

# APERCU



## MESSAGE FROM CHAIRMAN & CHIEF EXECUTIVE

**D**ear clients and friends,

Welcome to the debut issue of BDO's newsletter APERCU!

This new publication is designed to be a channel for us to share with you our insight in the subject matters that we are most familiar with and help you stay up-to-date with the latest development in the accounting and financial arenas.

It is simply because what matters to you, matters to us – and we hope that APERCU will touch on issues which matter to you and help you face today's challenges.

We hope you enjoy reading APERCU.

At our 30th Anniversary, I would like to take this opportunity to thank you for your business and dedication all these years and I look forward to your continuing support for many more years to come.



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# NEW CHALLENGES FOR EXPATRIATES WORKING IN CHINA

**R**ecent changes in the regulations about social security contributions and individual income tax will undoubtedly pose new challenges for expatriates working in China, as well as foreign organisations that employ them.

## New Social Insurance Law

The new social insurance law passed by the Standing Committee of the National People's Congress on 28 October 2010 became effective on 1 July 2011. Its provisions stipulate that all foreigners working in China must participate in the social insurance system. That implies they must contribute to social security insurance for benefits such as pensions, healthcare, occupational injuries, unemployment and maternity, just like local Chinese citizens. The total contribution amount varies from city to city; but generally speaking, foreigners will have to pay 15% or more of their salaries to China's social security fund.

The measure is not entirely new. The requirement for Hong Kong, Macau and Taiwan residents working in China to pay social security contributions was first mentioned in the PRC Labour and Social Security Decree No. 26 issued by the Ministry of Labour and Social Security on 14 June 2005. Although

Decree 26 took effect on 1 October 2005, this requirement has not been strictly enforced.

The new social insurance law makes employers responsible for registering employees for social security contributions within 30 days of their employment. Those who fail to do so or fail to pay social security contributions for them will be fined between one to three times the amounts of the outstanding contributions. A daily surcharge of 0.05% will also be imposed on the contributions concerned.

On 10 June 2011, the Ministry of Human Resources and Social Security issued a notice calling for public consultation on Article 97 of the new social insurance law, the one that requires foreigners to contribute to social security funds. The consultation period ended on 17 June 2011.

The above developments lead us to believe that China will more stringently enforce the participation of foreigners in the social security contribution system in future. Following the public consultation period, we can expect further detailed administrative measures regarding the implementation of the new requirement to be released later this year.

## Amendments to Individual Income Tax aim to improve wealth distribution

The 11th National People's Congress passed to amend the Individual Income Tax Law on 30 June 2011. The amendments aim to achieve better income distribution by reducing income gaps between taxpayers with different income levels and will become effective on 1 September 2011.

Their key points can be summarised as follows:

### a. Increased monthly deductions

Individual Income Tax returns are filed on a monthly basis in China. The amended Individual Income Tax Law increases the monthly standard deduction for local Chinese citizens from RMB2,000 to RMB3,500.

It is unclear whether this change would also increase the monthly standard deduction for expatriates, for whom a monthly deduction of RMB4,800 is currently available.

### b. Changes in tax brackets

Under the current Individual Income Tax Law, there are nine tax brackets ranging from 5% to 45%, with increments of 5% between each bracket. The amended law reduces the tax brackets from nine to seven by eliminating the 15% and 40% tax rates.

Comparisons between old and new tax brackets:

Current Individual Income Tax Law				Amended Individual Income Tax Law (Effective on 1 September 2011)			
Income after standard deduction		Tax rate		Income after standard deduction		Tax rate	
RMB		%		RMB		%	
0	-	500	5	0	-	1500	3
501	-	2,000	10	1501	-	4,500	10
2,001	-	5,000	15				
5,001	-	20,000	20	4,501	-	9,000	20
20,001	-	40,000	25	9,001	-	35,000	25
40,001	-	60,000	30	35,001	-	55,000	30
60,001	-	80,000	35	55,001	-	80,000	35
80,001	-	100,000	40				
	Over	100,000	45		Over	80,000	45

One significant change would be that a taxpayer would be subject to Individual Income Tax at 45% if his or her monthly taxable income reaches RMB80,000. Only monthly taxable income of RMB100,000 or more currently falls within the 45% tax bracket under the existing law.

The amended Individual Income Tax Law aims to achieve better income distribution by requiring high-income earners to pay more tax. Low-income taxpayers would be benefited due to the increased monthly deduction.

About 28% of China's workforce is subject to Individual Income Tax under the existing tax

brackets. After the amendments take effect, this figure will be significantly reduced. Clearly, higher income tax payers would have to shoulder a greater tax burden.

#### What Next?

##### For Foreign Employees

All foreign employees working in China should carefully evaluate the combined impact of their liabilities under the amended Individual Income Tax Law and their contributions under the new social insurance law. What will be their net take-home pay under the new measures? Do they have a tax equalisation scheme in place? Who will be responsible for the additional burdens?

##### For Foreign Employers

Foreign employers who intend to assign foreign employees to work in China must review and calculate the additional costs to their company. What is its policy for coping with such changes?

Everyone should carefully follow future developments in this area, as they will have a huge impact on the financial position of foreign workers in China.

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## BDO ANNUAL RESULTS FOR 2010

In its Annual Statement 2010, BDO reports that the fee income for all its member firms – including the exclusive members of its US and Spanish member firms' alliances – amounted to €3.893 billion / US\$ 5.284 billion during the year ended 30 September 2010.

This represents an increase of 4.92% in Euro terms compared to the previous year, and an increase of 5.11% in US dollars.

Asia Pacific was BDO's fastest-growing region in 2009/10, with an increase in its combined fee income of 32%. This was driven by the Chinese firm's rapid expansion, supported by substantial growth in almost every other firm in the region and the benefits of last year's merger in Hong Kong. In terms of fees split by service lines, there was very little change from 2008/09. Audit and accounting continued to produce almost 61% of combined fee income, while tax and advisory services remained steady at 19% and 20%, respectively.

Jeremy Newman, BDO's CEO commented that it was a creditable performance, given

the challenging economic climate. "We can be very pleased that, despite difficult market conditions, our overall revenues have grown by some 5% in both Euro and US dollar terms. Clearly, the substantial expansion of our Chinese firm had a significant effect — its revenues increased 65% over the prior year and they now amount to over €149 million."

Albert Au, Chairman & Chief Executive of BDO Hong Kong, added: "As its Hong Kong member firm, we are happy to have contributed to BDO's continued success. Our 2009 merger was followed by another one in late 2010. So, in less than two years, our headcount and business have both doubled. With 50 partners, more than 1,000 staff and approximately 200 listed clients, we have further fortified our leading position in the profession, and we are looking forward to an even more successful 2011."

If you wish to obtain a copy of the BDO Annual Statement 2010, please visit [www.bdo.com.hk](http://www.bdo.com.hk) or contact us via [info@bdo.com.hk](mailto:info@bdo.com.hk).



# A NEW ORDINANCE TO COMBAT MONEY LAUNDERING AND TERRORISM FINANCING, AND HOW FINANCIAL INSTITUTIONS MUST ADDRESS THESE ISSUES

## Background

Every year, trillions of dollars are laundered to disguise the fact that they are the proceeds from criminal activities, such as illegal arms trading, drug trafficking, bribery and corruption, insider trading and embezzlement, as well as other white-collar crimes like computer fraud and tax evasion. Some of this money is also linked to terrorism.

Hong Kong's well-developed regulatory regime to combat money-laundering has been in place for many years. It encompasses a legal structure to counter money laundering, with measures to trace, restrain and confiscate illicit proceeds. The legislation associated with this includes the Drug Trafficking (Recovery of Proceeds) Ordinance, and the Organised and Serious Crimes Ordinances. In addition, financial regulators such as the Hong Kong Monetary Authority (MA), Securities and Futures Commission (SFC) and Hong Kong Insurance Authority (IA) have promulgated Anti-money laundering (AML) guidelines and codes of practice under these ordinances. The enforcement authorities involved in this area are the Independent Commission Against Corruption (ICAC) and the Joint Financial Intelligence Unit (JFIU). The latter is a joint enforcement unit staffed by the Hong Kong Police Force and the Customs and Excise Department (C&ED).

## Changes to the existing regime

After rounds of public consultations and hearings, the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Bill was gazetted on 29 October 2010. Its aim is to improve the AML/CTF regime by aligning the local financial sector more closely with prevailing international standards, and thus reinforce Hong Kong's status as a global financial centre. The Legislative Council has started to examine the Bill, and the Government expects it to be implemented on 1 April 2012. Its full text is available on the Government's website (<http://www.gld.gov.hk/egazette>).



The Financial Action Task Force (FATF), an inter-governmental body responsible for developing and promoting national and international policies to combat money laundering and terrorist financing, has evaluated Hong Kong's existing AML/CTF regime. In its report, it points out that the city lacks statutory backing and appropriate sanctions for customer due-diligence (CDD) and record-keeping requirements. It also notes that regulators have only a limited range of supervisory and enforcement powers, and the absence of an AML/CTF regulatory regime for money service operators MSOs (such as remittance agents and money changers).

The Bill's main proposals are:

- Codification of the CDD and record-keeping requirements of financial institutions. Its measures concerning these are in line with the prevailing international standards, which are being promoted by the FATF. They are also substantially the same as the existing requirements in administrative guidelines issued by the MA, SFC and IA.
- Supervisory and criminal sanctions for contravention of statutory CDD and record-keeping requirements.
- Empowerment of the MA, SFC, IA and C&ED to supervise compliance with the statutory requirements by relevant financial institutions.

- Establishment of a licensing regime for MSOs, which will be administered by the C&ED.
- Establishment of an independent review tribunal to review the decisions of relevant authorities about imposing supervisory sanctions and licensing matters related to MSOs.

## Looking ahead

Other than the new requirements for MSOs, the changes to the AML/CTF regime contained in the Bill are mainly about codifying requirements that have already been put in place by the regulators of banking, insurance and securities firms. But there are still holes to be plugged. One area mentioned in the FATF evaluation report that is not covered by the proposed new legislation is the need to enhance the AML/CTF regime for designated non-financial businesses and professions, such as real estate agents, dealers in precious metals, lawyers and accountants.

## Internal Controls

A country whose financial and commercial sectors facilitate money laundering and terrorist financing – or which is even perceived to be under the influence of organised crime and terrorists – will be unable to create an environment that allows for its sustained economic development. Instead, it will only foster an atmosphere that is conducive

to criminal pursuits and corruption. The managements of financial institutions have a responsibility to ensure that their organisations do not help money launderers and terrorist financiers in carrying out their illicit activities.

Compliance with all the relevant statutory and regulatory AML/CTF requirements is essential if financial institutions are to protect their integrity and reputations. Therefore, they need to understand the risks that are associated with money laundering and terrorist financing, and put their own controls and systems (AML/CTF programme) in place to deal with them effectively.

A successful AML/CTF programme encompasses a number of critical elements. These are governance, risk assessment, specific control procedures, information sharing and reporting, and monitoring.

Governance and leadership are the fundamental ingredients of such a programme. An institution's board needs to create an AML/CTF culture and emphasise its importance via policy statements. It must encourage AML/CTF accountability throughout the institution. It should designate the officials who will be responsible for maintaining the senior leadership's commitment to the programme, setting and directing its strategies, and establishing institution-wide compliance processes.

The programme should not be a "cut-and-pasted" version of the legal requirements. Instead, it has to be customised according

to an institution's business risk profile and operations.

To be effective, an institutional AML/CTF programme must:

- Focus on and direct resources to high-risk areas, and undertake enhanced due diligence wherever necessary (eg for customers and business lines that pose greater risk). At the same time, it should ensure that low-risk customers do not suffer from unduly burdensome procedures and requirements.
- Design and implement appropriate policies and control procedures. They must cover compliance; governance; know your customer; detection, investigation and reporting of suspicious activity; and record keeping and monitoring.
- Institute know-your-customer and CDD procedures in accordance with risk prospects and business lines, and investigate high-risk customers.
- Develop automated transaction-monitoring controls to identify "red flag" (suspicious) transactions.
- Develop sanctions and compile lists of undesirables.
- Establish adequate communication channels to ensure that accurate and high-quality information about the programme is shared and reported in a timely way.

- Find ways to share information with other institutions while preserving customer confidentiality.
- Formulate processes and controls to ensure that any escalation of suspicious activity is investigated and/or reported to law enforcement bodies.
- Build awareness and conduct training about the detection and reporting of key money laundering risks, and develop and distribute relevant training programmes and materials.
- Ensure compliance with the statutory and regulatory regime and the internal programme through systematic, transparent and effective monitoring and internal audit systems.

### Conclusion

A robust AML/CTF regime plus effective AML/CTF programmes in its financial institutions will help Hong Kong combat money laundering and terrorist financing and fight crime. It will also enhance the city's status as an international financial centre and thus contribute to its sustainable long-term economic development.

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## CORPORATE GOVERNANCE REVIEW

**T**he BDO Corporate Governance Review 2010, our fifth annual research report on governance practices and disclosures reveals how the performance of 200 major Hong Kong-listed companies measured up against the Code on Corporate Governance Practices. It contains a complete set of consolidated survey results and provides a good reflection of the state of corporate governance in Hong Kong.

Since the introduction of the Hong Kong Code on Corporate Governance Practices in 2005, our Risk Advisory Services team has worked extensively with listed companies and their board members, to guide them in their

pursuit of compliance with the Code and the achievement of corporate governance best practices.

In continuation of our role as specialist advisors in this area and to further promote education and knowledge management on good corporate governance, we are pleased to conduct this research and issue this report annually. In its fifth iteration, we not only could track overall compliance with the Code, but also identify critical areas that we could target as we strive to help lead the global advance towards more effective corporate governance.

For a copy of the research report or more information, please visit [www.bdo.com.hk](http://www.bdo.com.hk) or contact us via [info@bdo.com.hk](mailto:info@bdo.com.hk)



# SPOTLIGHT: CARBON TRADING – THE WAY FORWARD?

## Overview

A global initiative to cut greenhouse gas (GHG) emissions emerged from the 1997 Kyoto Protocol. Governments, environmental agencies and financial institutions initiated platforms that would make it possible for carbon to be traded as a soft commodity in the form of carbon credits and other complex financial products, such as derivatives and exchange-traded funds. The intention was that carbon trading would allow companies to sell any rights to emit CO<sub>2</sub> to other companies who needed those options.

Carbon trading refers to a scheme whereby governments or international bodies set an overall limit on the amount of carbon that can be emitted. It enables companies who emit more than the permitted amount of carbon to buy additional credits on the open market, and those who emit less to sell their spare credits.

The Kyoto Protocol agreement was a hesitant and imperfect first step on the path to reducing emissions, with the goal that developed economies would cut their emissions by about 5% by 2008-2012, compared with emissions in 1990. The Kyoto Protocol came into force in February 2005, and the European emissions-trading scheme was established as the world's largest carbon market in January 2005. This market set a carbon price, thus providing a platform and incentive for regulated companies to reduce their emissions.

In a typical "cap-and-trade" scheme, a government issues a total number of permits or allowances giving companies the right to emit pollution. These allowances are less than what

the companies typically need. Consequently, they have a value and can be traded for a price. The trading price provides firms with an incentive to decrease their emissions, as this is cheaper than purchasing allowances. The overall objective is that, over time, the number of allowances in circulation will be reduced as emissions decline<sup>1</sup>.

The amount of carbon capital is determined by the Clean Development Mechanism (CDM), which issues Certified Emissions Reductions (CERs). The rationale for the CDM is that industrialised countries who need to reduce their greenhouse gas emissions can invest in projects that lower emissions in developing countries, rather than cut emissions themselves. In theory, that allows overall global emissions to be reduced at lower cost. Carbon credits would be earned by the creation of environmental projects, generally in developing countries.

## Market Analysis

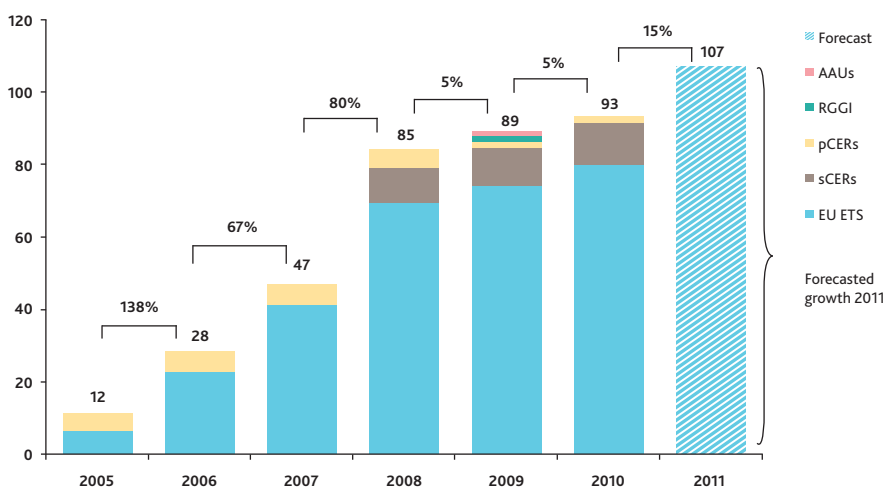
The CDM allows developing countries to sell their CERs to developed countries. One example is clean coal technology. As a leader in the global supply of CERs, China has an influence on their overall market price. In fact, it accounts for 61% of the global supply of CERs, followed by India with a 12% share. China, India, Malaysia, Thailand and South Korea together generated around 80% of all the CERs in 2009<sup>2</sup>. Many foreign countries use China's relatively stable price floor as a basis for negotiating near-equivalent prices in their CER transactions<sup>3</sup>.

According to Oslo-based research firm Point Carbon, the global carbon trade crossed the €85 billion threshold in 2008 with an increase of 80% on the previous year's figure. In terms of volume, 5 billion tonnes of carbon dioxide equivalent credits were traded. However, there was only 5% growth in 2009 and 2010. Bloomberg New Energy Finance recently released its annual forecast of the 2011 global carbon market. It estimates the market will reach a total value of €107 billion in 2011 – a 15% increase over 2010's €93 billion (see table below).

Europe will continue to dominate the global carbon market, with the European Union Emissions Trading Scheme (EU ETS) accounting for 81% of total trades in 2010. The predicted rise in value of the global carbon market will largely be driven by a boost in demand for allowances from utilities in the EU ETS<sup>4</sup>. At present, almost all the CERs are purchased by European companies and governments to meet their own emission-reduction targets under the Kyoto protocol. The EU ETS currently covers over 10,000 energy and manufacturing companies, and it plans to include airlines, petrochemical companies and aluminium producers between 2012 and 2020.

The bulk of CER trading takes place through brokers, bilateral agreements and personal negotiations. At the start of 2011, there were at least five main markets for trading carbon allowances – the Chicago Climate Exchange, European Climate Exchange, Nord Pool, PowerNext and European Energy Exchange<sup>5</sup>.

Projected carbon market size 2005-2011 (EURbn)



Source: Trading figures taken from ECX from Bloomberg, ECX, Bluenext, EEX, CCX, Nordpool, other sources include UNFCCC and our own Bloomberg New Energy Finance estimations

1. Climate Bridge, <http://www.climatebridge.com/>
2. "Asia switches on to the carbon market" Climate Change Corp. <http://www.climatechange.org/content.asp?ContentID=5518>
3. "China has bigger role to play in carbon trading" China.org.cn, <http://www.china.org.cn/english/environment/231869.htm>
4. Carbon Capitalist "Global Carbon Market Value to Increase by 15% in 2011", <http://carboncapitalist.com/global-carbon-market-value-set-to-increase-by-15-in-2011/>
5. Climate Action "Carbon Reduction Guide, Understanding carbon credits", [http://www.climateactionprogramme.org/carbon\\_reduction/carbon\\_dioxide\\_emissions\\_understanding\\_carbon\\_credits/#](http://www.climateactionprogramme.org/carbon_reduction/carbon_dioxide_emissions_understanding_carbon_credits/#)

However, the United Nations' continued failure to reach a global consensus to reduce GHG has had dire consequences for the carbon trading markets. The price of carbon credits has been falling since the failed Copenhagen climate talks in December 2009. The Japanese declared the Kyoto Protocol unworkable at the subsequent climate summit in Cancun in November 2010. The Chicago Climate Exchange, set up in 2000 and recently bought out by the Intercontinental Exchange, closed its carbon-trading platform in January 2011. Meanwhile, the European scheme was recently rocked by the discovery of carbon credit thefts.

#### Current Outlook

Many researchers and analysts have been predicting the beginning of the end for carbon markets without a global deal to restrain companies in developed economies like the USA. That was, however, before the devastating earthquake and tsunami in Japan and the subsequent radiation leak at the crippled Fukushima Dai-Ichi nuclear plant. Many countries, including Germany and China, are now reviewing their atomic energy programmes and carbon prices have spiked since the incident.

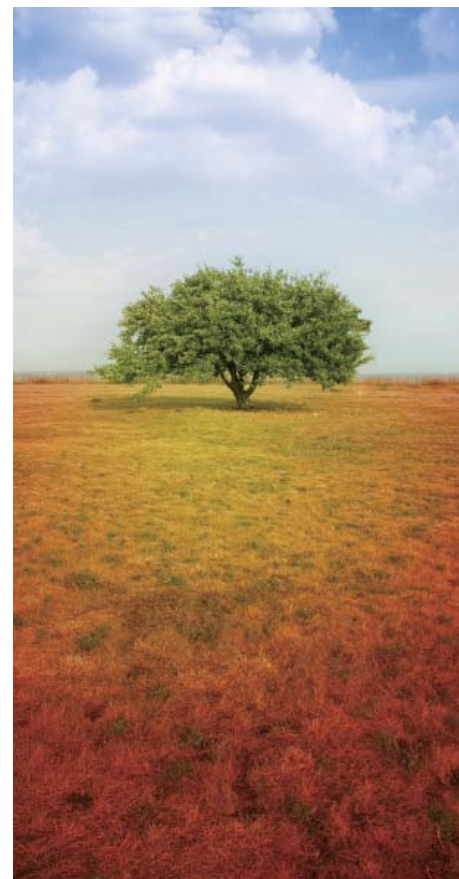
This could perhaps be the wake-up call for governments finally to secure a global climate consensus at the next climate talks in South Africa in November 2011. In the interim, certain countries have implemented their own emissions limitation and trading programmes. India has an incentive scheme that involves renewable energy projects, while the US issues GHG permits in certain states. In China, the China Beijing Environmental Exchange was formed as a platform for carbon credit trade in 2008. It was the first of its kind in the developing world. During the same year, the Tianjin Climate Exchange was established as a domestic carbon market cap-and-trade scheme exchange. China is now considering limited cap-and-trade schemes in other cities, and it could be in pole position to revitalise carbon-emission trading just when the outlook for this market appeared bleak.

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## BDO BACKS THE CHAMBER OF HONG KONG LISTED COMPANIES (CHKLC) DIRECTOR TRAINING SERIES

**B**DO supports the CHKLC Director Training Series of six seminars, spanning April to November in 2011. The seminars are designed to equip company directors with the most-relevant information and up-to-date knowledge concerning the role of directors, and help them to discharge their duties more effectively.

Our partners **Kenneth Yeo**, **Patrick Rozario**, **Ricky Cheng** and **Teresa Lau** will be among the speakers on important aspects of directorship

in listed companies during the CHKLC Director Training Series.

The first session on "Board effectiveness" by Dr Kelvin Wong, Chairman of Hong Kong Institute of Directors and Executive Director and Deputy Managing Director of COSCO Pacific Limited was held on 19 Apr 2011 at BDO's premises.

The second session on the topic of "Coping with the latest CG requirements" by our partners Ricky Cheng and Teresa Lau was

successfully held on 26 May 2011. Ricky and Teresa delivered an informative presentation on the proposed changes to the Code on CG, challenges in complying with the CG requirements, as well as the role of INEDs and company secretaries in CG compliance.

The third session on "Internal control and risk management" by our partner Patrick Rozario was held on 7 Jul 2011. Patrick gave a holistic view on internal control and risk management, as well as the whistle blowing system.

The schedule and topics for the other sessions is as follows:

Dates	Topics
15 Sep 2011	Price Sensitive Information: Updates on Hong Kong's Proposed New Disclosure Regime
13 Oct 2011	Liquidity and Capital Management: A global Perspective
15 Nov 2011	Ensuring the Integrity of Company Transactions

If you are interested in attending them, please enrol with the CHKLC directly. For more information, visit their website: [www.chkcl.org](http://www.chkcl.org)

# HOW A GOOD CORPORATE CULTURE AND CODE OF ETHICAL PRACTICE CAN PREVENT FRAUD

Over the years, I have commissioned many internal investigations into suspected irregularities and fraud in companies. Although a number of the organisations concerned already had sound internal control policies in place and carried out regular internal and external audit functions, they were still not immune from becoming the victims of fraudulent activities. What was the problem? Why didn't their allegedly well-established "firewalls" prevent fraud? Is there a perfect internal control system that can eliminate every form of it in an enterprise?

In fact, regardless of how perfectly or rigorously an internal control system is designed, it may still be compromised unless it applies to everybody inside and outside the organisation. Unfortunately, I have seen many examples of where companies became victims, not because they lacked codes of good practice or internal control policies, but because there were too many exemptions from them. A survey shows that more than 70% of serious commercial fraud cases involve senior executives, including long-serving and highly trusted employees. In some circumstances, these individuals are the very people who create and then take advantage of loopholes in the control system, thereby undermining its effective implementation.

For example, a few years ago I investigated a fraud case that involved the former CEO of a large water-purification system manufacturer. He had successfully penetrated his company's internal control system. One of the allegations

against him was that he had incurred a considerable amount of personal expenses during his employment, and that he had used his authority and status to mislead the company into reimbursing him for them.

These alleged personal expenses included air fares and accommodation for leisure trips for himself and his family, together with meals, transportation, car-rental fees, gasoline, etc. Of course, as the CEO, he often made business trips; so it was believed some of these expenses were legitimate and necessary. However, due to his status and the nature of his work, coupled with a lack of supervision, he was able to abuse the system. For example, the records revealed that, for three consecutive years, he and his family members had taken vacations in the same ski resort in February or March, and that he had routinely booked all the costs to his employer's expense account. There were also other suspicious charges, such as groceries, wine, caviar, electronic digital cameras and MP3 players.

During an interview, the former CEO claimed the transactions were all business related. He explained that, during the family vacations, he had used his personal time to visit customers, promote products and network. The pricy electronic gadgets and luxurious foodstuffs were bought as gifts for customers. However, he was unable to recall who those customers were, because it had happened a long ago and he had not kept detailed records. Of course, we could not rule out that some of his claims

might be true. But the total amount ran to millions of dollars, which gave rise to suspicion. In fact, the accounting personnel had noted these abnormal transactions and felt doubtful about them. Yet, they remained silent because they involved the company's top executive, and the head of the accounting department had approved the expense claims. As a result, the company was victimised, and the shareholders had to suffer the loss.

Another case involved the marketing head of a refining industry company in North America. He was required to travel regularly as part of his duties, so he incurred a large amount in business expenses every month. Soon after taking the job, he began to see this as a golden opportunity to defraud his employer. Like many other perpetrators, he started his misconduct on a small scale and it gradually became more serious.

His trick was simple. He would attach receipts for personal or non-business-related transactions to his expenses claim form at the end of each month. During the first few months, he would only occasionally add some receipts for items like food or personal daily necessities. Since no one queried these, he became more confident that he could conceal his fraud. A few months later, he proposed a change to the procedure for claiming his expenses. He would provide the accounting department with copies of his credit card statements as the only proof of his expenses. He would not need to submit the original





receipts, in case they got lost. He succeeded in convincing his boss to accept this proposal, which effectively gave him a licence to defraud.

It should be noted that many North American business executives use their personal credit cards to pay for business expenses, and they are subsequently reimbursed by their employers. Therefore, they commonly submit their credit card statements as proof of the expenses incurred. But these are normally supported by vendors' receipts.

Having got the green light to proceed with his deception, the marketing executive began to charge personal and family expenses to the company's account by manipulating his credit card statements and submitting bogus receipts. An investigation into these statements and receipts showed he had drawn large sums in cash advances on his credit card, and then altered the statements to disguise them as gasoline, vehicle-repair or car-wash costs. On the other hand, he routinely collected irrelevant receipts to support his purported business expenses. As the critical vendor information on these receipts had been altered, these transactions were difficult to trace. Unfortunately, the company's accounting staff were too busy to verify the transactions, so they accepted and processed the claims for them.

How much money did this executive's dishonest acts involve? A detailed investigation into the expense claim forms, bank statements, bogus receipts and other evidence confirmed he had misappropriated over HK\$2 million in about three years!

The perpetrators in both of these cases were not unusually clever, nor were their methods sophisticated. Rather, they were blatant and inferior. In the latter case, the culprit would have needed to drive around the city for four hours non-stop every day to use up the quantity of fuel he was claiming on his expense forms. In fact, this would have been impossible for him to do, and the amounts shown on the statements were actually cash advances. In addition, the records showed he had visited two or three petrol stations during one afternoon, and had his car repaired and/or washed every other day. He also ate two business meals some afternoons! In addition, many of his so-called business lunches took place during weekends, or while he was on annual leave. Greedy as it may seem, he even altered the receipt for a haircut every other week to make a claim! Amazingly, he never got caught during his three years of employment, thanks to his luck, the lax corporate culture, and the fact that some staff members turned a blind eye to what he had been doing.

A company will be able to cut down on employee fraud if it has a good corporate culture and a clear code of ethics in place. However, to be effective, any control system must apply to everyone, without exception. Ideally, it should also be promoted and implemented by one or more key senior management members. In addition, a safe and secure mechanism should be established that will allow whistleblowers to voice their suspicions; and employees should be encouraged to report any unusual transactions or potential breaches of the conduct rules by

any person inside or outside the organisation, regardless of his or her status. All reported incidents should be treated seriously and investigated thoroughly. Last, but not least, training for all staff members about proper ethical behaviour is a key measure for preventing fraud.

Developing a full-scale monitoring and investigation mechanism may not be cost-effective for small and medium-sized enterprises. As an alternative, they could sponsor staff members to enrol in relevant training and seminars on business ethics, so as to strengthen their grasp of business ethics. In addition, businesses might seek external help in designing and establishing a sound and proper corporate governance system that is capable of preventing fraud. They can conduct spot checks when required at a reasonable and affordable cost.

Many organisations face similar challenges: insiders who seek opportunities to circumvent their control firewalls and take advantage of loopholes. Although no single control or preventative system can eliminate fraud, a good and well-defined corporate culture and code of ethics can effectively reduce and detect its occurrence, and enhance a company's business results.

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## BDO WINS FOUR BRAND AWARDS

**B**DO's rebranding was recognised in the UK's Communicate Magazine Transform Awards 2011 with four honours in the following categories:

- GOLD award for Best Brand Evolution
- GOLD award for Best Implementation of a Rebrand
- SILVER award for Best Internal Communication of a Rebrand
- SILVER award for Best Corporate Rebrand to Reflect Changed Mission/Values/Positioning

The BDO rebranding project was commissioned to align with the adoption by every member firm in its international network of a single global trading name. Its visual identity was fully refreshed with a comprehensive brand, engagement and implementation strategy throughout the BDO network. The rebranding campaign has resulted in a strengthened and unified brand that spans BDO's presence in over 120 countries.

For a related press release, please visit [www.bdo.com.hk/news.php](http://www.bdo.com.hk/news.php)



# LESS IS MORE: NEW FINANCIAL REPORTING FRAMEWORK FOR HONG KONG SMEs

On 9 July 2009 the International Accounting Standards Board (IASB) issued an IFRS designed for use by small and medium-sized entities (SMEs). On 30 April 2010 the HKFRS for private entities (PEs) was issued as a new financial reporting option in Hong Kong for PEs with immediate effect, which is based on the IFRS for SMEs. As a result, Hong Kong now has three financial reporting frameworks:

- Full HKFRSs – for publicly accountable entities and non-publicly accountable entities that choose to adopt.
- HKFRS for PEs – for non-publicly accountable entities.
- SME-FRF&FRS – for Hong Kong incorporated companies eligible for claiming relief under s141D of the Companies Ordinance and other companies meeting the eligibility requirements contained in SME-FRF & FRS.

## New concepts and principles

The HKFRS for PEs has introduced new concepts and principles that are different from the full HKFRSs. These new concepts and principles have simplified the complexity of financial reporting without reducing the value of financial reporting by SMEs, and include:

- Cost-benefit considerations;
- Simplified accounting; and
- Presentation and disclosure simplifications.

## Cost-benefit considerations

In order to provide additional relief to preparers of financial statements under the HKFRS for PEs, an "undue cost or effort" principle has been introduced in some sections of the HKFRS for PEs to replace the "impracticability" relief criterion in the full HKFRSs. Applying a requirement is considered to be "impracticable" when the entity cannot apply it after making every reasonable effort to do so. Although not defined, the notion of "undue cost or effort" focuses on the concept of balancing costs and benefits which, in turn, might require management's judgment of when a cost is considered to be excessive. In other words, the "undue cost or effort" principle implies that cost is always a key element to be considered.

## Sections 14 & 15 – Investments in associates and joint ventures

An entity using the fair value model is required to use the cost model for any investment for which it is impracticable to measure fair value reliably without cost or effort.

## Section 16 – Investment property

An investment property whose fair value can be measured reliably without undue cost or effort shall be measured at fair value. An entity shall account for all other investment property as PPE using the cost-depreciation-impairment model.

## Section 21 – Provisions and contingencies: disclosures about contingent assets

If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an entity shall disclose a description of the nature of the contingent assets at the end of the reporting period, and, when practicable without undue cost or effort, an estimate of their financial effect.

## Section 28 – Employee benefits: actuarial valuation method

If an entity is able, without undue cost or effort, to use the projected unit credit method to measure its defined benefit obligation and the related expense, it shall do so. If an entity is not able, without undue cost or effort, to use the projected unit credit method to measure its obligation and cost under defined benefit plans, the entity is permitted to make simplifications in measuring its defined benefit obligation with respect to current employees.

## Section 34 – Specialised activities: biological assets

An entity using this HKFRS that is engaged in agricultural activity shall determine its accounting policy for each class of its biological assets as follows:

- The entity shall use the fair value model for those biological assets for which fair value is readily determinable without undue cost or effort.
- The entity shall use the cost model for all other biological assets.

## Simplified accounting

The more useful simplifications are highlighted below which represent only a selection of the listed simplifications.

## Borrowing costs and research and development costs

For cost-benefit reasons, all charged as expenses as incurred and capitalisation is not allowed.

## Financial instruments accounting

Accounting complexity is reduced by limiting the classification categories, specifying a

measurement attribute and limiting the use of other optional measurement attributes:

- Classification of financial instruments. Financial instruments that meet specified criteria are measured at cost or amortised cost, and all others are measured at fair value through profit or loss. The available-for-sale and held-to-maturity classifications in HKAS 39 are not available.
- Derecognition. The HKFRS for PEs establishes a simple principle for derecognition. That principle does not rely on the "pass-through" and "continuing involvement" provisions that apply to derecognition under HKAS 39. Those provisions are complex and relate to derecognition transactions in which SMEs are typically not engaged.
- Hedge accounting. The HKFRS for PEs focuses on the types of hedging that SMEs are likely to do, and requires periodic recognition and measurement of hedge ineffectiveness, but under less strict conditions than those in HKAS 39.

## Simple accounting for PPE and intangible assets other than goodwill

For cost-benefit reasons, PPE and intangible assets other than goodwill are accounted for as follows:

- only the cost model is allowed;
- annual review of estimated useful lives, residual value, depreciation/ amortisation



method is required only when there is an indication of changes affecting the assets, not annually;

- impairment testing is required only when there is an indication of impairment, not annually; and
- all intangible assets are considered to have a finite useful life, and only if useful life cannot be reliably estimated, then it is presumed to be ten years.

#### Simple accounting for goodwill

For cost–benefit reasons, rather than conceptual reasons, goodwill is accounted for as follows:

- all assumed to have a finite useful life and are amortised over their estimated useful lives;
- only if useful life cannot be reliably estimated, then it is presumed to be ten years;
- impairment testing is required only when there is an indication of impairment, not annually; and
- no impairment reversal is allowed.

#### Cost method and fair value model allowed for associates and joint ventures

Recognising the special problems of SMEs in applying the equity and proportionate consolidation methods, and also the relevance of fair values for lenders, the cost method or fair value through profit or loss is permitted as an accounting policy choice which should be applied to the whole class of associates or joint ventures.

#### No special accounting for non-current assets held for sale

No separate held-for-sale classification for cost–benefit reasons, as it is felt that an accounting result similar to that of HKFRS 5 could be achieved more simply by including intention to sell as an indicator of impairment.

#### No recycling for exchange differences on monetary items

An exchange difference that is recognised initially in other comprehensive income is not reclassified in profit or loss on disposal of the investment in foreign subsidiary. Not requiring reclassification is less burdensome for SMEs because it eliminates the need for tracking the exchange differences after initial recognition.

#### Simplified share-based payments calculation

Expense for equity-settled share-based payments is measured on the basis of observable market prices, if available. If observable market prices are not available, SMEs should measure the expense using the directors' best estimate of the fair value of the equity-settled share-based payment.

#### Presentation simplifications

On the basis of the needs of users of SME financial statements and costs to smaller entities, the HKFRS for PEs has reflected the following simplifications of financial statement presentation:

- An entity should not be required to present a statement of financial position as at the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.
- An entity is permitted to present a single statement of income and retained earnings (SIRE) in place of separate statements of comprehensive income and changes in equity if the only changes to its equity during the periods for which financial statements are presented arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy.
- All deferred tax assets and liabilities are classified as non-current assets or liabilities.

#### Disclosure simplifications

The disclosure requirements in the HKFRS for PEs are substantially reduced, and the reasons for the reductions are of four principal types:

- they relate to topics covered in the full HKFRSs that are omitted from the HKFRS for PEs;
- they relate to recognition and measurement principles in the full HKFRSs that have been replaced by simplifications;
- they relate to options in the full HKFRSs that are not included in the HKFRS for PEs; and
- some disclosures are not included on the basis of users' needs or cost–benefit considerations.

The following are examples of disclosure reduction:

- not required to disclose the fair value of the carrying amount for PPE and investment property on cost model;
- not requiring the vast majority of the disclosure requirements of HKFRS 7 – Financial instruments: disclosures;
- not required to disclose all the estimates used to measure recoverable amount of cash-generating units containing goodwill; and
- for disclosure relating to income taxes, only required to provide an explanation of the significant differences in amounts reported in the statement of comprehensive income and amounts reported to tax authorities.

#### Concluding remarks

The types and needs of users of SME financial statements are often different from the types and needs of users of public company financial statements and other entities that would probably use the full HKFRSs. The full HKFRSs are designed to meet the needs of equity investors in companies in public capital markets. Users of the financial statements of SMEs don't generally have those same needs. Rather, users of the financial statements of SMEs are more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage and solvency issues. Also, the full HKFRSs impose a burden on SME preparers in that the full HKFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as the full HKFRSs have become more detailed and subject to more frequent changes.

As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective. The HKFRS for PEs is therefore designed to meet that need. With the issuance of the HKFRS for PEs, many SMEs will have the option of using a much simplified, HKFRSs-based accounting framework to prepare their financial statements. Although they are more simplified, they may better serve the information need of SMEs' financial statements users.

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## HKICPA'S SPECIALIST DESIGNATION IN INSOLVENCY

**B**DO's managing partner Johnson Kong who also chairs the Restructuring & Insolvency Faculty Executive Committee of HKICPA, and partner Andy Choi have been awarded the newly introduced "Specialist Designation in Insolvency" by the Hong Kong Institute of Certified Public Accountants (HKICPA), effective 1 July 2011.

According to HKICPA, "only CPAs who can demonstrate... that they have sufficient experience, as well as industry-leading technical and practice skills, are awarded this prestigious designation". The "prestigious title is only held by the very top experts in the

field" and "is meant for CPAs who have many years of experience in insolvency practice" and "must have competency at mastery level in at least one of the three main areas of insolvency practice – corporate insolvency, corporate rescue and restructuring, or personal insolvency

– at advanced level in a second, and at basic level in a third."

There were only 32 awardees in this first batch of "Specialist Designation in Insolvency" accreditation.



## BDO HKFRSs / IFRSs UPDATES

### A Guide to the new Hong Kong Financial Reporting Standards 2010

**B**DO issued the *Update on the New and Revised HKFRSs 2010* in February 2011. It provides an overview of the Standards that became mandatory for the first time for 2010 year-ends, as well as those available for early adoption for 2010 year-ends.

### Latest Developments on the IAS 39 Financial Instruments Replacement Project

The Update on Latest Developments on the IAS 39 (HKAS 39) Financial Instruments Replacement Project - Hedging, Impairment and Offsetting was issued in January 2011. This focuses on the recent IASB activities concerning the IAS 39 Financial Instruments Replacement Project, particularly hedging, impairment and offsetting.

### Accounting for subsidiaries, joint arrangements and associates, and disclosures of interests in other entities

This publication intends to provide you with an overview of five new and amended IFRSs issued by the IASB on 12 May 2011, which set out new requirements for consolidation, joint arrangements and disclosure of interests in other entities.

### Update on IAS 39 Replacement Project Phase 2 - Financial Instruments: Impairment

The objective of IAS 39 Replacement Project Phase 2 is to improve the decision-usefulness of financial statements for users by improving the amortised cost measurement, in particular the transparency of provisions for losses on loans and for the credit quality of financial assets.



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