 1 March 2011 which is accounted for as a compound financial instrument. The note is convertible into ordinary shares at the option of the holder at any time after issue. The terms also include an embedded put option exercisable by the holder from the second anniversary of the date of issue of the note. The option has been accounted for separately as a derivative financial liability.

Entity Y classifies the debt component of the note as non-current in its financial statements for the year ended 31 December 2011. The fact that the note can be settled by issuing shares within twelve months does not affect this classification. Entity Y will however classify the debt component as a current liability in the following financial year as it cannot avoid the obligation to settle the note in cash within twelve months if the holder exercises the put option.

Financial instruments – dealing in commodities

Contracts to buy and sell non-financial items such as commodities are accounted for as derivatives where the contracts can be settled net in cash unless they are entered into and continue to be held for the entity's own use. One of the ways a contract will be considered to be settled net in cash is where the entity has a past practice of taking delivery of the commodity and selling it within a short period after delivery for the purpose of generating profit from short-term fluctuations in price or dealer's margin. The own use exemption does not apply to these contracts. Consequently entities that are dealing or trading in commodities will normally have to account for their purchase and sale contracts as derivatives.

Example 9

Entity Z buys and sells non-ferrous metals such as copper and aluminium to generate a dealing profit. Z sells the metals within a short period after delivery in the same condition that they were purchased from Z's suppliers. Z provides no services related to the metals to customers.

Entity Z's commodity sales and the purchase contracts are considered to be net cash settled and will be accounted for as derivative financial instruments.

Service contracts – recognition of costs

Revenue and costs that relate to the same transaction or event are normally recognised together. For some service contracts the timing of incurring costs may vary considerably from the timing of recognising revenues. Costs should only be deferred however when they qualify for recognition as an asset.

Example 10

Entity C provides environmental project development and advisory services to customers to assist them in reducing their carbon emissions. Each service contract normally lasts for five years. The amount of consideration is based on the annual emissions allowances obtained by the customer during the contract period. Revenue is recognised when the emissions allowances are certified each year by the relevant authority. C incurs significant non-recurring set-up costs including staff costs, professional fees and travel expenses in the first year of the contract. There are few such costs in later years.

The one off set-up costs will be expensed as incurred as they do not meet the definition of inventory, property, plant and equipment or intangible assets. Spreading these costs over the contract period would not be appropriate.

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EARNINGS PER SHARE (EPS)

We discussed Basic EPS in the January 2013 issue of APERCU. This time, we will move on to discuss another aspect of it – diluted EPS. Diluted EPS is a measure of an entity's EPS taking into account the dilutive potential ordinary shares that are outstanding during a reporting period. Diluted EPS is therefore a calculation of what the EPS would have been if the holders of all the dilutive potential ordinary shares would have been entitled to share the entity's performance during the reporting period.

Before we go into the details of diluted EPS, let's revisit the formula for basic EPS:

$$\text{Basic EPS} = \frac{\text{Profit or loss attributable to equity owners of the reporting entity}}{\text{Weighted average number of ordinary shares outstanding during the reporting period}}$$

If dilutive potential ordinary shares are eventually converted, this would increase the total number of shares that are entitled to a share of equity earnings. Nevertheless, the extent of dilution is calculated in a hypothetical and prescriptive manner. For instance, an entity shall assume the exercise of dilutive options and warrants of the entity. The assumed proceeds from these instruments shall be regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration.

However please note that not all potential ordinary shares are dilutive. If the conversion of potential ordinary shares would increase basic EPS or decrease loss per share, they would be anti-dilutive.

The calculation of diluted EPS does not assume conversion, exercise, or other issues of potential ordinary shares that would have an anti-dilutive effect on the EPS. Each issue or series of issues of potential ordinary shares is considered separately when determining whether the potential ordinary shares would be dilutive or anti-dilutive: they are not considered in aggregate.

Basic EPS is a measure of the earning power per share of an entity, whereas dilutive EPS is determined to answer the question of what that earning power would have been if the holders of all the dilutive potential ordinary shares would have been entitled to share the entity's performance. So, let's elaborate on the crucial concept of dilutive potential ordinary shares, to ensure that we fully understand the calculation and implication of diluted EPS.

Dilutive potential ordinary shares

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares. Potential ordinary shares are dilutive when, and only when, their conversion to ordinary shares would decrease basic EPS or increase loss per share from continuing operations.

Common examples of potential ordinary shares are:

- Share options, warrants and their equivalents; and
- Convertible instruments, including convertible bonds and convertible preference shares.

1. Calculation of diluted EPS – theory

Diluted EPS is calculated mathematically as:

$$\frac{\text{Profit used for basic EPS + effect on profit or loss attributable to dilutive potential ordinary shares}^{\#}}{\text{Number of shares used for basic EPS + number of dilutive potential ordinary shares}}$$

See 1.1 below for the details of effect on profit or loss attributable to dilutive potential ordinary shares

The sequence in which potential ordinary shares are included in diluted EPS calculation may affect whether they are dilutive. In order to maximise the dilution of EPS, each issue or series of potential ordinary shares is considered separately in sequence from the most dilutive to the least dilutive. Generally, share options and warrants are included first, because they do not affect the numerator of the above calculation. The elements in relation to the dilutive potential ordinary shares can be further described as follows:

1.1 The effect on profit or loss attributable to dilutive potential ordinary shares

The effect on profit arising from dilutive potential ordinary shares should be an "after-tax" effect of:

- Any dividends or other items related to dilutive potential ordinary shares deducted in order to arrive at the profit or loss attributable to ordinary equity holders as used in basic EPS calculation;
- Any interest recognised during the period that is related to dilutive potential ordinary shares; and
- Any other consequential changes in income or expenses that would result from conversion of the dilutive ordinary shares.

The conversion of some potential ordinary shares may also result in consequential changes to other income or expenses. For instance, the reduction of interest expenses related to potential ordinary shares and the resulting increase in profit or reduction in loss may lead to a consequential increase in the expenses related to a non-discretionary employee profit-sharing plan. For the purpose of calculating diluted EPS, the profit or loss attributable to ordinary equity owners is adjusted for any such consequential changes in income or expenses.

1.2 Number of dilutive potential ordinary shares

The calculation of diluted EPS assumes that all dilutive potential ordinary shares are converted into ordinary shares at the beginning of the reporting period or, if later, the date of the issue of instruments with the potential ordinary shares. The total number of ordinary shares in the diluted EPS calculation would be the weighted average number of shares used for the calculation of basic EPS plus the weighted average number of ordinary shares that would have been issued upon conversion of all the dilutive potential ordinary shares into ordinary shares.

For all EPS calculations, the number of ordinary shares as the denominator in the formula should be calculated on a weighted average basis. Accordingly, the number of potential ordinary shares is weighted for the accounting period when they are outstanding. That means potential ordinary shares that are cancelled or lapsed during the accounting period are included in the calculation of diluted EPS only for the portion of the period when they are outstanding. Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted EPS from the beginning of the period to the date of their conversion. From the date of their conversion, the resulting ordinary shares are already included in both the basic and diluted EPS. This is to avoid duplication in the diluted EPS calculation.

There are two other noteworthy points concerning the impact of dilutive potential ordinary shares:

- The computation of diluted EPS assumes the most advantageous conversion rate or exercise rate from the standpoint of the holders of the potential ordinary shares; and
- A subsidiary, joint venture or associate may issue potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or else ordinary shares of the reporting entity. If these potential ordinary shares have a dilutive effect on the consolidated basic EPS of the holding company on a group level, the dilutive potential ordinary shares of the investee companies should be included when calculating the diluted EPS of the holding company on a group level.

2. Calculation of diluted EPS - examples

2.1 Share options, warrants and their equivalents

If the exercise price of share options and warrants is higher than the average market value of the ordinary share of the reporting entity (ie out of money), these potential ordinary shares are regarded as anti-dilutive and therefore these instruments are not included in the calculation of diluted EPS. In the event of share options and warrants with exercise price lower than the average market value of the ordinary share of the reporting entity (ie in the money), the exercise of share options and warrants is regarded as a combination of (i) the issue of certain shares at the average market value in full, and (ii) the issue of remaining shares at nil consideration. In fact, the shares at nil consideration are dilutive and the denominator of the calculation of diluted EPS is increased by the number of shares at nil consideration.

[Example 1: Share option]

Profit attributable to ordinary equity holders of entity in 2012	HK$3,000,000
Weighted average number of ordinary shares outstanding during 2012	1,000,000 shares
Average market price of one ordinary share during 2012	HK$50
Weighted average number of shares under share option during 2012	200,000 shares
Exercise price of shares under share option during 2012	HK$45

Basic EPS 2012:

$$= \frac{\text{HK\$3,000,000}}{\text{1,000,000}} \qquad \text{HK\$3}$$

Number of shares under share option that would have been issued at the average market price:

$$= 200{,}000 \times \frac{\text{HK\$45}}{\text{HK\$50}} \qquad 180{,}000$$

Number of remaining shares under share option to be issued for nil consideration:

= 200,000 – 180,000   20,000

Diluted EPS:

$$= \frac{\text{HK\$3,000,000} + \text{HK\$0*}}{(1{,}000{,}000 + 20{,}000)} \qquad \text{HK\$2.94}$$

* The dilutive potential ordinary shares arising from a share option have no effect on the profit or loss of the reporting entity.

2.2 Convertible instruments

Like all other instruments that give rise to potential ordinary shares, convertible instruments may be dilutive or anti-dilutive. To ascertain which the case is, we must determine the effect on the after-tax change in profit or loss from continuing operation of the number of potential ordinary shares that would have been converted.

Example 2: Convertible bonds

Profit attributable to ordinary equity holders of the entity in 2012	HK$5,000,000
Weighted average number of ordinary shares outstanding during 2012	500,000 shares
Convertible bonds outstanding throughout 2012	100,000
Each convertible bond is convertible into 2 ordinary shares	
Interest charge for the current year relating to the liability component of the convertible bonds	HK$30,000
Current and deferred tax credit relating to the interest charge	HK$6,000

Basic EPS 2012:

$$= \frac{HK\$5,000,000}{500,000} \qquad HK\$10$$

Effect of the related dilutive potential ordinary shares on the profit or loss of the reporting entity:

= HK$30,000# – HK$6,000# HK$24,000

Number of ordinary shares resulting from conversion of convertible bonds:

= 100,000 x 2 200,000

Diluted EPS

$$= \frac{HK\$5,000,000 + HK\$24,000}{(500,000 + 200,000)} \qquad HK\$7.2$$

The idea is to assume the full conversion of convertible bonds at the beginning of the reporting period. Therefore, the related amounts such as interest charge and the tax effect directly attributable to the convertible bonds during 2012 (ie their effect on the profit or loss attributable to dilutive potential ordinary shares) are adjusted as if these amounts had not been incurred for the purpose of calculating diluted EPS.

3. Presentation of basic and diluted EPSs

A reporting entity should present on the face of the statement of comprehensive income the basic EPS and diluted EPS attributable to the ordinary equity owners of the reporting entity, even if the amounts are negative (ie a loss per share):

- From continuing operations; and
- For the reporting period (ie both continuing and discontinued operations)

for each class of ordinary shares that has a different right to share in the profit for the reporting period. The basic and diluted EPS should be presented with equal prominence for all periods presented.

If the reporting entity reports a discontinued operation, it must disclose the basic and diluted EPS for that discontinued operation, either in the statement of comprehensive income or in notes. The idea is to help readers understand the profitability of the reporting entity easily from the information provided about EPS because EPS is a comparable measure of earning power per share of entities.

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In view of the current economic uncertainties, will Asian markets still drive global growth? To discuss the region's outlook and provide a platform for experts and professionals to share their views, we are holding the BDO Asia Pacific Corporate Finance Summit 2013 on Friday, 29 November 2013 at the Hong Kong Convention and Exhibition Centre.

With its theme of "Markets and Finance - the Asian Impetus", this year's summit will focus on emerging trends and hot topics in finance and economy, and will reflect input and commentary from finance experts, economists and advisors in global and regional institutions as well as speakers from BDO member firms overseas. The keynote speaker will be Professor KC Chan, GBS, JP, Secretary for Financial Services and the Treasury.

The summit will bring together attendees from banking and financial institutions, corporates, private equities, corporate finance intermediaries, the legal profession and BDO corporate finance delegates in the Asia Pacific Region.

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Here is the range of our IFRS publications:

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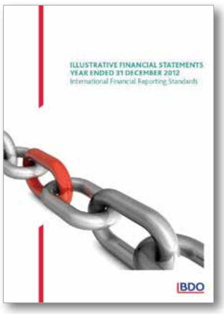
Interim Financial Statements – IAS 34 explained provides guidance for the preparation of interim financial statements and includes an illustrative example of a condensed set of interim financial statements and accompanying notes.

International Financial Reporting (IFR) Bulletins

IFR Bulletins is a regular publication focusing on the latest developments in the area of international financial reporting. They are issued when a new International Financial Reporting Standard or Interpretation is released or, if the subject is significant, when an exposure draft is issued for comment.



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Model IFRS financial statements are illustrative IFRS financial statements prepared in accordance with International Financial Reporting Standards and are intended to be used as a source of general technical reference, as they show suggested disclosures together with their sources.

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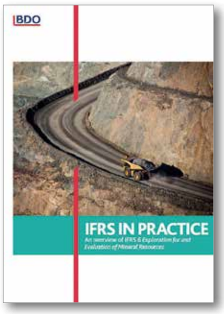
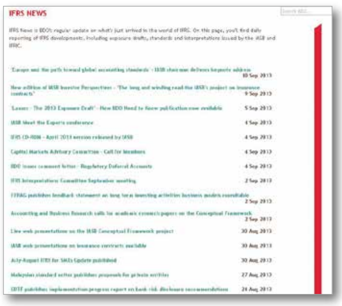


IFRS in Practice

IFRS in Practice sets out practical information about the application of key aspects of International Financial Reporting Standard, including industry specific guidance.



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WHAT'S EATING UP YOUR FUTURE PROFITS? CHANNEL STUFFING!

The distributorship business model creates a valuable supply chain. Using the resources and intelligence of their distributors, companies can efficiently explore new sales networks and gather market information beyond their own normal reach. It is particularly useful in markets that are geographically, economically or culturally segregated.

While the distributorship model itself is beyond question, the practice of "channel stuffing" has evolved from its misapplication. Channel stuffing is a deceptive ploy in which a company artificially inflates its current revenue by simply unloading and parking excessive amounts of inventory that greatly exceed actual sales levels and the needs of end users within the distribution system (the channel).

Accounting-wise, Channel Stuffing is a premature revenue recognition practice that brings forward future profits. On the operational side, it impairs the company's liquidity, profitability and market position.

In fact, channel stuffing is an age-old practice, only it is constantly being repackaged and disguised in different forms by companies, including some Fortune 500 corporations. What haven't changed much are the driving forces behind it, such as heavy pressure to meet short-term earnings targets, desperate executives wishing to cash in on their short-term bonuses/options, and the obligations that debt-financing arrangements impose on stock market prices.

Let's look at Figure 1 for some classic examples of channel stuffing.

Although channel stuffing comes in various forms, it is usually accompanied and signalled by some common and conspicuous red flags.

Substantial and improper influence over distributors

A company cannot engage in channel stuffing on its own. It needs the cooperation of its distributors. It is therefore important to assess the likelihood of whether a company has substantial and improper influence over them. Indicators of "Substantial and improper influence" include:

- An abnormally high turnover rate in the distributor network, with distributors appointed and terminated without commercially justifiable reasons;
- A sharp increase in the number of distributors whose rights of exclusivity are either not clearly defined or protected;
- Imposition of explicit or implicit minimum purchase orders on distributors;
- Distributors trading under the same name and/or in the same office as the company;
- Distributors acting in accordance with direct instructions from the company

Figure 1:

Classic channel-stuffing cases	Underlying impacts
In 2011, a Fortune 100 US automobile manufacturer was accused of forcing large inventories onto its dealers, leaving its unsold vehicles parked at their lots while recording them as revenue.	Within three months of the publication of an article revealing this channel-stuffing scheme, the company's share price fell by 30%, far below its IPO price. Naturally, a group of angry IPO investors filed a class action lawsuit against it.
In 1998-2000, a global computer security software company incentivised its distributors to overbuy by offering sizeable price discounts and rebates, and by secretly reimbursing them for holding onto the excess inventory in order to avoid returning goods and claiming corresponding sales adjustments.	The company's market capitalisation crashed by US$1 billion when the news about the channel stuffing emerged. The company eventually paid a US$50-million penalty to settle a charge filed by the US Securities and Exchange Commission.
In 1993, a global contact lenses manufacturer forced its distributors to purchase its products at inflated prices, and it overstated its profit and accounts receivables, which did not require settlement until the lenses had been sold. It turned out that most of the lenses involved remained unsold for a long period.	The Company was sued for fraudulently overstating its profit by US$18 million. It agreed to pay US$12 million to settle the related lawsuit.

regarding subsequent stock movements and allocations; and

- Distributors owned or operated by connected persons, their associates or employees of the company.

Excessive rights of return

To induce its distributors to overbuy during the current period, the company might offer them excessive rights to return unsold products during subsequent reporting periods, either under an explicit agreement or via established practices.

More complicated schemes involve companies pumping up their revenue and avoiding inventory impairment provisions at the same time by intentionally shipping out products that will soon expire, are technologically dated or else banned by regulations during the current period end. Again, the aim is to conceal accumulated unwanted inventory in distributorship channels until they can be returned during subsequent periods for reasons that “legitimately” comply with relevant warranty and returns clauses.

This channel-stuffing tactic can easily be detected by:

- Carefully reviewing contractual clauses governing returns;
- Carefully examining the reasons for returns;
- Correlating the revenue at the current period end with the rates of returns during future reporting periods; and
- Analysing the sources and movements of returned inventory and how it is written down in future periods.

Abnormal credit terms and big discounts

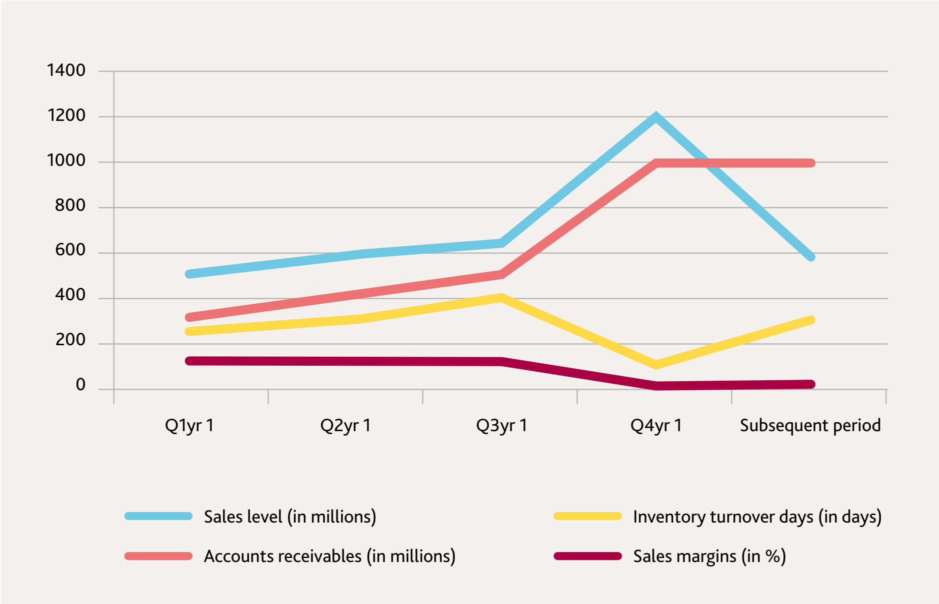
Since there is no real demand for it in the market, the backlog of inventory that piles up in the channel cannot simply be liquidated. Companies therefore have to offer distributors abnormally-long credit terms and/or big discounts in order to support their overbuying activities on an on-going basis.

The underlying effect of abnormal credit terms is usually reflected in the company’s poor liquidity performance and cash flow index. Indicators that should blow the whistle about this tactic include:

- Significant deviations from long-established credit policies;
- Significant deviations from long-established pricing policies;
- Increased sales to distributors whose credit terms have also been extended;
- Fluctuating inventory turnover days, particularly at the period end;
- Increasing long-aged accounts receivable, particularly at the period end;
- Unusual accounts receivable write-off in subsequent periods; and
- Decreasing or substantially low sales margins comparing to the industry level.

Figure 2: Typical financial performance patterns of companies that engage in channel stuffing

1. Sharp increases in sales at the end of the reporting period, followed by a steep decrease at the start of the next one;
2. Accumulating and long-aged accounts receivables;
3. A sudden fall in inventory turnover days at the period end, followed by a leap in the subsequent period; and
4. A decrease in sales margins caused by deep discounts or price adjustments.



Unusual payments and financial supports

Distributors who are holding excessive inventories will inevitably incur certain storage, insurance and shipment expenses. These would not arise in the normal course of business. Companies engaged in channel stuffing therefore have to reimburse their distributors in some ways. This is done either directly or by granting them unusual financial supports, such as cash advance and large sales bonuses. This tactic is usually red flagged by:

- Direct reimbursements for inventory carrying costs to distributors (eg payment of warehouse rent, insurance, freight costs, etc);
- Unnecessary reimbursements for selling costs to distributors (eg payment of advertisement, marketing expenses etc);
- Unexplained or unauthorised sales bonuses to distributors; and
- Commercially-unjustified cash advance to distributors without properly defined repayment terms;

Offering deep discounts has an impact on a company’s operational side too. As deep discounts widen the price differentiation between various distribution networks, it may create a grey market that indirectly affects the company’s future profitability.

In practice, channel-stuffing schemes are usually sophisticated in their design, and they are carefully executed. A robust corporate governance structure and effective control procedures are required to prevent or detect such practices. For more information about the distributorship business model and related risks and governance, please contact our Head of Risk Advisory Services at patrickrozario@bdo.com.hk

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UPDATE ON LATEST AMENDMENTS TO MANDATORY PROVIDENT FUND (MPF) REQUIREMENTS

Changes will take effect on 1 November 2013
As readers of Apercu may recall, our article "What Matters to Employers in 2013" published in April, described MPF revisions that will be enforced this year. The Legislative Council has since amended the minimum level of relevant income for MPF contributions, which will increase to HK$7,100 per month (the current amount is HK$6,500 per month) with effect from 1 November 2013.

From that date, mandatory MPF contributions will be calculated as follows:

Table 1

Monthly relevant income	Amount of mandatory contributions		
	Employer's Contribution	Employee's Contribution	Self-employed person's contribution
Less than HK$7,100	Relevant income x 5%	Not required	Not required
HK$7,100 to HK$25,000	Relevant income x 5%	Relevant income x 5%	Relevant income x 5%
More than HK$25,000	Capped at HK$1,250	Capped at HK$1,250	Capped at HK$1,250 or HK$15,000 per year

The amendment to relevant income will not affect the employer's portion of MPF contributions, as the employer is required to contribute this regardless of the amount of the employee's relevant income, and to calculate its contributions according to the new minimum level of relevant income shown in **Table 1**.

Table 2 below summarises the changes:

Table 2

Details	Minimum level of relevant income	
	Contribution periods prior to 1 November 2013	Contribution periods on or after 1 November 2013
Monthly paid employee	HK$6,500 per month	HK$7,100 per month
Self-employed person	HK$6,500 per month or HK$78,000 per year	HK$7,100 per month or HK$85,200 per year
Casual employee in an Industry Scheme	HK$250 daily	HK$280 daily

Proposed future amendments to MPF requirements
Following the increase of the minimum level of relevant income to HK$7,100 per month, the next stage of the amendment of MPF requirements to be implemented by the MPFA will be an increase in the maximum monthly relevant income figure from HK$25,000 to HK$30,000 in 2014. If this comes into effect, the current cap of monthly contributions, HK$1,250, will change to HK$1,500. This will have a greater impact on both employers and employees than the increase of the minimum level of relevant income.

It means that employees will be required to contribute more than they do currently; in other words, their take-home pay will be reduced. As a result, there is likely to be greater pressure for reform of the MPF system.

On the other hand, employers will be required to contribute the same amount of money that employees do. This will undoubtedly increase their operating costs accordingly.

The proposed date for amendment of the maximum relevant income is 1 June 2014. Both amendments will be implemented by the MPFA, and the calculation of the MPF contributions is summarised in **Table 3**:

Table 3

Monthly relevant income	Amount of mandatory contributions		
	Employer's Contribution	Employee's Contribution	Self-employed person's contribution
Less than HK$7,100	Relevant income x 5%	Not required	Not required
HK$7,100 to HK$30,000	Relevant income x 5%	Relevant income x 5%	Relevant income x 5%
More than HK$30,000	Capped at HK$1,500	Capped at HK$1,500	Capped at HKS1,500 or HK$18,000 per year

With reference to Table 3, the monthly MPF contributions of employees with a current relevant income of HK$25,000 per month will remain unchanged. Employees whose current relevant income exceeds HK$25,000 will see their monthly MPF contribution increase after the implementation of the above amendments.

The above amendments will be implement by the MPFA, and employers should keep an eye on the timeline when they come into effect. They should also be cautious when calculating MPF contributions for employees on the basis of the revised minimum and maximum levels of relevant income.

Employers who have established MPF schemes with voluntary contributions based on the calculation of both the mandatory and voluntary MPF portions are reminded to review their MPF voluntary participation agreement with their MPF service providers to avoid possible disputes arising from unambiguously defining the basis of MPF voluntary participation.

We believe that the MPFA will continue to review the existing MPF system and that it will implement more reforms in the future. It is therefore important for both employers and employees to keep abreast of the forthcoming changes to MPF requirements, as these will impact their margins and entitlements to future retirement benefits respectively.

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BDO EXECUTIVE FORUM 2013 – PART 2

Following the well-received first session of the BDO Executive Forum in the year, the second session will be held on Wednesday, 13 November 2013 at the BDO Office, 25th Floor, Wing On Centre, 111 Connaught Road Central, Hong Kong.

We hope Executive Forum Part 2 will arm you with the professional knowledge you need for dealing with the latest and most-pressing finance and accounting issues. The forum's topics will focus on financial standards.

Further details will be announced later, and we will keep you updated. If you wish to get more information about the forum, please feel free to contact us at info@bdo.com.hk

We thank all our guests for supporting the last forum, and we look forward to seeing you at the next session.

BDO'S INTERNATIONAL RANKING

The International BDO network has maintained its position as the world's fifth-largest accounting network, as at 30 September 2012, according to the global International Accounting Bulletin magazine. The network retained its momentum by scoring 6% growth in revenue.

For more details, please visit http://www.bdointernational.com/

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BDO GLOBAL NETWORK DEVELOPMENT AT A GLANCE

BDO Eastern Caribbean opens an office in Anguilla

BDO has admitted a new firm in Anguilla to BDO Eastern Caribbean, effective 1 August 2013. BDO Eastern Caribbean's territory previously consisted of St Lucia and St Vincent & the Grenadines. The new BDO Anguilla extends it to include the federation of St Kitts & Nevis, and Montserrat. The new firm thus extends the vibrant BDO region beyond the Eastern Caribbean to cover the entire Caribbean region, in which BDO is now represented by 12 firms.

The Anguilla firm specialises in audit and advisory services. It was founded in 1991 by its current Managing Partner, Claudel Romney. As elsewhere in BDO, the firm has strong national roots and is an expert in its home market. This appointment will ensure that clients throughout the Caribbean will find the service capabilities they need to fulfil their complex requirements within BDO.

Auckland mid-market force strengthened as BDO and PKF merge

Auckland chartered accounting and business advisory network member firms BDO and PKF Ross Melville have announced their pending merger, creating a strong new mid-market force offering full taxation, audit & advisory services.

Under the BDO brand, the newly merged firm will continue to be based in the Auckland CBD, East Tamaki and Takapuna. Total staff will increase to 250 including 26 partners. The merged entity creates the largest accounting firm operating on the North Shore. As a result BDO's presence in New Zealand will increase to over 800 people including 86 partners.

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