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BDO AMBITION SURVEY 2011

The BDO Ambition Survey: Global opportunities 2011 assesses where established international businesses see the greatest opportunities for further growth and which markets will have the biggest impact on their balance sheet in the next three years. The survey is now into its second year.

The BDO study reveals some interesting findings about the China market. Among 750 mid cap CFOs interviewed from 13 countries, Chinese businesses were found to place least trust on professional firms as source of advice for international expansion. In addition, 60% Chinese CFOs admitted they encountered difficulties in seeking practical advice when expanding abroad.

By contrast, companies from other developed countries such as the UK, Netherlands, Australia and the US tended to place a significant higher level of trust to professional firms including accountants/tax advisers, law firms, management consultants and investment banks for their international expansion initiatives. Comparatively, less CFOs from developed countries said it was difficult to find practical advice for overseas expansion.

As the survey results indicate, it is vital for Chinese companies to overcome the obstacles of seeking practical advice by utilising professional firms. Albert Au, Chairman & Chief Executive of BDO Hong Kong said, "Professional firms in Hong Kong and China play an important role to provide unbiased and knowledge-based guidance, as well as to ensure that hedging and risk strategies are in place. There is a huge room for professional advisory services to grow in China."

For more details of the BDO Ambition Survey 2011, please visit BDO website at www.bdo.com.hk

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SPOTLIGHT: THE GRAPE WINE INDUSTRY IN CHINA

Industry overview

Liquor production has a rich history in China that goes back thousands of years. Rice liquor has been one of the country's most popular beverages throughout that time.

However, grape wine has begun to realise its potential in China since the turn of the century. Even so, the Chinese still consume far less of it than other nationalities, only drinking around 0.4 to 0.5 litres per person every year, compared to the French, who quaff more than 50 litres each[1].

Yet, the Chinese wine industry is growing at a dramatic pace. Between 1999 and 2008, its sales grew faster than those of any other type of alcoholic beverage; by 20% a year compared to 12.2% for the entire alcohol market[2].

Moreover, wine consumption has more than doubled since 2003, mainly driven by domestic demand. China is expected to become the world's seventh-biggest wine market by 2012, consuming more than 103.5 million nine-litre cases per year[1].

Wine merchants Berry Brothers & Rudd expect that China will be the world's largest wine producer in 50 years[3]. Increasing investment, improving expertise, and a climate that is suitable for vineyards offer huge scope for the industry's expansion. The same report also forecasts that the number of wineries throughout China will increase 10-fold, to about 4,000, in this period.

Currently, more bottles of wine are uncorked in Hong Kong than anywhere else in Asia. According to International Wine and Spirit Research, consumers in Hong Kong will drink 4.5 litres per person this year, twice the amount they imbibed five years ago. Japan holds the region's No. 2 spot with 2.4 litres[4] per capita each year.

The market in China

Domestic companies

According to the National Bureau of Statistics, 83% of the wine consumed in China in 2009 was produced domestically. That highlights the dominant position of local companies in the industry, as the following table shows:

Company and brand share analysis – China wine brand share, by volume, 2008-2009 (%)

Company	Brand	2008	2009
Yantai Changyu Group Company Ltd	Overall	20.2	20.6
China Great Wall Wine Co., Ltd	Piper Heidsieck	16.8	17.1
Tonghua Grape Wine Co., Ltd	Moët & Chandon	12.9	12.9
Dynasty Fine Wines Group Ltd	Great Wall	9.9	9.6
Remy Cointreau	Dynasty	1.6	1.7
Yantai Weilong Grape Wine Co., Ltd	Overall	0.4	0.3
Shengda Wine Co., Ltd	Overall	0.3	0.2
Beijing Dragon Seal Winery Co., Ltd	Overall	0.2	0.1
Others	N/A	37.7	37.5
Overall	**N/A**	**100**	**100**

Source: Datamonitor

The Chinese have immense brand loyalty, and they prefer established brands. This is demonstrated by the 60% combined market share of the top four companies. The wines consumers' preferences vary a lot geographically as well. Yantai Changyu is popular in Shandong and Fujian provinces, whereas Great Wall is well-liked in both North and South China. Tonghua has a strong presence in the Northeast, while Dynasty is the big favourite in the east of the country[5].

Red wine is far more popular than white, accounting for an estimated 80% of all the grape wine consumed[1]. This is due to its perceived health benefits, plus the fact it is produced and advertised more widely on a national scale.

The market's potential and China's ideal climate for viniculture have encouraged a number of European producers to set up subsidiaries in various places. For instance, famous French label Chateau Lafitte recently established a 62-acre vineyard[5] in Shandong province.

1. Wine industry in China, http://www.business-in-asia.com/china/china_wine.html
2. China wine market snapshot, http://dpi.vic.gov.au/agriculture/investment-trade/market-access-and-competitiveness/markets/china/china-wine-market
3. Vintage future seen for Chinese wine, http://news.bbc.co.uk/2/hi/7498334.stm
4. Vinexpo, http://www.vinexpo.com
5. Department of Primary Industries, http://dpi.vic.gov.au/
6. The wine market in China: Opportunities for Canadian wine exporters, http://www.ats.agr.gc.ca/asi/4398-eng.pdf
7. SCMP report on 27 September 2011

Imported wine

China's wine imports have also rocketed, as these charts show:

Figure 1: Bottled wine imports (excluding sparkling) 2004 – 2009 US$ million

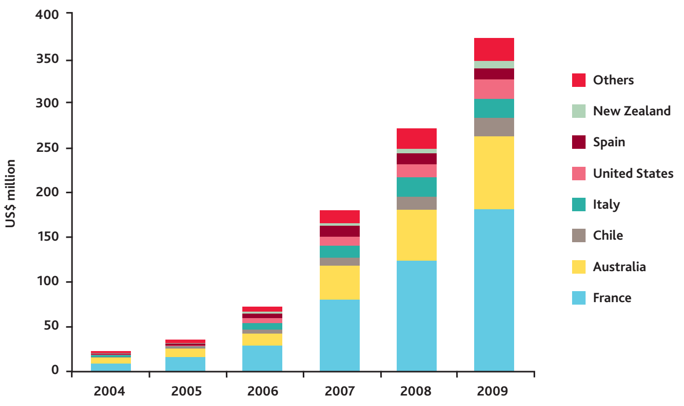
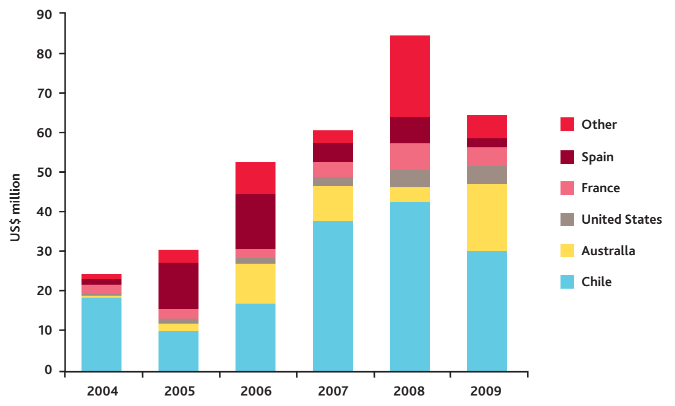


Figure 2: China bulk wine imports 2004 – 2009 US$ million



Source: GTIS, (from China Customs Data) 2010

The value of bottled wine imports increased from US$25 million in 2004 to US$377 million in 2009[2]. Meanwhile, bulk wine imports also rose in this period; although their value decreased from US$84 million in 2008 to US$64 million in 2009, largely due to the rapid growth of domestic production.

The average wine consumer still has relatively little knowledge about the various types and quality of wines. Most are price sensitive too; they prefer local or regional wines instead of higher-end ones. However, increasing wine imports indicate growing interest; and consumers seeking to project a more modern image are turning to foreign brands. Imported wine is as such appearing more widely on restaurant menus and in supermarkets[1].

There are large barriers to entry for importing wines. Import taxes can total as much as 50%, due to tariffs of around 12-20% on bottled or bulk wines, 17% value-added tax and 10% consumption tax[6]. The Chinese wine market is therefore not easy to enter – especially when you also consider the popularity of domestic brands.

Outlook

China has no wine-grading system or regulations about production or content. This has encouraged some domestic wineries to make their products more palatable by mixing them with imported wine. Consumers also need to be vigilant about domestic wines labelled as foreign ones, and wine that is labelled as vintage when it is not. In this context, foreign competition is playing a positive role in the market by helping to expose consumers to more established products and brands. This in turn increases the pressure on local companies as they either have to improve the quality of their produce or lose market share to imports.

Wine consumption in China is expected to increase by 90% between 2009 and 2014[6]. That makes the industry a potentially attractive investment target for both domestic and foreign companies. Continued enhancement of lifestyles, especially in urban areas, is also fuelling rising demand for quality wines, both domestic and foreign.

Fine wine prices are now back to levels in November 2010, having fallen off their peaks in June 2011 according to the Liv-ex Fine Wine 50 Index[7]. In addition, continued uncertainty in the global economy and markets, particularly in Europe, are offering wine producers consolidation opportunities, whether they are Chinese players seeking foreign acquisitions, or foreign brands aiming to enter the Chinese market.

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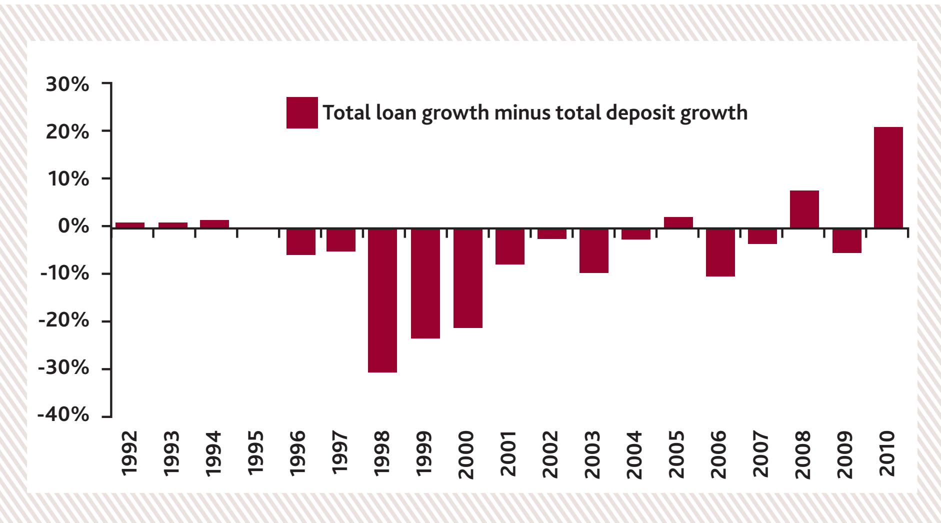
NEW CEO OF BDO INTERNATIONAL NETWORK

Martin van Roekel is the new CEO of BDO International Limited. He joined BDO CampsObers in the Netherlands in 1975 and became a partner in 1988. In 2009, Martin stood down from his role with BDO Netherlands and from the chairmanship of the international Policy Board in order to join the Global Leadership Team as Global Head of Network Development and CEO for Europe. His appointment reflected the importance of network development to BDO, and under his leadership the network grew from 110 member firms to 125, covering 15 additional countries.

LIQUIDITY MANAGEMENT — HKMA URGES BANKS TO PERFORM STRESS TESTS

We have been able to avoid a meltdown and achieve a modest recovery since the 2008 global financial crisis. Governments and central banks around the world have committed funds for acquiring bad assets, capital injections, loans, guarantees and other forms of assistance to stabilise financial systems. However, we are far from regaining financial stability. We can see the looming credit crises in some European countries like Greece, Ireland and Portugal, while other larger European economies such as Italy and Spain may yet find themselves in trouble; even the United States too. Although key commodity prices have declined slightly, inflation is rising worldwide, and it has contributed to unrest in the Arab world, and the recent riots in England and other places. Financial stability and management of financial risk are crucial to the sustainable development of our economy and society.

The Hong Kong Monetary Authority (HKMA) is tightening its monitoring of the liquidity positions of banks, due to concerns about the rapid expansion of bank credit. Bank loans have been growing much faster than deposits. The loan-to-deposit ratio is at its highest level since October 2008, and this is the largest growth differential recorded during the past two decades (see diagram below).



Sources: Economics, DBS Group Research

The HKMA is very concerned about the possibility of a substantial outflow of deposits from Hong Kong as global liquidity tightens. It therefore recently urged banks to conduct stress tests to reveal their liquidity positions if they were to face a substantial outflow of deposits within a short period of time.

The authority has also asked banks to prepare and submit their plans for conducting stress tests that would assume depositors withdraw US$89 billion of their funds from the Hong Kong banking system. That means half the HK$1.38 trillion (US$177 billion) of customer deposits in Hong Kong dollars and foreign currencies that have been added since the 2008 financial crisis would flow out during the next six to 12 months.

In the context of impending instability in financial markets and regulatory developments, let us see how Hong Kong's banks can best comply with the HKMA's request, and even turn this potential liquidity threat into an opportunity.

The boards and managements of banks and regulators each have their own roles to play in ensuring the basic but crucial liquidity level is monitored and managed effectively. It is important for a bank's board to ask quality questions about its likely performance under worst possible stress scenarios; and which balance sheet and liquidity levers should be pulled to make a difference. Meanwhile, its management needs to establish effective strategic and operational liquidity monitoring and management systems. That is a crucial differentiator between survivors and the fallen during a crisis. There have been many recent developments on the regulatory front as international and Hong Kong regulators revise their policies and standards. They include

BIS 2008: *Principles for Sound Liquidity Risk Management and Supervision (Sound Principles)*, **The BASEL III**: *International Framework for Liquidity Risk Measurement, Standards and Monitoring (December 2010)* and the **HKMA Supervisory Policy**: *Liquidity Risk Management (LM-1) and Sound Systems & Controls for Liquidity Risk Management (LM-2) (April 2011)*. Yet, the regulatory requirements that have so far been published lack quantitative criteria or guidelines.

There are two kinds of liquidity risk: funding liquidity risk and market liquidity risk. Funding liquidity risk is current or prospective risk arising from a bank's inability to meet funding demands in a timely manner without affecting its routine business and financial situation. Market liquidity risk means that banks cannot dispose of their assets at reasonable market prices in order to obtain funds, because the market is so disorderly that acute illiquidity leads to unreliable valuations. Examples of liquidity risk include reduced capacity to borrow, increased collateral requirements, off balance sheet exposure, such as undrawn commitments, and a disorderly market such as we saw in 2008.

Liquidity risk is very difficult to manage, due to uncertainty about cash flow obligations that would depend on external events and the behaviour of other parties. Uncertainty is difficult to predict and manage; the severity of an economic issue or consequence can increase very rapidly, as we saw during the 2008 financial crisis.

When managing liquidity risk, the board must take responsibility for defining its capacity, appetite and limits. Capacity represents the maximum amount of risk that can be supported; it is expressed as an aggregate capital amount. Risk capacity is determined by considering the availability of capital resources, the ability to raise capital (access to capital markets) and earnings strength and stability. Risk appetite is an overall guide to resource and capital allocation. It is the amount of risk that management and the board are willing to take, given available capacity, risk preferences, and strategic business objectives. Business strategy must be aligned with risk appetite. Risk appetite should be allocated to individual risk types, businesses, and additional dimensionality (or combinations thereof) based on capital requirements relative to potential returns and risk concentrations. Limits must be established to control significant risks effectively within the context of overall risk appetite. Such limits should be expressed in specific metrics that are appropriate for a given risk. They should also reflect an enterprise's risk preferences and be aligned to support strategic plans and capital allocation. Limits should also be set at levels that can be tested periodically (ie they should be established at levels that might be exceeded sometimes).

A bank should ensure its board and management exercise proper oversight to maintain its solvency through its organisation, management committees and policies and procedures. For example, an asset liability management committee can provide a forum for discussing capital adequacy and liquidity issues, whereas a risk management committee can oversee and direct risk profile and risk appetite.

Banks need a comprehensive risk management process that covers identifying, measuring, monitoring and controlling the liquidity risks of the bank, its products, and its business lines in a prudent and effective manner. That will ensure the bank has sufficient funds to cope with increases in assets and payment of matured debts under normal business conditions and in stress situations.

Many factors can affect a bank's liquidity requirements. They include balance-sheet items such as banking and trading assets, fixed assets, net receivables and payables; off-balance-sheet items such as forward-dated contract obligations and undrawn lending facilities; outstanding debt, such as unsecured fixed maturity long-term debt, committed and uncommitted facilities drawn down, time deposits, unsecured variable-term long-term debt for variable-term and call deposits and secured debt; undrawn facilities, portfolio characteristics with assets pledged and not pledged, assets for sale and assets hedged. They can also be affected by its reputation.

A bank must review plausible scenarios to test its resources to navigate and survive stress events. Stress-testing and scenario analysis functions are needed to provide an integrated view of risk that encompasses all types of credit and market risk, including secondary effects and liquidity risk, such as bank deposit outflows.

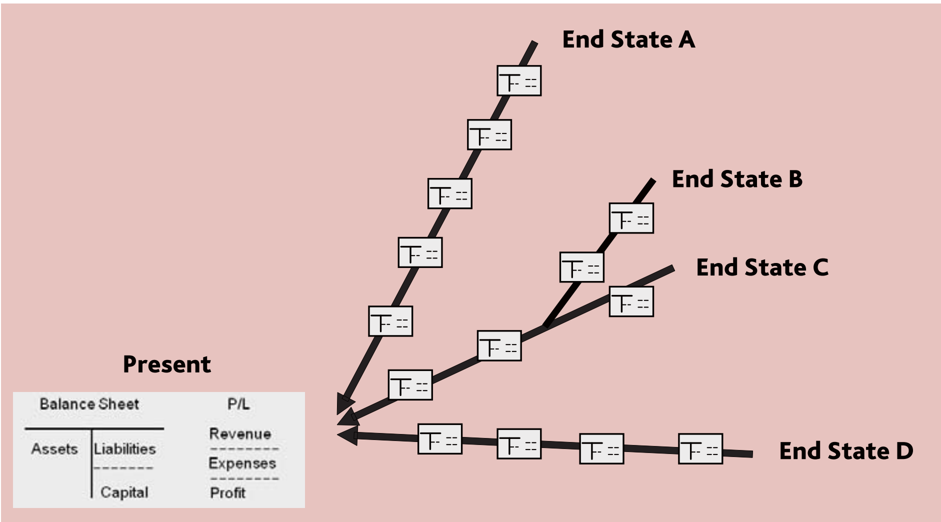
The analysis platform must consist of a sophisticated risk aggregation engine that allows different risks to be aggregated, which means it plays an important part in record keeping, as well as the development of metrics, information and data for timely regulatory reporting. It can facilitate rapid management responses as well. An integrated stress testing and scenario analysis function should monitor and communicate test results in different ways, thus providing risk, financial and other qualitative information that will help a bank to make proper decisions.

Even the most sophisticated stress test is only as good as the scenario on which it is based. Constructing a good scenario involves estimating the probability of an occurrence, ensuring the variables actually influence the output concerned, taking into account various assumptions, and having clear documentation about the rationales.

Scenario analysis must correspond to the portfolio of exposure. That is to say, it must be relevant to the bank. It must test normal conditions as well as various versions of extreme volatility. Finally, the analysis must concentrate risk around particular asset classes, and have outcomes that directly assist management to take timely action.

The future could turn out to be entirely different from the scenarios tested and analysed during stress testing. Nonetheless, forecasts must be built on events and outcomes that form a cohesive story about how a business would evolve in such circumstances, as the diagram below shows.

To ensure it would survive a substantial outflow of deposit money, the board of a bank needs to have members who possess an understanding of what can go wrong with liquidity, under normal, stressed and extreme scenarios. That will help them to perform their governance role more effectively on behalf of their shareholders. Board members, senior managers and lines of business should ensure strong and transparent linkage exists between business line strategies, liquidity, risk and capital adequacy. On the other hand, regulators should set a minimum liquidity threshold. If a bank falls below this level, it would be forced to liquidate or deposit its assets as security for its depositors.



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DON'T UNDERESTIMATE THE POTENTIAL IMPACT OF HKFRS 10 CONSOLIDATED FINANCIAL STATEMENTS

The accounting profession and business sector were full of excitement about the potential implications of the accounting standards on financial instruments when they were first adopted in Hong Kong a few years ago. The implementation of HKFRS 10 and other standards covering accounting and disclosure of interests in other entities may become an equally hot topic.

This article will introduce the key features of HKFRS 10, give some insights about the practical issues it may raise, and share with you our recommended courses of action to prepare for the adoption of the standard.

The scope of HKFRS 10

In line with its policy to converge with IFRSs, in June 2011 the HKICPA adopted a batch of new standards on how to account for and disclose an entity's interests in other entities. These are:

- HKFRS 10 Consolidated Financial Statements;
- HKFRS 11 Joint Arrangements; and
- HKFRS 12 Disclosure of Interests in Other Entities.

Major consequential revisions were made to:

- HKAS 27 Consolidated and Separate Financial Statements (revised to become HKAS 27 (2011) Separate Financial Statements); and
- HKAS 28 Investments in Associates (revised to become HKAS 28 (2011) Investments in Associates and Joint Ventures).

The following standard and interpretations will be withdrawn when the new HKFRSs and revisions to existing ones take effect:

- HKAS 31 Interests in Joint Venture;
- HK(SIC)-Int 12 Consolidation – Special Purpose Entities; and
- HK(SIC)-Int 13 Jointly Controlled Entities – Non-Monetary Contributions by Venturers.

HKFRS 10 replaces sections in the extant HKAS 27 that deal with consolidation requirements and procedures. The preparation of separate financial statements[1] and disclosures in separate financial statements are covered in HKAS 27 (2011), whereas disclosures about the parent's consolidated financial statements are moved to HKFRS 12[2].

Diagram 1

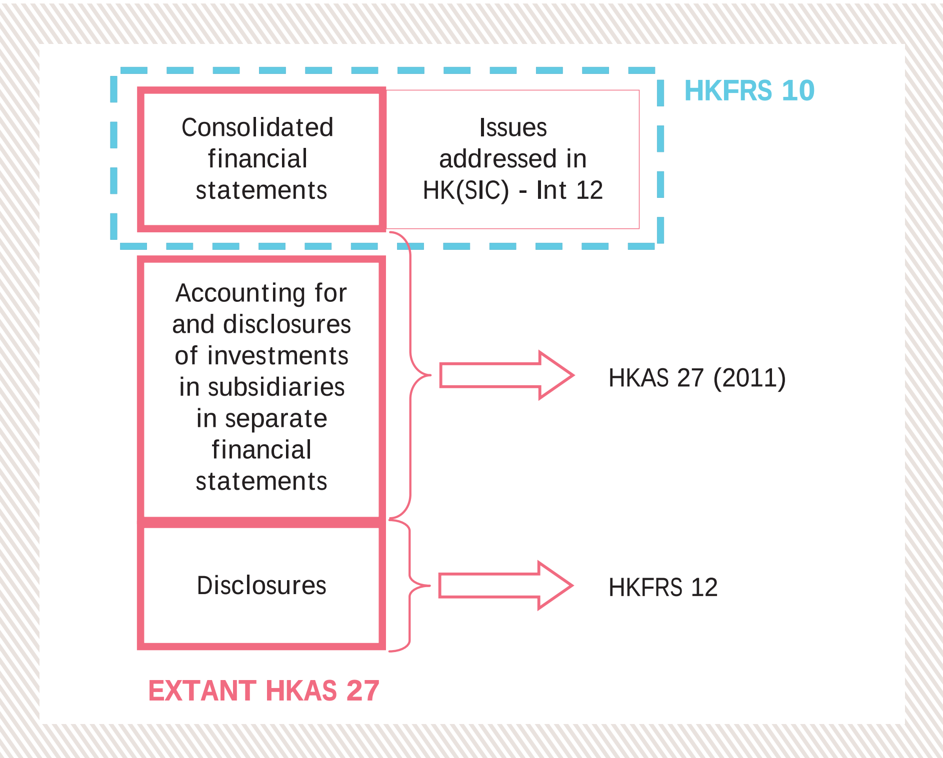


Diagram 1 illustrates how the scope of the extant HKAS 27 is being split, and how the parts will be covered in the new and revised standards.

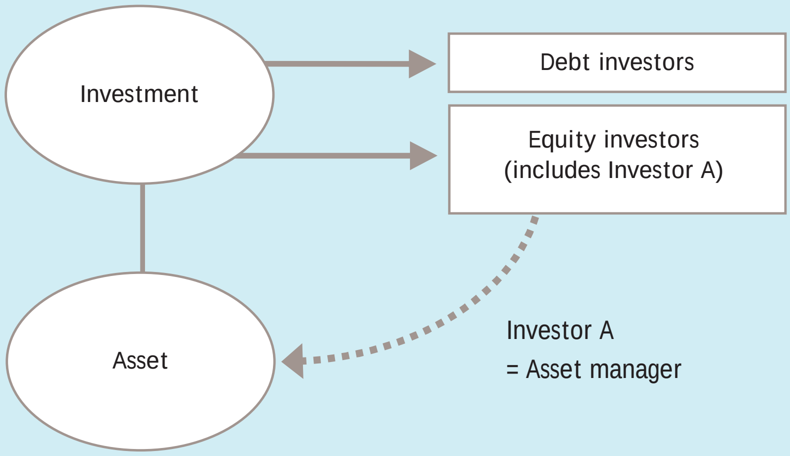
How does HKFRS 10 differ from the extant HKAS 27 and HK(SIC)-Int 12?

The conditions for consolidation exemption, consolidation procedures and accounting for changes in ownership interests that may or may not result in loss of control contained in the extant HKAS 27 have been brought forward unchanged to HKFRS 10. The change that HKFRS 10 introduces is the new definition of "control", and consequently the scope of consolidation.

HKFRS 10 is a principle-based standard that contains a single consolidation model. Unlike the extant HKAS 27, HKFRS 10 does not set any "bright line" that would presume the existence of control. To apply the principles in HKFRS 10 to the assessment of existence of control would involve a significant amount of judgement in certain circumstances. HKFRS 10 also introduces a change in the "unit of account". A reporting entity should consolidate specified assets and liabilities of an investee if those assets are "ring-fenced" from the overall investee.

B2 to B79 of Appendix B[3] of HKFRS 10 provide guidance on how to apply the principles contained in the main body of the standard. Some entities consolidated under the extant HKAS 27 or HK(SIC)-Int 12 might be deconsolidated under HKFRS 10, or vice versa. The following example has been adopted from the Project Summary and Feedback Statement prepared by the International Accounting Standards Board (IASB) to illustrate the different conclusion drawn under HKFRS 10.

1. Separate financial statements is defined in HKAS 27 (2011) as those presented by a parent (ie an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with HKFRS 9 Financial Instruments.
2. HKFRS 12 should also be applied by an entity that has an interest in joint arrangements (as defined in HKFRS 11), associates and/or unconsolidated structured entities.
3. Appendix B is an integral part of HKFRS 10, and therefore the paragraphs it contains are of equal authority as those in the main body of the standard.



An investment vehicle is created to purchase a portfolio of financial assets, funded by debt and equity instruments issued to a number of investors. The equity tranche is designed to absorb the first losses and to receive residual returns of the investee. Investor A holds 30 per cent of the equity and is also the asset manager who manages the vehicle's asset portfolio within portfolio guidelines. This management includes decisions about the selection, acquisition and disposal of the assets within those portfolio guidelines and the management upon default of any asset in the portfolio.

SIC-12
In applying SIC-12, some would conclude that Investor A does not consolidate the investment vehicle. Investor A holds 30 per cent of the equity and therefore does not bear the majority of the risks and rewards. The investment vehicle was arguably created for the benefit of all investors, and not only for the benefit of Investor A.

IFRS 10
According to IFRS 10, Investor A controls the investment vehicle. Investor A has the ability to direct the relevant activities, has rights to variable returns from the performance of the vehicle and has the ability to use its power to affect its own returns.

Meaning of control

Under HKFRS 10, "control" consists of three elements:

(a) Power over an investee. Power is defined as existing rights that give current ability to direct the relevant activities of an investee. Relevant activities are activities of the investee that significantly affect the investee's returns;

(b) Exposure or rights to variable returns from its involvement with the investee; and

(c) The ability to use its power over the investee to affect the amount of the reporting entity's returns.

Under HKFRS 10, control must have economic substance. When assessing whether it has power, an investor considers only substantive rights it holds and held by others as well as whether these rights give the investor authority over an investee's relevant activities. For a right to be substantive, the holder must have the practical ability to exercise that right. Usually, that means the rights have to be currently exercisable. However, rights can sometimes be substantive, even if they are not currently exercisable but exercisable when decisions need to be made about the investee's relevant activities. Examples of such situations are provided in Examples 3 – 3D of Appendix B of HKFRS 10.

Variable returns are returns that are not fixed and have the potential to vary, as a result of the performance of an investee.

The definition of control in HKFRS 10 uses the concept of returns in two ways. The link to return in element (a) above is to clarify that having the current ability to direct inconsequential activities is not relevant to the assessment of power and control. The second way the concept of return is used is in element (b) above. This retains the concept that control conveys the right to returns from an investee. However, control is not a synonym of power, because equating power and control would result in incorrect conclusions in situations when an agent acts on behalf of others. HKFRS 10 is specific that an agent cannot be an investor.

Assessment of substantive rights and sufficiency of power

Power arises from rights. Yet not all types of rights give an investor power to direct an investee's relevant activities. Protective rights either relate to fundamental changes to an investee's activities, or else they apply only in exceptional circumstances. Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor holding only protective rights cannot have power or prevent another party from having power over an investee.

Appendix B of HKFRS 10 contains a long list of factors to consider when assessing power over relevant activities in more complex cases. Regardless of whether the case is straightforward or not, we recommend that investors understand the purpose and design of the investee as the first step of assessing control. When developing IFRS 10, the IASB confirmed that considering the purpose and design of an investee is important when assessing control, because it is the means by which an investor can identify the relevant activities and the rights from which power arises, as well as who holds those rights. It can also assist in identifying investors that may have sought to secure control, and whose position should be understood and analysed when assessing control.

With the benefit of an understanding of the purpose and design of the investee, we also advise investors to make the following two analyses before they go through the list of factors in Appendix B of the standard. In the most straightforward cases, the results of these analyses may show that the investee is controlled by means of equity instruments that give the holder proportionate voting rights. In the absence of other arrangements, the investor that holds a majority of those voting rights controls the investee. Then there is no practical need to consider the other factors contained in Appendix B of HKFRS 10.

Identifying the investee

As highlighted above, an investee can be an entire entity or a portion of an entity (deemed separate entity). The conditions for a deemed separate entity (or a "silo", as used in HKFRS 10) are stated in HKFRS 10.B77 which is reproduced below:

"Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee. Thus, in substance, all the assets, liabilities and equity of that deemed separate entity are ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'."

The implications of this new concept are twofold:

(a) Specified assets and liabilities (not the entire entity) are consolidated; and

(b) Other investors in the investee should exclude those specified assets and liabilities when it consolidates the investee.

That means if an investor determines it has control over an investee, it should be aware of whether another investor has control over specified assets and liabilities of that investee.

The unit of account should be determined appropriately in the first place. The assessment of power and control can then be performed within the right scope.

Identifying an investee's relevant activities and how decisions about them are made

For the purpose of HKFRS 10, relevant activities are an investee's activities that significantly affect the investee's returns. Depending on the circumstances, examples of relevant activities are researching and developing new products or processes, determining a funding structure or obtaining funding, and selling and purchasing goods or services. When two or more investors have the current ability to direct relevant activities and those activities occur at different times, the investor who is able to direct the activities that most significantly affect the return is considered to have power.

For many investees, a range of operating and financing activities significantly affect their returns. Deciding which activity most significantly affects the returns of an investee is highly judgemental, and the decision may fundamentally change the investor's financial position and performance (eg accounting for the investor's investment as financial asset under HKAS 39 or HKFRS 9, or consolidating the investee under HKFRS 10). Below is an example provided in HKFRS 10 Appendix B that illustrates the difficulty of making this decision.

Two investors form an investee to develop and market a medical product. One investor is responsible for developing and obtaining regulatory approval of the medical product - that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the other investor will manufacture and market it - this investor has the unilateral ability to make all decisions about manufacturing and marketing of the project.

If all the activities - developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product - are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee's returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee's returns and whether it is able to direct that activity.

In determining which investor has power, the investors would consider:

(a) the purpose and design of the investee;

(b) the factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product;

(c) the effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in (b); and

(d) the investors' exposure to variability of returns.

In this particular example, the investors would also consider:

(e) the uncertainty of, and effort required in, obtaining regulatory approval (considering the investor's record of successfully developing and obtaining regulatory approval of medical products); and

(f) which investor controls the medical product once the development phase is successful.

In situations where an investee is not controlled by voting rights or the investor does not hold the majority of voting rights, assessment of sufficiency of power should take into account other factors contained in Appendix B of HKFRS 10. They include:

- Rights that arise from contractual arrangements with the investee or other vote holders;
- Substantive potential voting rights. Substantive potential voting rights alone, or in combination with other rights, can give an investor the current ability to direct the relevant activities;
- Rights to appoint or remove key management personnel who have the ability to direct the investee's relevant activities;
- Evidence of practical ability to direct relevant activities unilaterally. Indicators include *de facto* power, potential voting rights exercisable by other parties and their pattern of involvement in the investee, and contractual arrangements;
- A special relationship with the investee. An example is when the investor controls assets such as licences that are critical for the investee's operations;
- Large exposure to variability of return. The logic is the greater an investor's exposure or rights to the variability of returns from its involvement with an investee, the greater is the incentive for the investor to obtain sufficient rights to give it power. However, this indicator does not in itself determine whether an investor does have power over the investee;
- An explicit or implicit commitment by an investor to ensure that an investee continues to operate as designed. Such a commitment may increase the investor's exposure to variability of returns, and thus increase the incentive for the investor to obtain sufficient rights to give it power. Again, this indicator alone does not give an investor power, nor does it prevent another party from having power; and
- The ability to direct another party to act on the investor's behalf (ie de facto agent)

Variable returns

The standard uses the term "returns" rather than "benefits" because benefits are often interpreted as implying only positive returns, whereas an investor's returns could be wholly positive, wholly negative or both positive and negative. In practice, an investor may benefit from controlling an investee in a variety of ways. In finalising the standard, the IASB confirmed its intention to have a broad definition of "returns" that would include synergistic returns as well as more direct returns, for example, dividends or changes in the value of an investment.

The assessment of variable returns should be based on the substance of the arrangement, regardless of its legal form. The standard gives the following examples to explain what "variable" means for the purposes of HKFRS 10.

- An investor holds a bond with fixed interest payments. The fixed interest payments are variable returns because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond. The degree of variability (ie how variable those returns are) depends on the credit risk of the bond; and
- Fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the investee's performance risk. The amount of variability depends on the investee's ability to generate sufficient income to pay the fee.

Although only one investor can control an investee, more than one party can share in its returns. For instance, holders of non-controlling interests can share in an investee's profits or distributions.

The link between an investor's power over an investee and the amount of the investor's returns

This linkage corresponds to the third element in the definition of control, ie the ability of an investor to use its power over an investee to affect the amount of its returns. An agent is a party primarily engaged to act on behalf of and for the benefit of another party or parties (the principal(s)). Therefore, the agent does not control the investee when it exercises its right to direct the investee's activities. Based on this principle, an investor or another party delegated with the right to make decisions (decision-maker) should determine whether it is acting as a principal or an agent when it assesses whether it controls an investee.

The decision-maker should consider the overall relationship between itself, the investee being managed, and other parties involved with the investee. In particular, the decision-maker is required to consider all the factors in HKFRS 10.B60, as follows:

(a) The scope of its decision-making authority over the investee;

(b) The rights held by other parties;

(c) The remuneration to which it is entitled in accordance with remuneration agreements(s); and

(d) The decision maker's exposure to variability of returns from other interests that it holds in the investee. Holding other interests in an investee indicates the decision-maker may be a principal. The decision-maker should evaluate its exposure relative to the total variability of the returns of the investee.

Different weightings are applied to each of these factors based on particular facts and circumstances.

An exception to the requirement to consider all of factors (a) to (d) above is when a single party holds substantive rights to remove the decision-maker without cause. In this situation, the decision maker is obviously an agent.

Determination of control is an ongoing exercise

One other profound potential impact arising from the adoption of HKFRS 10 on an entity's financial reporting practice is that an investor should reassess its control over an investee when facts and circumstances change even if there is no actual or deemed disposal of the investor's shareholding in the investee. HKFRS 10.B82 states that an event can cause an investor to gain or lose power over an investee without the investor being involved in that event.

In assessing control under HKFRS 10, the rights of other parties involved in the investee are also relevant. This feature increases the difficulty of continuous assessment. The investor should keep track of events relating to the investee, no matter whether it is involved in those events or not. In practice, it is hard to expect an investor who does not already control an investee to be knowledgeable about events relating to an investee in which it is not involved.

Recommended action

Appendix B of HKFRS 10 contains a wide range of factors an investor may need to consider when it assesses whether or not it has control over an investee. Entities should develop their own systematic approach to performing the assessment, to ensure that all the facts and circumstances are considered.

The factors relevant to the assessment of control under HKFRS 10 are much broader than HKAS 27 and HK(SIC)-Int 12. Entities are advised to revisit their accounting systems to see whether any system update is necessary to capture the required information.

As noted at the beginning of this article, the adoption of HKFRS 10 may change the scope of consolidation of some investors – to deconsolidate some investees and/or consolidate others for the first time. As a result, the investor's financial position and financial performance may become different from the views presented previously. If an investor is subjected to externally imposed capital requirements, it may consider liaising with contracting parties to work out contingency arrangements in the event that it is adversely affected by HKFRS 10.

HKFRS 10 generally requires retrospective application, except for the impracticability as allowed in the standard. Entities may not have the necessary information on hand to perform an assessment of control; so they should start to assess the potential impact of HKFRS 10 immediately. That would promise a smooth transition to the new standard.

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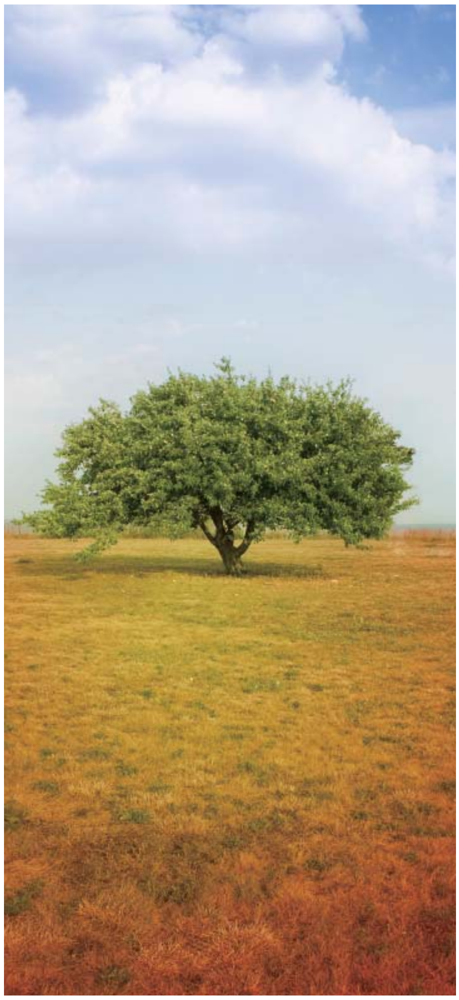

WHAT MATTERS TO EMPLOYERS

MPF amendment

The change

The Legislative Council has passed an amendment concerning the minimum level of relevant income for Mandatory Provident Fund (MPF) contributions. With effect from 1 November 2011, this amount will be increased from HK$5,000 to HK$6,500.

From the same date, monthly paid regular employees and their employers will need to make the MPF contributions shown in table 1.

Table 1

Monthly relevant income	Mandatory contribution amount	
	Employer's contribution	Employee's contribution
Less than HK$6,500	Relevant income x 5%	Not required
HK$6,500 – HK$20,000	Relevant income x 5%	Relevant income x 5%
More than HK$20,000	HK$1,000	HK$1,000

If the contribution period does not run from the beginning to the end of the calendar month, but instead straddles two calendar months, for example from 20 October to 19 November 2011, the MPF contribution based on the new level should take effect from the contribution period that starts on 20 November 2011.

Daily paid casual employees and non-daily paid casual employees (eg those paid on a weekly or bi-weekly basis) whose daily relevant income does not exceed HK$250 will not be required to make contributions, but their employers will.

Self-employed persons whose relevant income is less than HK$6,500 monthly or HK$78,000 annually will not have to make contributions.

What's next

This is the second amendment to the MPF scheme since 2008. In response to the community's requests, more amendments will be proposed and discussed in future, including the issue of members choosing their own MPF service providers. However, there is currently no timetable for such further changes, and it is likely to be a long time before they are put into place.

Minimum Wage Ordinance

Developments since implementation

There has been much debate about the effects of the Minimum Wage Ordinance (MWO) since it came into force on 1 May 2011. This centres on whether the legislation will prove beneficial, detrimental or neither in the long run, and whether it will increase or decrease employment opportunities.

In the face of rising staff costs due to the implementation of the MWO, some employers in labour-intensive industries, such as cleaning, catering, property management and security services, have cut their costs by changing the terms of employment of their low-skilled workers. They have either turned full-time employees into part-time ones, or else altered their status to self-employed, which means they aren't paid for meal breaks, rest days, etc.

However, the cost-reduction benefits are being outweighed by an increase in the number of labour disputes and damage to employer-employee relationships. Meanwhile, other employers have adhered to the MWO's requirements and increased their employees' pay.

The MWO not only affects lower-skilled workers, but also other employees and their employers. The latter are required to revisit the terms and conditions of employment for their existing employees, their HR policies and procedures and their operational arrangements as a result of the MWO. They also need to review their staff costs. The ordinance also obliges employers to keep detailed attendance records showing employees' leave, the hours they work, and related remuneration. Failure to do so will make employers subject to penalties and prosecution.

Going forward

To meet the MWO's requirements, employers are advised to update their operational practices, HR policies and procedures. More importantly, they should analyse the concerns of their employees before implementing such changes. Last but not least, they ought to remember that the key to success when introducing new HR plans and policies is open communication: it is an essential way to minimise resistance to change.

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BDO NEW APPOINTMENTS

Alex Leung
Principal
Assurance Services

Alex Leung has over ten years of public accounting experience in leading audits of private and public companies, handling initial public offering and notifiable transaction assignment for companies listing on The Stock Exchange of Hong Kong Limited.

Alex's industries experience includes manufacturing and trading (footwear, garments and apparels, machinery, gaming accessories and packaging products), trade fair exhibition, advertising media, retailing, winery and investment holdings.

Alex is a Certified Public Accountant in Hong Kong and a member of the CPA Australia.

Cecily Tsang
Principal
Tax Services

Cecily Tsang started her career with an international accounting firm in Hong Kong where she gained extensive experience in corporation tax. She has over ten years of experience in providing tax compliance and consulting services to a broad range of local and multinational clients, such as advising on tax issues related to corporate restructuring, due diligence, and cross-border transactions. She also has experience in advising multinational clients on cross-border personal tax implications and related matters.

Cecily is a member of CPA Australia.

Rita Leung
Principal
Assurance Services

Rita Leung has extensive experience in handling audit assignments of listed companies operating mainly in Hong Kong and mainland China over a wide variety of industries including manufacturing, mining, online game, real estate development and garment. Rita is also involved in various transaction support assignments including initial public offerings and acquisitions of companies.

Rita is a Certified Public Accountant in Hong Kong.

Angela Wong
Director
Human Resources

Angela Wong possesses extensive HR generalist experience and exposure in a diversity of industries, such as IT consulting, banking, telecommunications, security and NGO, in addition to professional accounting. Angela held Human Resources Director positions and played a strategic regional / local HR role in a number of MNCs which are the world leaders in the respective industry. She has proven track record in acting as a professional business partner to the line management and in re-engineering the organisations.

Angela is a Professional Member of the HK Institute of Human Resource Management.

Franki Lui
Principal
Assurance Services

Franki Lui has extensive experience in handling Hong Kong and PRC listed company audit assignments over a wide variety of industries including manufacturing, construction, apparel, and property investment. He also specialises in transaction support assignments, such as initial public offerings and financial due diligence.

Franki is a Certified Public Accountant in Hong Kong and a fellow member of the Association of Chartered Certified Accountants.

Pauline Fung
Principal
Corporate Secretarial Services

Pauline Fung is a qualified corporate secretarial professional with over 20 years of experience. She has extensive experience in handling company secretarial and statutory compliance matters for local and offshore companies. She also has considerable experience in corporate restructuring and trust administration.

Pauline is a member of the Institute of Chartered Secretaries and Administrators in the UK and the Hong Kong Institute of Chartered Secretaries.

Kitty Tang
Principal
Assurance Services

Kitty Tang has over 12 years of experience in providing assurance and business advisory services to a wide range of public and private corporate clients in different industries.

Kitty has extensive experience in handling audit assignments of PRC based-entities listed on the Hong Kong Stock Exchange and the Securities and Exchange Commission in the US.

Kitty is a Certified Public Accountant in Hong Kong, a member of the Association of Chartered Certified Accountants and the Chinese Institute of Certified Public Accountants.

Zondra Lee
Principal
Corporate Secretarial Services

Zondra Lee is a qualified corporate secretarial professional with 20 years of experience. She has worked for the private trust division of a major bank in Hong Kong and a leading international law firm before joining BDO in 1994.

Zondra has extensive experience in various aspects of corporate secretarial and statutory compliance matters for companies in Hong Kong and other jurisdictions. She is also involved actively in corporate restructuring.

Zondra is a member of the Institute of Chartered Secretaries and Administrators in the UK and the Hong Kong Institute of Chartered Secretaries.

BDO RECENT PUBLICATIONS

China Tax

China social security contributions requirement to foreigners working in China

BDO issued the "China social security contributions requirement to foreigners working in China" newsletter in August 2011. This newsletter summarises the salient points and the impact of the Social Security Law and the Draft Measures on employers and foreigners working in China.

20% dividend withholding tax from China – why and how does it apply?

In view of the recent confusion over the announcement by various H share companies that they intend to withhold 20% tax on dividend payments from China, this newsletter sets out the background that had caused the confusion and the latest development.

Hong Kong Tax

Hong Kong group benefits from source basis taxation

This newsletter describes the planning necessary for a Hong Kong group to acquire a UK target with subsidiaries across Europe.

Risky Times

The whistleblower programme – a fraud-prevention mechanism

The latest newsletter on the topic "The whistleblower programme - a fraud-prevention mechanism" was issued in September 2011. This newsletter focuses on describing the final rule of whistleblower programme and its impact. It also provides some suggestions to prevent fraud.

WEBINAR WITH BDO RUSSIA AND HKEX

In a webinar on the topic of "Placement of Russian companies securities on Hong Kong Stock Exchange" conducted by BDO Russia on 20 Oct 2011, BDO Hong Kong had the pleasure of participating with our guest speaker from the Hong Kong Stock Exchange (HKEx) via an online platform. The webinar attracted 30 CFOs and senior executives from various Russian corporations.

Eric Landheer, Senior Vice President of HKEx shared with the Russian audience about the latest development of the capital market in Hong Kong and the benefits of listing in Hong Kong.

Our partner and head of assurance Jennifer Yip delivered her welcoming remarks to the participants. Our assurance partners Andrew Lam and Norman Tsui also spoke at the webinar on the listing requirements, procedures and accountants' roles in an IPO.

The event is a demonstration of successful joint effort of BDO Hong Kong and BDO Russia and showcase the strength of the BDO international network.

Eric Landheer (left) & Andrew Lam (right)

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