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Examination Techniques Seminar on QP Final Examination

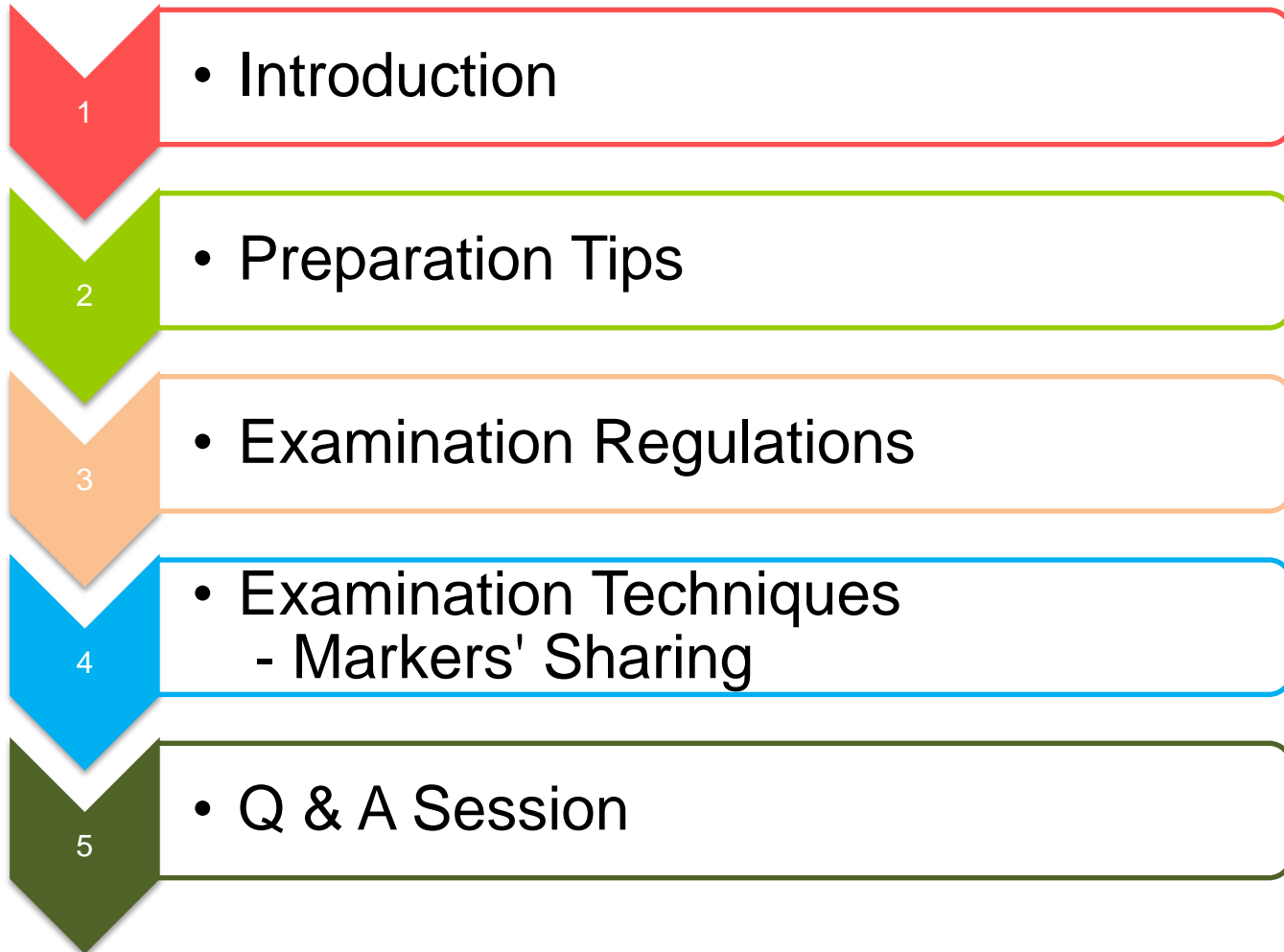
(December 2018 Session)

Date: 11 October 2018

**By: Ms. Lusa Lam
Associate Director**



Agenda





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Part 1: Introduction



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Today's objective:
***Finding ways to pass the
Final Examination!***



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HKICPA QP Final Examination

Examination Format:

- Paper I and Paper II (Open book)
- 3.5 hours duration for each Paper (included 30 minutes reading time)
- All compulsory questions
- Requirement to apply technical knowledge to case scenario on practical and businesses
- Requirement to apply technical knowledge from more than one discipline to the same case scenario



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Part 2: Preparation Tips



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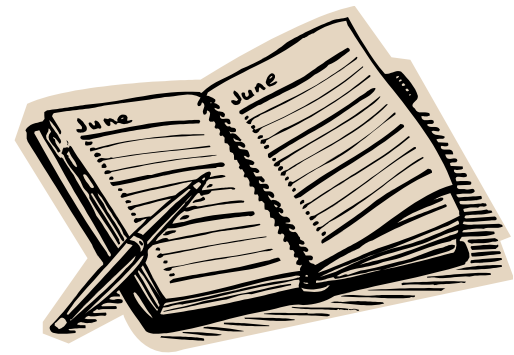


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Commit to your Study Plan

Advantages:

- Schedule ahead
- Build long term memories → maximize efficiency
- Avoid last minute work and minimize impact of unpredicted events...





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Prepare Critical File

How to prepare:

- Use different colour post-it for different standards / topics
- Organise materials by different standards / topics
- Understand theories behind each standards / topics
- Get familiar with this file

Advantages:

- Colour coding for standards / topics allows easy identification (same file used in examination – time saving!)
- Build up long term memories
- Avoid indexing without understanding

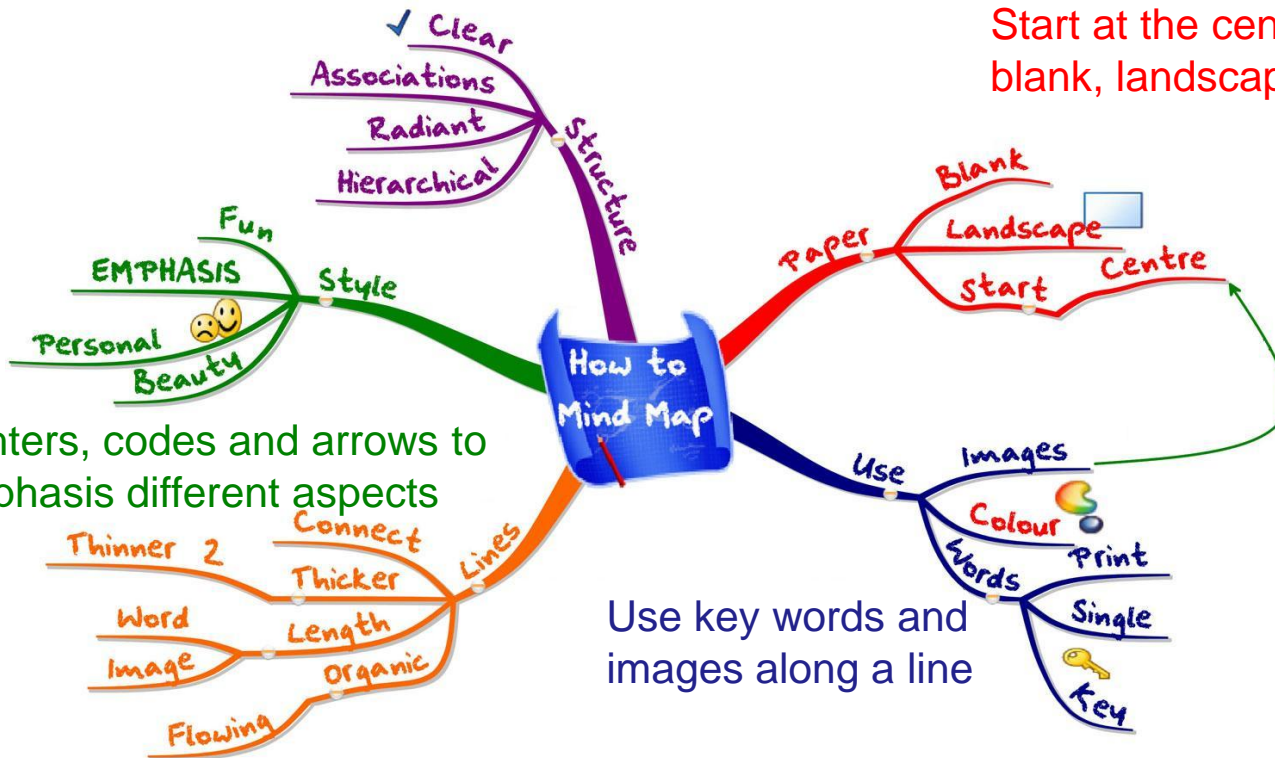


Mind Map

Radiate the ideas out from the central theme and main branches

Start at the centre of a blank, landscape paper

Use highlighters, codes and arrows to link and emphasize different aspects



Use key words and images along a line

Make the lines associate as clear as possible



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Other Preparation Tips

- Cover beyond LP
- Form Study Group with fellow students
- Visit QP Learning Centre
 - Past papers and Examiners' reports;
 - Special topics and/or Important notice; and
 - Module preparation seminar archives



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Part 3: Examination Regulations



Examination Regulations (highlights)

- Bring HKID card and Examination Attendance Docket ("EAD")
- Be aware of the **examination regulations** printed on the EAD which will be posted to students two weeks before the examination
- Arrive 45 minutes before the examination start
- Turn off your mobile phone or other electronic communication devices
- Don't write on the script booklet during the reading time (FE only)
- Don't write your name or personal information on anywhere of your script booklets
- Use blue or black ink pen
- Use appropriate script booklet to answer each section
- Stop writing immediately once the end of examination is announced

Failure to follow any of the examination regulations may result in marks penalty or even disqualification from the entire examination!

Noticeboard

Module A

Module B

Module C

Module D

Final Examination

Examination Support

Technical Articles

Webcasted Video

Audio Archives

Download

I'M INTERESTED IN

[Help for students](#)


[QP timetable](#)

[CPA recruitment - A-List](#)

[Becoming a Hong Kong CPA](#)





Examination guidelines

This [video](#)  provides guidance on preparing for your upcoming examinations. Make sure you are familiar with these guidelines.

If you are unable to open the video by Internet Explorer, try opening it in a different browser (e.g. Chrome).

Examination assistance

Here are some study tips to help QP students to get through their examinations (please click [here](#) ).

To help QP students prepare for the four module examinations, the Institute organizes a series of examination assistance functions for each examination session. For more details, please click [here](#) .



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Part 4:

Examination Techniques

- Markers' Sharing



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Marker 1



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“Attitude is a little thing that makes a big difference” – *Winston Churchill*



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1st action - Read the student handbook

Qualification
Programme



Candidate handbook



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Exam Structure

Final Examination

- Paper 1
 - A case study 75%
 - An essay 25%
- Paper 2
 - A case study 75%
 - An essay 25%

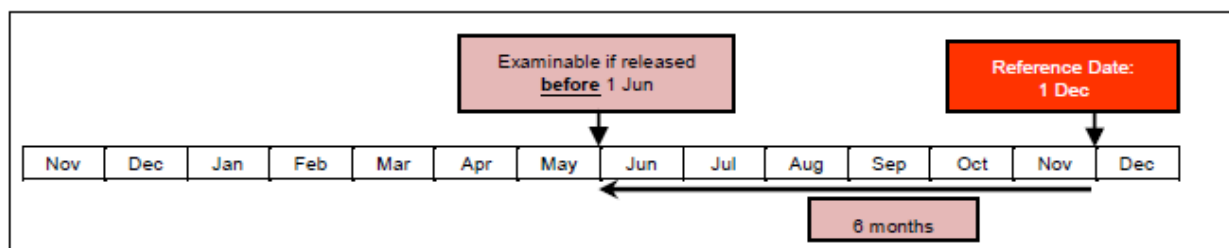
Module Examination

- Case questions 50%
- Essay / Short questions 50%

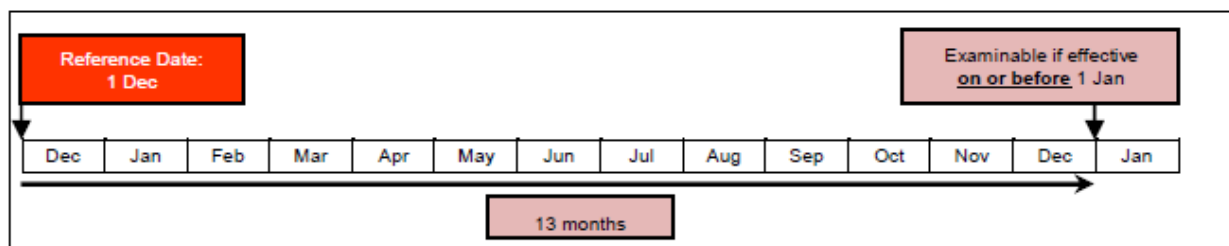


Examinable Content

Condition 1: Have been released six months prior to the **reference date** (the reference date is determined as the 1st day of the month the examination takes place); **AND**



Condition 2: Have been effective / will be effective on or before the 13th month from the **reference date**.





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FE Special Topics

- Special topics are nominated for the final examination
- At least 70 per cent of the examinable materials are drawn from the special topics
- These topics assist students in identifying areas that should receive particular attention
- Check this out from the QP Online Learning Centre



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Panelist report – General Comments

Jun 2018 – Paper 1

“In general, most candidates did not answer in the context of the case facts and candidates did not respond specifically or apply the case information properly.”



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Panelist report – General Comments

Jun 2018 – Paper 2

“...most candidates **had difficulties to further their application to more complicated scenarios**. As a future professional CPA, it is important to have **appropriate and in-depth discussions** in order to reach a proper and specific decision.”



Jun 2018 – Paper 1 – Q3(a)

Required

Explain **the difference** in the listing requirements between the Main Board and Growth Enterprise Market (“GEM”) in terms of minimum trading record and the financial requirements (including profit, market capitalisation, revenue and cash flow) and **whether Grand Music Group can meet the listing requirements. Advise if any additional information is needed** to make such a determination.

Panelist Report – Comments

The candidates’ performance was unsatisfactory. Most candidates could state the relevant listing requirements between the Mainboard and GEM. However, **very few could apply the requirements to the case**, in particular, the additional information required to be obtained to make the determination.



Jun 2018 – Paper 1 – Q2

Required

Assume that you are Rita Liu, the financial controller of Grand Music Group. Write a memo to Mr Julian Wong to advise as to the accounting treatment for revenue recognition in relation to the 20-lesson course offered by Fantastic using the five-step model under HKFRS 15 Revenue from Contracts with Customers. (13 marks)

Case Fact Pattern

- Fantastic offers **20-lesson one-hour** private class courses for playing different musical instruments in Music Land.
- The course fee of which is HK\$12,000, including the tuition fee of the instructors, rental services of the music room and / or the musical instruments (if necessary) to be used in the class
- The 20-lesson course must be completed within six months, with a maximum of two lessons per week.
- As a kind of incentive, students can enjoy **one extra lesson free-of-charge**
- **15% discount coupons** are given for students joining the 20-lesson course to purchase musical instruments from the Group
- Normally the Group would only give **a 5% discount to students who do not join a course**. Based on Fantastic's experience, **80% of the students will redeem the coupons before expiry**



Jun 2018 – Paper 1 – Q2

Sample answers

To: Mr. Julian Wong

From: Rita Liu

Date: 5-Jun-2018

Subject: Accounting treatment for revenue recognition to the 20-lesson course offered by Fantastic under HKFRS 15

In according to HKFRS15 *Revenue from contracts with customers*, the revenue should be recognised and measured by the following 5-steps:

- 1) Identify the contracts with a customer
- 2) Identify the performance obligations in the contract
- 3) Determine the transaction price
- 4) Allocate the transaction price to the performance obligation in the contract
- 5) Recognise revenue when (or as) the entity satisfies a performance obligation



Jun 2018 – Paper 1 – Q2

Sample answers – continued

For the step 1, Fantastic shall account for a contract with a customer only when all the following criteria are met:

The parties approved the contract and committed to perform

- Can identify each party's rights regarding the service to be performed
- Can identify the payment terms for the course fee
- Contract has commercial substance
- Probable to collect consideration

Once the customers signed the course fee contract, the step 1 had been identified.

For the step 2, we should identify the performance obligations in the contract.

The course fee and the discount coupon are given for the students are obviously separate performance obligations. Thus, there are 2 performance obligations.



Jun 2018 – Paper 1 – Q2

Sample answers – continued

For the step 3, we should determine the transaction price.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for services to a customer. It can be fixed amounts, variable amount or both, and it should be adjusted for the effects of the time value of money.

For the step 4, the transaction price is allocated to the identified obligation based on the relative stand-alone selling prices for services promised.

This allocation is made at contract inception and not adjusted to reflect subsequent changes in the stand-alone selling prices of those services or goods.

The best evidence of stand-alone selling prices is the observable price of a good or service when Fantastic selling that good or service separately.

Therefore, 20-lesson course fee will be allocated \$11,040 ($\$12,000 - \$12,000 \times 80\% \times (15\% - 5\%)$) and the discount coupon with \$960 of the total revenue.



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Example 2



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Jun 2018 – Paper 1 – Q2

Sample answers – continued

For the step 5, the course fee will be recognised over the time and the discount coupon will be recognised once it redeemed or expired.

Should you need further clarification, please feel free to contact me.



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Example 2



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Jun 2018 – Paper 1 – Q2

Panelist Report – Comments

The candidates' performance was less than satisfactory. Most candidates could perform a general analysis under the 5-step model but very few candidates could identify the specific requirements under each step under the 5-step model, e.g. the 15% off coupon offered to the customer when purchasing the musical instruments is one of the implied promises in the contract and hence a performance obligation in step 2. This demonstrated the candidates' knowledge needed to be strengthened.



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Thank you!



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Marker 2



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Sharing of common weaknesses

- Misinterpretation / misunderstanding of question and requirements
- Technical knowledge



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Jun 2018 session – Paper I – Q3 (d)

The management of Grand Music Group understands the issuance of shares is one of the ways to obtain funding for business expansion and is considering to issue new shares. Determine the **benefits** of obtaining a capital fund **by the issuance of shares** from the **company's and investors'** perspectives.

(8 marks)



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Jun 2018 session – Paper I – Q3(d)

Observation

- 8 marks questions = 8 different points
 - Candidates only focusing a few points
- Misread the question – obtaining the capital, not by issuance of shares
- Copy from learning pack or various study materials/ textbook
 - Public image
 - Marketability of share
 - Wider pool of finance
 - Freely trade



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Jun 2018 session – Paper I – Q3(d)

Panelist Report – Comments

The candidates' performance was fair. Candidates demonstrated their knowledge about the benefits of obtaining a capital fund by the issuance of shares from the company's perspective. However, candidates could not demonstrate their knowledge about the benefits of obtaining a capital fund by the issuance of shares from the investors' perspective.



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Jun 2018 session – Paper I – Q3(d)

Suggested answer

From the company's perspective:

Compared with the borrowings from banks or financial institutions as well as the issuance of bonds, issuing shares **saves the interest costs**.

Unlike interest payments that are **obligated** to pay to the banks or financial institutions or bondholders, dividends can be distributed to shareholders at the board of directors' **discretion**. (**No financial burden** on the Company)

Less Geared, no repayment, no fixed payment



Jun 2018 session – Paper I – Q3(d)

From an investors' perspective:

- (i) They can **participate and attend** the company's annual general meeting and extraordinary general meeting.
- (ii) They can **vote** on significant company matters, such as, the appointments of directors, changes to authorised shares capital and appointment of auditors.
- (iii) They can **participate in the new issue of shares**.
- (iv) They may receive **dividends** as distribution of profit. (*Share profit*)
- (v) They may receive any assets remaining after liquidation.
- (vi) They may **enjoy capital appreciation** if the share price increases.



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Jun 2018 session – Paper I – Q4

Assume that you are Rita Liu, the Financial Controller of Grand Music Group. The management of Grand Music Group is considering to expand its business in Hong Kong by acquiring Best Performance.

Advise the management team regarding the **concerns to be considered in acquiring Best Performance.**

(7 marks)



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Jun 2018 session – Paper I – Q4

Observation

Candidates tend to focus on 2 to 3 points. 7 marks = 7 points from different perspectives.

Candidates misunderstood the question requirement and provided irrelevant answers about

- the **advantages of** acquiring Best Performance
- the **steps** to perform acquisitions (**takeover code**)
- the procedures of **due diligence**

Some irrelevant points: e.g. Defensive strategy



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Jun 2018 session – Paper I – Q4

Panelist Report – Comments

The candidates' performance was less than satisfactory. Most candidates only focused on discussing one to two matters to be considered. Also, they failed to relate their answers to the question requirements tested. This demonstrated that candidates lacked practical experience and could not apply their technical knowledge to the facts provided.



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Jun 2018 session – Paper I – Q4

Suggested answer

In acquiring Best Performance, the management should consider the following matters:

- (i) Exposure to business risk (*Synergy/ Vertical Integration*)

It may cost a lot to the Group and consume a large portion of financial resources to acquire Best Performance. The Group must consider the financing of the acquisition plan.

The Group must consider **how to obtain the funding**.

Also, the Group is not familiar with the operation in overseas markets or branches that Best Performance has established. (*Grand Music management competence*)



Jun 2018 session – Paper I – Q4

(ii) Exposure to financial risk

The Group does not have a complete record and information on Best Performance.

There may be some **hidden and contingent** issues that the Group is not aware of. *(Off balance sheet items, unresolved litigation)*

(iii) Acquisition premium

When the Group acquires Best Performance, the acquisition premium should be at an appropriate level; otherwise, it is unprofitable.

(Determine the price/ share offer package)

(iv) Managerial competence

The management of Best Performance may not have the experience or ability to deal with the Group. *(Best Performance management*

competence)



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Jun 2018 session – Paper I – Q4

(v) Integration problem

The Group and Best Performance may have **different cultures**, different backgrounds and histories as well as **different management styles**.

Regulatory requirement/ tax consideration



Jun 2018 session – Paper I – Q5(a)

After a thoughtful evaluation, Grand Music Group plans to invest in a project rather than acquire Best Performance at this moment. Based on the forecast, the initial investment of the project is HK\$1,000,000. It is estimated that the project can provide a net cash inflow of **HK\$100,000 to Grand Music Group for the first year** and the **future cash flow is projected to grow at a constant rate of 3% per year** indefinitely; and the required return of 10% is expected.

- (a) **Determine the Net Present Value (“NPV”) and recommend to Mr Julian Wong, the CEO, whether the project should be accepted based on the NPV.**

(4 marks)



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Jun 2018 session – Paper I – Q5(a)

Observation

The candidate calculated the NPV incorrectly by discounting the cash flow for one more year.

The candidate did not provide a recommendation whether the project should be accepted.



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Jun 2018 session – Paper I – Q5(a)

Panelist Report – Comments

The candidates' performance was fair. Candidates demonstrated that they had a basic understanding of the technical knowledge tested. However, some candidates showed a poor understanding and application of technical knowledge to the facts provided in the question and were unable to calculate the NPV correctly.



Jun 2018 session – Paper I – Q5(a)

Suggested answer

The PV of the future cash inflows of the project (perpetuity) is as follows:

$$\text{PV of cash inflows} = C / (R - g)$$

$$\text{PV of cash inflows} = \text{HK\$}100,000 / (0.1 - 0.03) \text{ (103,000 at the first year)}$$

$$\text{PV of cash inflows} = \text{HK\$}1,428,571.43 \text{ (Discount one more year /1.1)}$$

NPV is the PV of the outflows minus the PV of the inflows; therefore, the NPV is as follows:

$$\text{NPV of the project} = \text{HK\$}1,428,571.43 - \text{HK\$}1,000,000 \text{ (Did not consider outflow)}$$

$$\text{NPV of the project} = \text{HK\$}428,571.43$$

Since the NPV is positive, therefore, the Group would accept the project.
(No recommendation)



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Jun 2018 session – Paper I – Q5(b)

Identify and explain the advantages and limitations in applying the NPV method in evaluating the proposed investment.

(6 marks)



Jun 2018 session – Paper I – Q5(b)

Observation

- Candidate copied from **learning pack/ studying materials/ textbook** directly.
- Candidate provided irrelevant points –
 - Advantage: **maximize shareholders wealth**
 - Disadvantage: **complex, not easy to explain difficult to forecast/ estimate, discount rate not accurate**

Panelist Report – Comments

The candidates' performance was unsatisfactory. Most candidates could not explain the advantages and limitations in applying the NPV method in evaluating the proposed investment.



Jun 2018 session – Paper I – Q5(b)

Suggested answer

- The NPV method is one of the methods that the management uses to evaluate capital projects. Since a capital project is **a long-term investment**; therefore, the determination of the present value of the project's estimated future income is important.
- The NPV method is **easy to use**, as it is a direct measure of the **dollar contribution** to the shareholders that enables the company to evaluate the project using a **straightforward** approach and facilitates the decision-making process. *(Consider cashflow, not profits, absolute amount)*
- The NPV method has **no serious flaws**.
- The NPV method considers the **time value of money**, since the future cash inflow and outflows are discounted to the present, therefore NPV reflects the value as of today.



Jun 2018 session – Paper I – Q5(b)

- The NPV method is superior for **ranking mutually exclusive projects**. It is a useful matrix for **comparison** when considering one project or another.
- The NPV method applies the discount rate that takes into **consideration the risk of the project**.
- The NPV method incorporates the **variations of the discount rates** as discount rates are expected to be different over the life of the project.
- The NPV method integrates the initial investment cost at present value, the future cash inflows of the project and the projected lifetime of the project etc. These factors may vary and change during the lifetime of the project. Consequently, the management may make the wrong decision due to those unforeseeable changes. *(Internal factors changes)*
- Also, as the macroeconomic and business environments vary from year to year, the interest rate (i.e. discount rate) may change as the project continues. This will make the NPV method inefficient. *(External factors changes)*



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Jun 2018 session – Paper II – Q3(a)

Assume that you are the CEO of the Group, analyse the **cost** of holding a substantial amount of cash on hand.

(4 marks)

Panelist Report – Comments

The candidates' performance was less than satisfactory. Most candidates demonstrated a lack of understanding regarding the cost of holding a substantial amount of cash on hand. Some students tried to calculate the optimal cash to be held which was not required.



Jun 2018 session – Paper II – Q3(a)

Suggested answer

- Holding idle cash on hand will result in an **opportunity cost of forgoing investment opportunities**.
- Holding idle cash on hand will affect the future growth opportunities as the Group can use the idle cash for various investments, such as, capital investment or shares investment that generate income and growth to the Group in future. *(Elaborate)*
- **Shareholders may wonder** whether WT Tours anticipates financial difficulties or contingent liabilities in near future.
- **Shareholders may expect more cash dividends** from WT Tours.
- Shareholders may wonder whether WT Tours acts in **their best interests to maximise the shareholders' wealth**.

Shareholder is the key stakeholder that CEO needs to consider



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Jun 2018 session – Paper II – Q3(b)

From the CFO' s perspective, justify with explanations the importance of holding sufficient cash on hand.

(4 marks)

Panelist Report – Comments

The candidates' performance was fair. In general, candidates were able to apply appropriate technical knowledge. However, candidates could not elaborate and present their answers from the CFO's perspective.



Jun 2018 session – Paper II – Q3(b)

Suggested answer

- The management of cash flow is important as the cash balance must be maintained at a sufficient level to ensure that **there is enough cash to pay liabilities when these are due for settlement**. Failure to meet the settlement will result in insolvency.
- WT Tours needs cash to pay **for purchases of supplies, dividends, interests and principal repayments on loan and tax liabilities**, etc.
- WT Tours needs cash to pay for **transactions arising in the ordinary course of business**.
- WT Tours may **hold cash for precautionary reasons** to have a buffer to satisfy potential cash needs.
- WT Tours may **hold cash for speculative purposes** in order to take advantage of potential profit-making situations, such as, investments.
CFO perspective of holding cash



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Jun 2018 session – Paper II – Q3(d)

It is believed that there are negative implications regarding the issuance of shares. Advise as to the **negative implications to shareholders** in relation to the issuance of shares.

(3 marks)

Panelist Report – Comments

The candidates' performance was less than satisfactory. Some candidates could not apply the appropriate technical knowledge and they presented their answers about the negative implications to the Company rather than shareholders.



Jun 2018 session – Paper II – Q3(d)

Suggested answer

(i) Division of profit

Shareholders are expecting the dividends from the Group. The Group may distribute profits to shareholders in the form of dividends in order to fulfil their expectations. From a long-term perspective, distributing dividends reduces the Group's potential for future earnings; and with the dividends being distributed, the profit will be reduced and that may harm the Group's expansion plan. *(More dividend needs to be distributed)*

(ii) Loss of control

Shareholders are provided with the right to vote on certain different issues. With more shareholders who are eligible to vote for or against the issues, the management may lose control of the Group. *(Dilute ownership)*

(iii) **Threat of takeover**

There is a risk of a hostile takeover by an individual shareholder.



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Thank you!



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Marker 3



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Jun 2018 session – Paper I – Q1(a)

Required

The question required candidates to **explain the fraud risks factors** of the case and **identify areas** where fraud risks may have existed in Grand Music Group.

(9 marks)



Jun 2018 session – Paper I – Q1(a)

Panelist Report – Comments

- Performance was **less than** satisfactory
- They did **not** have a clear concept of the **fraud risk factors** and **the fraud areas**.
- They were **not** able to **utilise the background information** in the case to identify sufficient points to score higher marks.
- For example, **the donation of HK\$5 million** should have been easily picked up as one of the fraud risk areas but not many candidates were able to spot it out.



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Jun 2018 session – Paper I – Q1(a)

Suggested approach

- Fraud risk factors
 - Incentive
 - Opportunity
 - Pressure



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Jun 2018 session – Paper I – Q1(a)

Suggested approach

- Fraud areas
 - Revenue recognition
 - Significant unusual transaction outside the normal course of business
 - Related party transactions
 - Payroll
 - Business development



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Jun 2018 session – Paper I – Q1(b)

Required

The question required candidates to **identify different revenue streams** of Grand Music Group and **suggest one substantive audit procedure** that could be performed to address the **accuracy** assertion of each revenue stream. It also required candidates to **justify** whether the different revenue streams could be **tested** on an **aggregated basis** for Grand Music Group's audit purposes.

(9 marks)



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Jun 2018 session – Paper I – Q1(b)

Panelist Report – Comments

- Performance was **satisfactory**
- Able to identify the different revenue streams and propose relevant substantive audit procedures to address the accuracy assertions.



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Jun 2018 session – Paper I – Q1(c)

Required

The question required candidates to **identify and determine other areas** that they have to consider **before concluding whether reliance could be placed on the reports generated from the systems** which have been tested and the respective information technology general and automatic controls were considered to be operating effectively.

(4 marks)



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Jun 2018 session – Paper I – Q1(c)

Panelist Report – Comments

- Performance was **unsatisfactory**.
- The question related to **consideration in the planning stage** but candidates' answers were more related to the procedures that they had to execute to test the information technology in general and automatic controls despite the fact that the question had already mentioned that they were considered to be operating effectively.



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Jun 2018 session – Paper I – Q1(c)

Other observations

- The discussion is **not relevant**
 - The experience of audit team (IT knowledge)
 - Understand, evaluate, validate the ITGC
 - Risk assessment
 - Whether substantive procedures can provide sufficient audit evidence
 - Audit trial



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Jun 2018 session – Paper I – Q1(c)

Suggested approach

- No interface between the systems
- Is the information properly transferred between the systems?
- Completeness – have all the relevant standing data / transactions been inputted into the systems and manually reconciled between different systems?
- Accuracy – are the standing data / transactions recorded correctly?



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Jun 2018 session – Paper I – Q1(c)

Suggested approach

- Validity – are there any controls to ensure only authorised / approved transactions are recorded?
- Restricted access – is the data protected and can it only be accessed and amended by authorised personnel with proper approval?



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Jun 2018 session – Paper I – Q1(e)

Required

The question required candidates to identify three improvements that the Grand Music Group needed to make in order to fulfill the listing requirements in relation to corporate governance.

(3 marks)

Panelist Report – Comments

Performance was **satisfactory**



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Jun 2018 session – Paper II – Q4(a)

Required

The question required candidates to identify, with explanations, **five financial statement line items** of **WT Tours** which they considered may have a **risk of material misstatement** and state the respective **additional information they would obtain from the management** for further risk assessment.

(10 marks)



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Jun 2018 session – Paper II – Q4(a)

Observations – Panelists' Report

- Performance was **unsatisfactory**
- **Only** point out **one** or **two** relevant financial statement line items
- **Not provide** the respective **additional information** they had to **obtain from the management** for risk assessment.



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Jun 2018 session – Paper II – Q4(a)

Other observations

- Identify items that the risk is relatively low
 - Cash and bank balances

- No application to the case fact
 - Trade receivables – significant increase as compared to prior year
 - Valuation of property, plant and equipment



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Trade receivables
 - 22% of current assets, material to the FSs
 - Full amount will be paid by the customers as deposits >> unlikely there will be any trade receivables
 - **Additional information:** listing / breakdown of trade receivables, aging analysis, provision policy, etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Customer deposits / Deferred revenue / Revenue
 - Deposits received in advance from the customers should be recognised as a liability – deferred revenue.
 - No such amount >> the amount has been recognised as revenue
 - **Additional information:** breakdown of customer deposits to match with the revenue recognised, etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Other assets
 - Except for fixed assets, trade receivables and customers deposits, the company has no other assets
 - No investment property
 - **Additional information:** details of fixed assets recognised, a list of other prepayment and deposits (such as utilities deposits), rental agreement (if any, to identify if any deposits have been paid), etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Bank loans
 - Not completely recognised
 - Not properly classified – current/non-current
 - **Additional information:** bank loan agreements, banking facilities letters, broad minutes (to understand if there are any other bank loans), etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Accounts payables / Accruals / Expenses
 - Accounts payables of 11 million
 - No other payables, accruals, provisions, etc.
 - **Additional information:** breakdown of trade payables, list of subsequent payments (to identify if there are any unrecorded liabilities), etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Provision for litigation
 - No provision for litigation was recognised
 - No disclosure made in the FSs
 - Risk of going concern
 - **Additional information:** details and status of litigations



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Tax liabilities / Tax expenses
 - No provision for tax
 - **Additional information:** detail of different types of tax that the company is subject to (e.g. Hong Kong tax, overseas tax), management's tax assessment, etc.



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Jun 2018 session – Paper II – Q4(a)

Suggested approach

- Intercompany balances
 - Intercompany transactions
 - No intercompany balances recognised on the statement of financial position
 - **Additional information:** details of intercompany transactions, movement of intercompany balances, etc.



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Jun 2018 session – Paper II – Q4(b)

Required

The question required candidates to **propose**, with **explanations**, the **benchmark(s) that should be used to determine the materiality** for the Group and each of its subsidiaries (including “Newco Ltd”).

(4 marks)



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Jun 2018 session – Paper II – Q4(b)

Panelist Report – Comments

- Performance was **less than satisfactory**
- Proposed an **inappropriate** benchmark
- Did **not** provide an **explanation** for their proposed benchmarks
- Did **not** consider the materiality for **all the companies** despite the fact that it was a requirement stated in the question.



Jun 2018 session – Paper II – Q4(b)

Suggested approach

- The Group / WT Tours Ltd / WT Advertising Ltd
 - **profit** should be used as the benchmark as they are **profit-oriented**

- WT Recruiting Ltd
 - **profit** should be used as the benchmark as it is **profit-oriented**; or
 - **expenses** can be considered as the benchmark as **it only provides services to WT Tours** and its revenue (i.e. the service fee) is determined based on the cost plus 10%



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Jun 2018 session – Paper II – Q4(b)

Suggested approach

- Newco Ltd
 - **assets** should be used as the benchmark as the management transfer assets to this company and plan to dispose it shortly

- WT Holdings Ltd
 - **net assets** should be used as it is **an investment holding** company with no other activities



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Jun 2018 session – Paper II – Q4(c)

Required

The question required candidates to analyse the **audit implications** in relation to the **litigations of WT Tours** with reference to relevant **ethical requirements**.

(4 marks)



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Jun 2018 session – Paper II – Q4(c)

Panelist Report – Comments

- Performance was **unsatisfactory**
- Did not understand the new HKICPA Code of Ethics for Professional Accountants in relation to the **non-compliance with laws and regulations** (NOCLAR)
- **Not** able to discuss the **impact on the audit opinion**



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Jun 2018 session – Paper II – Q4(c)

Other observations

- The discussion is **not specific to the NOCLAR requirement**
 - Discussion with management the reason for non-disclosure
 - Obtain understanding of the litigation
 - Request the management to amend the FSs
 - Seek legal advice
 - Increase the extent of audit procedures
 - Issuance of adverse opinion



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Jun 2018 session – Paper II – Q4(c)

Suggested approach

- Determination of whether further action is needed in the public interest
- Documentation as a result of the public interest consideration



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Jun 2018 session – Paper II – Q4(c)

Suggested approach

- New HKICPA Code of Ethics for Professional Accountants
- HKSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements (effective from 15 July 2017)
- Group communications: Team B has to consider reporting to Team A on the NOCLAR.



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Jun 2018 session – Paper II – Q4(d)

Required

The question required candidates to analyse the **risk of material misstatement** of **different types of advertising revenue** of WT Advertising and propose the **audit approach** for the audit of advertising revenue in relation to the assertions of **completeness** and **accuracy**.

(5 marks)



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Jun 2018 session – Paper II – Q4(d)

Panelist Report – Comments

- Performance was **less than satisfactory**.
- Not able to realise that the advertising revenue included **fixed** and **variable** portions.
- The fixed portion - not able to propose an appropriate audit approach.
- The variable portion - not able to discuss that the completeness and accuracy depended on whether the relevant information was properly captured by the system and thus they were not able to propose an information technology-related audit approach.



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Jun 2018 session – Paper II – Q4(d)

Other observations

- Discussion was not specific to the question requirement
 - Perform cutoff testing
 - Involve IT expert to investigate the result provided by IT company
 - Substantive procedures on related party transactions



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Jun 2018 session – Paper II – Q4(d)

Suggested approach

- Fixed amounts of advertising revenue
 - Risk of material misstatement is relatively lower >> the calculation is straight-forward
 - Completeness - Test of details >> reviewing the contracts and minutes)
 - Accuracy - performing a reasonableness test



Jun 2018 session – Paper II – Q4(d)

Suggested approach

- Variable amounts of advertising revenue
 - Based on the number of clicks on the particular advertisement
 - A higher risk of material misstatement
 - Completeness and Accuracy depends on whether the relevant information is properly captured by the system
 - Test of general IT controls
 - Test of application controls
 - Some substantive procedures or test of details (a reasonableness test or checking to the data used to the source information)



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Jun 2018 session – Paper II – Q4(e)

Required

The question required candidates to consider whether or not the audit manager, Jane Wong, could discuss the litigation of WT Tours with her friend, Kate Chan.

(2 marks)

Panelist Report – Comments

- Performance was satisfactory.
- But some candidates were not aware that Jane should not disclose that she was **involved in the audit** of WT Tours.



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Marker 4



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Key points recapped

- Interpretation of the requirements
- Understanding and application of knowledge
- Structure of the answer
- Time management



June 2018 session – Paper I – Q6(a)

- The group structure of Best Performance as at 31 March 2017 was as follows:





June 2018 session – Paper I – Q6(a)

- Best Performance is a company incorporated in Hong Kong with several overseas branches.
- The principal activities of Best Performance are the selling of musical instruments and co-ordination of orchestras for musical performances.
- The overseas branches of Best Performance purchase musical instruments from different countries, then deliver the same to a Hong Kong warehouse operated by a third party.



June 2018 session – Paper I – Q6(a)

- (i) For an overseas branch of Best Performance located in a jurisdiction that has a Double Tax Agreement (“DTA”) with Hong Kong, analyse the income tax and turnover tax implications of the branch purchasing musical instruments within the overseas jurisdiction for export purposes, and the tax protection and relief that could be provided by the DTA. (You may use the China – HK DTA as a reference for answering your question)
- (ii) Highlight the tax differences when the branch in Question 6(a)(i) is located in a jurisdiction that does not have a DTA with Hong Kong.

(6 marks)



June 2018 session – Paper I – Q6(a)(i)

Suggested answer

DTA – Income Tax

- There is a permanent establishment (“PE”) article in the DTA such that if the activities of the branch do not exceed a certain threshold, it would not constitute a PE and would then not be subject to income tax.
- The buying activities alone would not constitute a PE.



June 2018 session – Paper I – Q6(a)(i)

- In addition, if the branch somehow is subject to income tax in that tax jurisdiction, there is an article on elimination of double taxation such that either the same income is exempt from Hong Kong profits tax or the overseas tax paid could be used as a tax credit for offsetting Hong Kong profits tax payable (the latter applies to China – HK DTA).

DTA – Turnover Tax

- However, the DTA would not offer tax protection on turnover tax as it is generally excluded from a DTA.



June 2018 session – Paper I – Q6(a)(ii)

No DTA – Income tax

- There is a higher risk that the overseas branch may have income tax exposure in that jurisdiction, notwithstanding that, in most tax jurisdictions, buying office is generally not subject to income tax.

No DTA – Turnover tax

- In a jurisdiction that imposes turnover tax such as value added tax (“VAT”) or goods and services tax, the acquisition of goods may be subject to the turnover tax.
- However, if the goods are purchased for export purposes, the purchases are generally exempt from turnover tax or there is a refund of such turnover tax paid.



Not familiar with
buying office



Sample answer I

- Permanent establishment (PE) as defined under the Arrangement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income refers to a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- It covers an agency PE where a dependent agent acting on behalf of enterprise has and habitually exercises an authority to “conclude contracts” in the name of the enterprise.



Not familiar with
buying office



Sample answer I

- Best Performance does have branches in overseas, it has constituted an fixed PE in overseas. Thus, its profit attributable to that PE will be subject to corporate income tax in overseas according to DTA.
- However, Best Performance would be protected by tax credit allowed against the Hong Kong tax payable on that income. Only tax paid in overseas can be allowed as a credit under the DTA against HK.



Not familiar with
buying office



Sample answer I

- For turnover tax, it was not covered under any DTA. Thus, the branch is subject to the turnover tax in overseas without any protection from DTA.
- The main difference is that Best Performance can apply for tax credit to avoid double taxation, if it located in a jurisdiction that have a DTA with Hong Kong. Otherwise Best Performance is exposed for double taxation.



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Example 1



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June 2018 session – Paper I – Q6(b)

- Some Hong Kong employees would be sent to work for the overseas branches for three to six months every year to assist with the purchase process.
- The staff based in Hong Kong would then arrange to sell to customers in Hong Kong and mainland China through the internet. Best Performance does not have any set-up or agents in mainland China.



June 2018 session – Paper I – Q6(b)

- (i) Analyse the income tax implications applicable to employees of Best Performance (Hong Kong tax residents) who were assigned to the branch located in a jurisdiction that has a DTA with Hong Kong, and the tax protection and relief that could be provided by the DTA. (You may use the China – HK DTA as a reference for answering your question)
- (ii) Highlight the tax differences applicable to the employees when the branch in Question 6(b)(i) is located in a jurisdiction that does not have a DTA with Hong Kong.

(6 marks)



June 2018 session – Paper I – Q6(b)(i)

DTA – Income tax

- For employees, they would generally not be subject to personal income tax in the other tax jurisdiction if they do not spend 183 days or more in any 12-month period in that jurisdiction.
- In addition, if the employees somehow are subject to personal income tax in that tax jurisdiction, there is an article on elimination of double taxation such that either the same income is exempt from Hong Kong salaries tax or the overseas tax paid could be used as a tax credit for offsetting Hong Kong salaries tax payable.



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Example 1



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June 2018 session – Paper I – Q6(b)(i)

- In other words, there is no need to rely on s.8(1A)(c) although this provision as well as the offshore income regime under s.8(1) are still applicable.

No DTA – Income tax

- For Hong Kong tax resident employees, it would generally take a shorter period (e.g. less than 183 days in any 12-month period) for them to be subject to personal income tax in that tax jurisdiction.



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Example 1



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June 2018 session – Paper I – Q6(b)(ii)

- In relation to the overseas personal income tax which the employees have paid, the employees would not be subject to Hong Kong salaries tax on the same income if it could be proved that the overseas tax paid is of substantially the same nature as Hong Kong salaries tax under s.8(1A)(c) of the Inland Revenue Ordinance.
- If the income is offshore sourced under s.8(1), the income is not subject to Hong Kong salaries tax and there is no issue of double taxation.



Unable to analyze the
situation correctly



Sample answer I

- For the HK employees of Best Performance, as they are Hong Kong residents, the DTA potentially provides exemption from the Individual Income Tax where the tax residents of HK fulfill all of the following criteria:
 - The individual is present in overseas for a period or periods not exceeding the aggregate 183 days in any twelve month period commencing or ending in the taxable period concerned;
 - The remuneration is paid by, or on behalf of, an employer who is not a resident at overseas; and



Unable to analyze the
situation correctly



Sample answer I

- The remuneration is not borne by a permanent establishment which the employer has in overseas.

If employees fulfil all criteria, he/she could exempt from the IIT in overseas.

- It seems that the employee would be sent for 3 to 6 months, further information has to be obtained to consider (e.g. how many days in total and who has the responsibility to pay to the employee).



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Unable to analyze the
situation correctly



Sample answer I

- The main difference is that the employees may need to charge for the Individual Income Tax even if all conditions were satisfied when there is no DTA between the overseas country and Hong Kong.



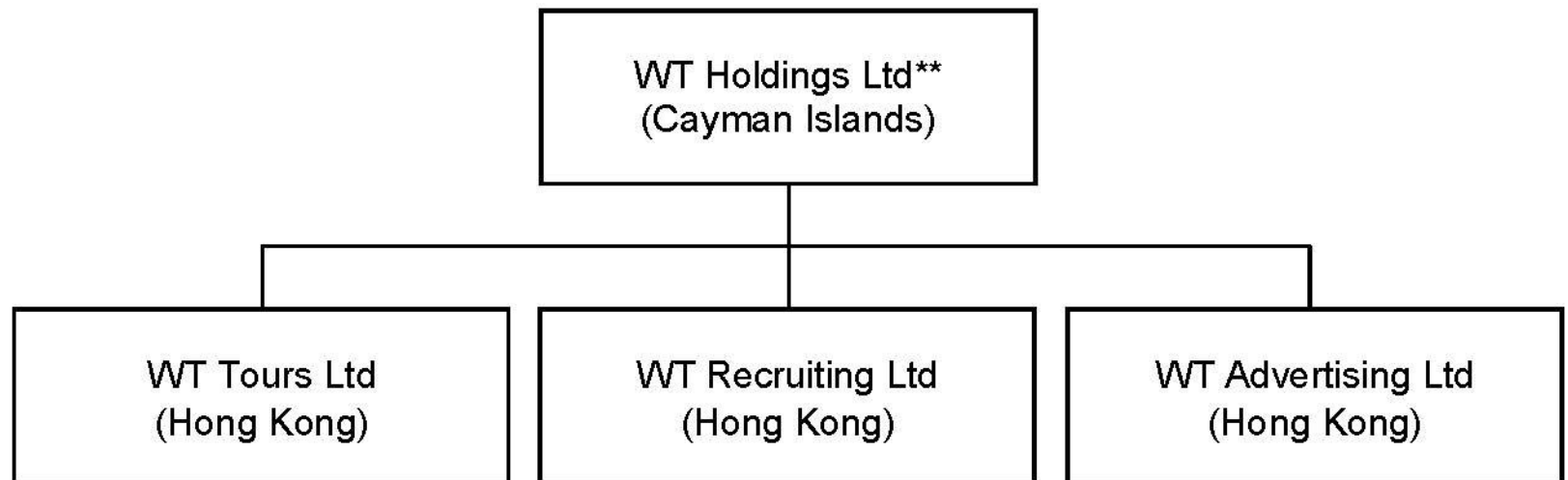
June 2018 session – Paper II – Q5(c)

- WT Holdings Ltd (“WT Holdings”) is a Cayman Islands incorporated company listed on the Main Board of the Stock Exchange in Hong Kong.
- The principal activities of WT Holdings and its subsidiaries (the “Group”) are providing tour services in Hong Kong and overseas.
- The Group has a financial year end of 31 December.



June 2018 session – Paper II – Q5(c)

- The group structure of WT Holdings as at 31 December 2016 was as follows:





June 2018 session – Paper II – Q5(c)

- WT Recruiting solely provides services to WT Tours and its profits are approximately 5% to its revenue.
- It recruits local as well as overseas employees or subcontractors to provide tour services in Hong Kong as well as overseas.
- The Group is planning to carve out its Hong Kong travel tour business for bidding purposes.



June 2018 session – Paper II – Q5(c)

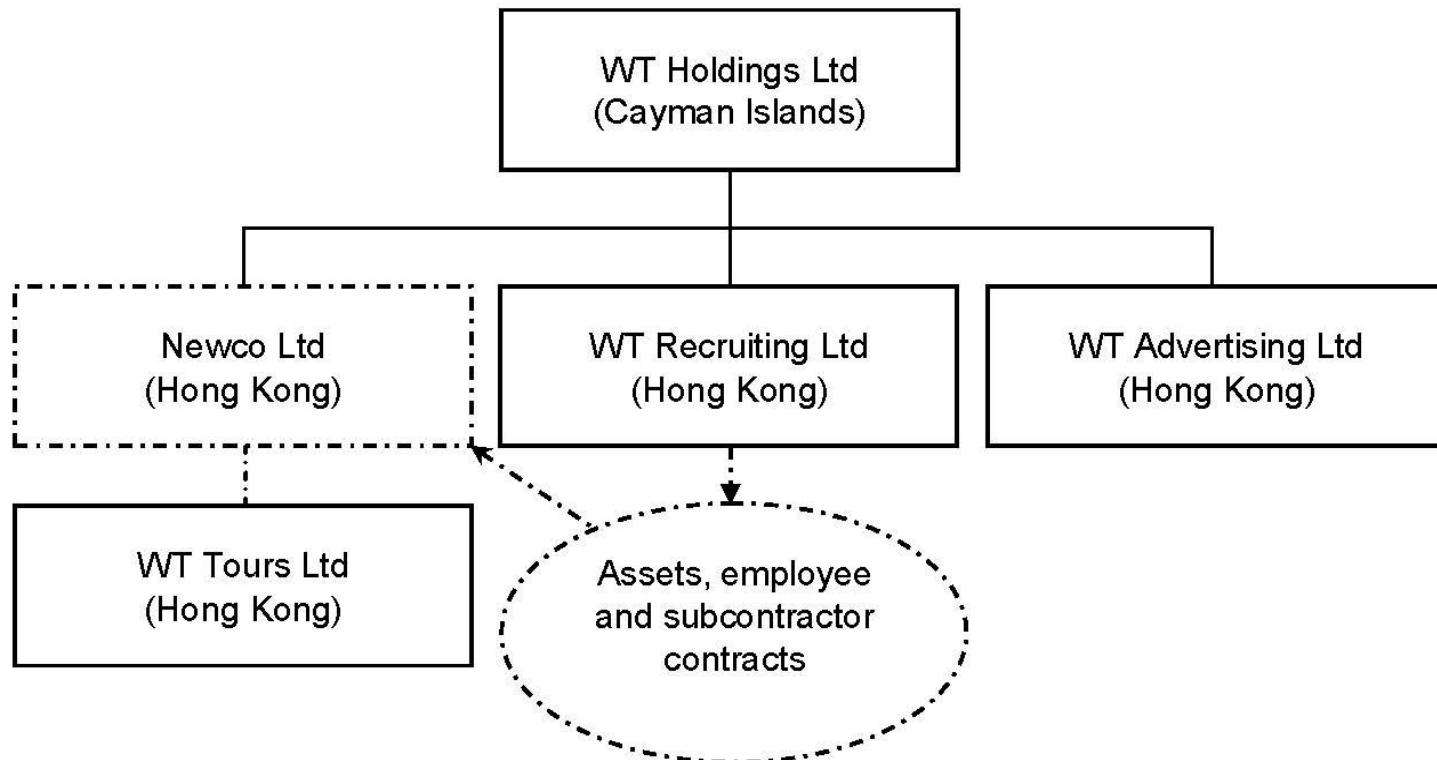
- In doing so, the Group plans to establish a new company “Newco Ltd” in Hong Kong and transfer
 - (i) all the equity interest in WT Tours and
 - (ii) all the business assets as well as employee and subcontractor contracts of WT Recruiting to Newco Ltd.

It is planned that the shares of Newco Ltd would be sold two months after the transfer.



June 2018 session – Paper II – Q5(c)

The revised structure is as below:





June 2018 session – Paper II – Q5(c)

Compare and contrast the current arrangement (i.e. transferring the assets, employees and subcontractor contracts of WT Recruiting) to the situation where the management of the Group directly sells the shares of WT Recruiting from both the tax and non-tax perspectives.

The following mark allocation is provided as guidance for this question requirement:

- Tax perspective (10 marks)
- Non-tax perspective (4 marks)



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Suggested answer

Share transfer – Tax issues

- By acquiring shares of WT Recruiting, the tax loss b/f, if any, of WT Recruiting may be utilised to offset future assessable profits, assuming there is documentary evidence to demonstrate the sole or dominant purpose of the transfer is not to avoid tax.
- Selling the shares of WT Recruiting means the buyer would have to undertake the tax and non-tax liabilities of WT Recruiting.



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- Since WT Recruiting recruited employees as well as subcontractors to provide tour services in Hong Kong and overseas countries, it is probable that WT Recruiting may have historical overseas permanent establishment (“PE”) tax exposure.
- Although such PE issue may be avoided through the PE article under the Double Taxation Agreement (“DTA”) between Hong Kong and the relevant country, Hong Kong may not have DTA with the relevant country (such as the US or Singapore) or the presence of employees may have exceeded the prescribed period under the relevant PE article (e.g. 183 days over any 12-month period for China – HK DTA).



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- WT Recruiting may have unsettled Hong Kong tax liabilities or there may be tax disputes or tax investigations with the Inland Revenue Department in the past six years. Acquiring the shares of WT Recruiting means the buyer would need to undertake these Hong Kong tax liabilities.

Asset transfer – Tax issues

- When the office equipment of WT Recruiting are transferred, there will generally be a balancing charge (being sales proceeds (restricted to cost) less the respective tax written down values) to WT Recruiting assuming that the sales proceeds of office equipment are higher than the tax written down values under different poolings.



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- At the same time, the buyer should be entitled to an initial allowance (60%) and annual allowances (10% to 30%) based on the acquisition cost.

Share transfer – Stamp duty issues

- There will be a stamp duty of 0.2% on the higher of the consideration or the open market value of the shares of WT Recruiting when these shares are transferred.

Asset transfer – Stamp duty issues

- However, there is no stamp duty when the assets of WT Recruiting are transferred.



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- If the buyer needs to enter into a new lease agreement taking up the office of WT Recruiting during the acquisition of assets and contracts, there will be a stamp duty (from 0.25% to 1%) on the yearly rent depending on the duration of the lease term.

Share transfer – Non-tax issues

- Selling the shares of WT Recruiting may prolong the due diligence process as WT Holdings would have to spend time in answering the questions regarding the historical tax and non-tax liabilities of WT Recruiting from the buyer.



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- In addition, there is a risk that the historical hidden tax and non-tax liabilities may not be fully discovered and resolved.

Asset transfer – Non-tax issues

- By acquiring the assets and contracts, the buyer may not need to worry about any potential hidden legal liabilities of WT Recruiting, such as
 - the adequacy of long service payments and MPF;
 - legal disputes with third party subcontractors; and
 - whether the transfer of subcontractor contracts requires the consent of the subcontractors.



Missed the overseas
PE issues



Sample answer I

- If the transfer is made with consideration, the profits arising from the transfer of asset will not be taxable under s.14, as being capital in nature.
- Transfer of subcontractor contracts may be taxed under s.15(1)(m), being sum received as consideration for transfer of right to receive income.
- If the assets are plant & machinery have been depreciated by WT Recruiting for tax purpose, any proceed derive from the transfer above the tax written down value will be taxable (limited to cost of the asset).



Missed the overseas
PE issues



Sample answer I

- However, if the different assets are sold together at one price, IRD has power to allocate price to each individual asset (s.38A).
- If the transfer is made without consideration and the P&M is still valuable, it is necessary for WT Holdings to make a deduction from the pool. The amount deducted from the pool is the market value of the asset at time of transfer out. It does not limited to the cost of the asset.
- As the asset is transfer not at the time of business cessation, no balancing allowance will be available for WT Holdings.



Missed the overseas
PE issues



Sample answer I

- The transfer of WT Recruiting shares is chargeable to stamp duty under Head 2 given that it is a HK stock.
- Chargeable amount will be the consideration or closing price at date of transfer of WT Recruiting is listed. Contract notes will be stamped at 0.2% of stampable amount. Instrument of transfer at \$5 fix rate.
- As Newco will be disposed 2 months after the transfer, no group relief on stamp duty under s.45 allowed.



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Thank you!



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Part 5: Q & A Session