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# Examination Techniques Seminar on QP Final Examination

## (June 2018 Session)

**Date:** **23 March 2018**

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**Associate Director**

CPA Hong Kong Institute of Certified Public Accountants 香港會計師公會

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# Agenda

1. Introduction
2. Preparation Tips
3. Examination Regulations
4. Examination Techniques
   - Markers' Sharing
5. Q & A Session

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# Part 1: Introduction

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## Today's objective:

# *Finding ways to pass the Module 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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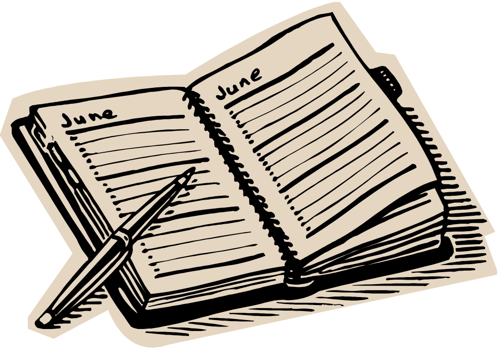
# Commit to your Study Plan

## Advantages:

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



# 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

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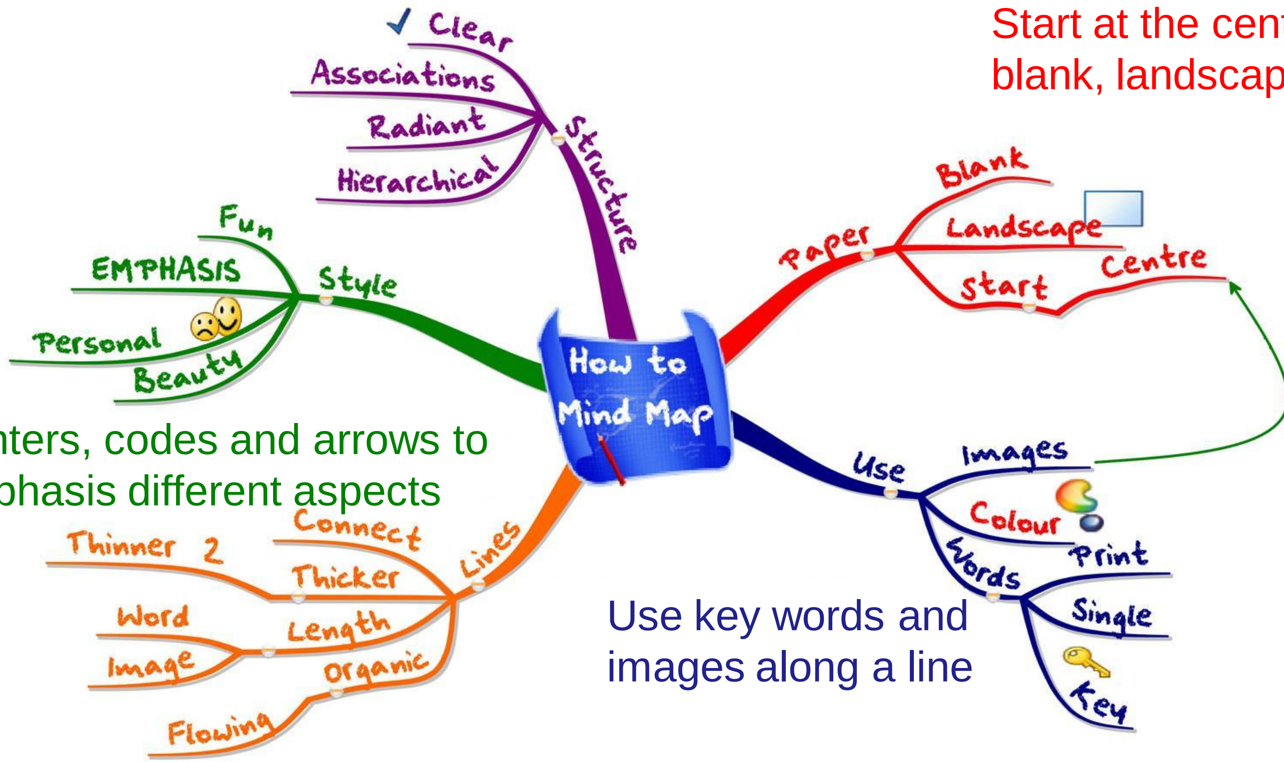
# Mind Map

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 emphasis different aspects




Use key words and images along a line

Make the lines associate as clear as possible

# 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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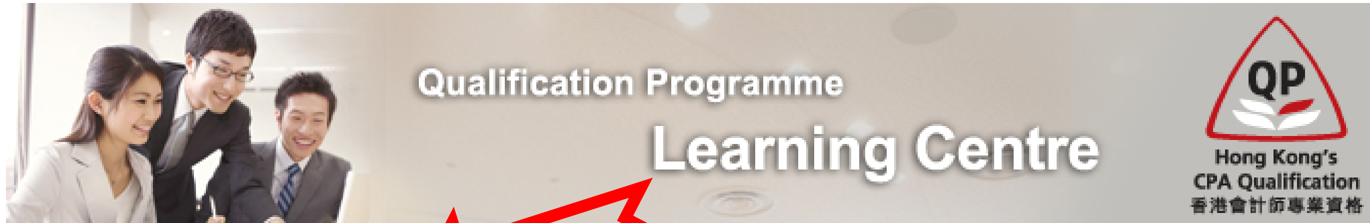
# Part 3:
# Examination Regulations

# 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!**




## 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

# Marker 1

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# Panelists' Report – General Comments

**Dec 2017 Session - Paper I**

"Candidates did not respond specifically or apply the case information properly."

"…should have an appropriate discussion to reach a proper and specific response."

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# Panelists' Report – General Comments

**<u>Dec 2017 Session - Paper II</u>**

"…most candidates showed
- insufficient comprehension of the case facts
- insufficient understanding of the question requirements…"

"… did not answer in the context of the case facts and did not respond specifically or apply the case information properly."

"… <u>should</u> devise the proper and specific response."

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# Points to note

- Interpretation of questions requirements
  - Final Exam integrates all 4 modules
  - A question may test for more than 1 module
  - Identify the company concerned (company names are similar)
  - **READ** the question **TWICE**
  - Pay attention to the **action word** used in the question
- Application of technical knowledge
- Structure of answers

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Example 1

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# Dec 2017 session – Paper I – Q3

**Required:**

Advise on the accounting implication of the DP Points Scheme under HKFRS 15 *Revenue from Contracts with Customers*

(10 marks)

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Example 1

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# Dec 2017 session – Paper I – Q3

*Case facts:*

- DaiPang Group ("The Group") provides a wide range of courier and courier-related services;
- The Group considers to implement a customer loyalty programme, namely DP Points Scheme;
- For every HK$5 spent, one DP Point will be awarded to the customers;
- Each DP Point is redeemable for a HK$1 discount on any future spending on the Group's services;
- All DP Points will expire in three months time after being awarded; and
- The Group expects 80% of its customers will utilise the DP Points before expiry

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Example 1

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# Dec 2017 session – Paper I – Q3

## Focus of the question

- Advise the accounting implication of the DP Points Scheme under HKFRS 15 **(note: "Advise the accounting implication" => detailed discussion for both initial and subsequent accounting treatments, supported with calculation)**

## Observations

- Performance was unsatisfactory. Candidates' understanding on HKFRS 15 was weak.
- Some candidates, instead of referring to the specific requirement of "customer options for additional goods or services", applied the five-step model in their answers.
- Some other candidates referred to HK(IFRIC) Int. 13 *Customer Loyalty Programmes*" by mentioning that transaction price should be allocated on the fair value basis. **(note: HKFRS 15 supersedes HK(IFRIC) Int. 13)**

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Example 1

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# Dec 2017 session – Paper I – Q3

**Suggested approach**

- Point out that DP Points Scheme is one of the forms of customer options for additional goods or services under HKFRS 15
- One DP Point rewarded for every HK$5 spent demonstrated that DP Points constitute a material right to the customers
- The Group is required to allocate the transaction price to performance obligations (i.e. courier services and DP Points awarded) on a relative standalone selling basis

**Initial recognition & measurement**

- Assuming 80% expected redemption rate, the standalone selling prices for courier services and DP Points awarded would be HK$5 and HK$0.8 ($1 x 80%). Hence, allocation of transaction price to courier services and DP Points based on relative standalone selling price basis: Courier services=HK$4.3 (HK$5 x 5/5.8) and DP Point=HK$0.7 (HK$5 x 0.8/5.8)

**Supported with calculation**

- The Group then recognise revenue for DP Point upon DP Points redeemed or expired
- Contract liability (i.e. deferred revenue) would be recognised for unredeemed and unexpired points at each reporting period.

**Subsequent accounting treatment**

Example 2

# Dec 2017 session – Paper I – Q6

**Required:**

Advise Mr. Tim Tang (Finance Director) whether (a) borrowing costs for the bank loan drawn down for the acquisition, and (b) the cabin fit-out costs could be capitalized as part of the cost of the aircraft. (7 marks)

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Example 2

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# Dec 2017 session – Paper I – Q6

*Case facts:*

- DaiPang Group ("The Group") plans to acquire 2 more cargo aircraft at total price of HK$500 million ("The Consideration");
- The Consideration is required to be paid in full once vendor starts its work;
- Delivery of the aircraft would be expected 15 months after the payment is made;
- A five-year bank loan of HK$500 million will be drawn to finance the acquisition;
- Cabin fit-outs at cost of HK$10 million are expected to be incurred.

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Example 2

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# Dec 2017 session – Paper I – Q6

## Focus of the question

- Advise whether the borrowing costs and cabin fit-out costs could be capitalized as part of the cost of the aircraft.

## Observations

- Performance was unsatisfactory.
- Although candidates could demonstrate basic knowledge of borrowing costs, most candidates were unable to conclude advance payment was a qualifying asset.
- Many candidates jumped to their conclusion without explaining the rationale for capitalisation of borrowing costs.
- Only a few candidates could identify the interest capitalisation period properly.

Example 2



# Dec 2017 session – Paper I – Q6

## Suggested approach

- Since aircrafts formed part of the PPE, we should highlight under HKAS 16 cost of an item of PPE should include costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management ("Directly Attributable Costs").
- According to HKAS 23 *Borrowing* Costs, advance payment could be considered as a qualifying asset and the interest could be regarded as a Directly Attributable Costs.
- Interest capitalisation period should be from the date of advance payment up to the delivery of the aircraft.
- The cabin fit-outs costs of HK$10 million would be capitalised as part of aircraft costs as they fulfil the recognition criteria under HKAS 16 - i.e. probable that future economic benefits associated will flow to the entity and the costs can be measured reliably.

# Exam Technique – per question

- Read over the question requirement first
- Highlight key words that indicate what you are being asked to do (e.g. Calculate / Advise / Explain / Prepare etc…)
- Plan your answer ahead before attempt
- Time management

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# Five-Step Thinking Process in Module A workshop

Identify Issues

↓

Identify relevant accounting standards

↓

Understand the requirement of the accounting standards

↓

Apply the standards

↓

Recommend and Justify

Example 3

# Dec 2017 session – Paper II – Q1(a)

**Required:**

Analyse and advise as to the financial impact and disclosure requirement to the consolidated financial statements for the year ended 31 March 2017 if the waiver letter from Lion Bank for strict compliance of financial covenants was obtained on 10 April 2017 instead of 30 March 2017. (5 marks)

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Example 3

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# Dec 2017 session – Paper II – Q1(a)

*Case facts:*

- Celebrity Group ("The Group") currently borrowed a long-term bank loan of HK$30 million from Lion Bank due in 2020, several financial covenants were stipulated in the loan agreement;
- The loan will become repayable on demand if there is any breach of the financial covenants requirement;
- Management expected the financial covenants would be breached and has applied for a waiver from Lion Bank for strict compliance of financial covenants as at year ended 31 March 2017;
- The waiver letter from Lion Bank was received on 30 March 2017.

Example 3

# Dec 2017 session – Paper II – Q1(a)

## Focus of the question

- Analyse and advise the financial impact and disclosure requirement if the waiver letter for strict compliance of financial covenants was obtained after year end (10 April 2017) instead of before year end (30 March 2017).

## Observations

- Performance was less than satisfactory.
- Most candidates were clear about the question requirement and could comment that the breach led to the reclassification of the bank loan of HK$30 million to current.
- However, many candidates copied the general disclosure requirement from accounting standards instead of the specified disclosure requirement based on the case facts.

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Example 3

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# Dec 2017 session – Paper II – Q1(a)

## Suggested approach

- According to HKAS 1 (Revised) *Presentation of Financial Statements*, since the Group breached the financial covenants, the entire bank loan of HK$30 million becomes payable on demand as at 31 March 2017, the bank loan should be reclassified to current.
- As at 31 March 2017, the Group does not have an unconditional right to defer its settlement for at least 12 months after 31 March 2017.
- Waiver letter obtained on 10 April 2017 was regarded as a rectification of breach and should be disclosed as a non-adjusting event in accordance with HKAS 10 *Events after the Reporting Period*.
- Furthermore, per HKFRS 7 *Financial Instruments: Disclosures*, the Group is required to disclose (i) details of the defaults; (ii) the carrying amounts of the loan payable in default as at 31 March 2017; and (iii) default was remediated before the financial statements were authorized for issue (i.e. waiver letter obtained on 10 April 2017).

Example 4



# Dec 2017 session – Paper II – Q3

**Required:**

Explain the impact of the rights issue granted after the year end on the financial statements for the year ended 31 March 2017. Calculate the basic and diluted earnings per share. (6 marks)

Example 4



# Dec 2017 session – Paper II – Q3

*Case facts:*

- Celebrity Group ("The Group") completed a rights issue of 100,000,000 rights shares at the subscription price of HK$0.3 per rights share on the basis of one rights share for every 4 shares held on 20 April 2017;
- Market price immediately before the rights issue was HK$0.5 per share;
- There are no changes in the number of shares or any potentially dilutive ordinary shares in issue during the year ended 31 March 2017 and 2016.

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Example 4

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# Dec 2017 session – Paper II – Q3

## Focus of the question

- Explain the impacts of the rights issue granted after year end on the financial statements and calculate the basic and diluted earnings per share for the year ended 31 March 2017 and 2016..

## Observations

- Performance was less than satisfactory.
- Only a few candidates could identify the bonus element in the rights issue.
- Most candidates demonstrated a lack of understanding regarding the impact of the rights issue on EPS.
- Some candidates even stated that rights issue was a non-adjusting event and have no impact on EPS in year 2017 and 2016.

Example 4



# Dec 2017 session – Paper II – Q3

## Suggested approach

- According to HKAS 33 *Earnings per share*, rights issue has a bonus element and is required to adjust the weighted average number of shares outstanding "WANOS") in calculating EPS. If rights issue occurred after year end but before the financial statements authorised for issue, retrospective adjustment to the WANOS during the year ended 31 March 2017 and 2016 are required.
- Calculation of the theoretical ex-rights value per share:

  [(4 x HK$0.5) + (1 x HK$0.3)] / 5 = HK$0.46 per share
- Calculation of the adjustment factor:

  Market price immediately before rights issue / theoretical ex-rights value =

  HK$0.5 / HK$0.46 = 1.087
- Basic EPS for 2017 = HK$34,388,000 / (400,000,000 **x 1.087**) = HK$0.079
- Basic EPS for 2016 = HK$29,112,000 / (400,000,000 **x 1.087**) = HK$0.067
- Since no potentially dilutive ordinary shares in issue during both years, the diluted EPS are the same as the basic EPS.

# Key Points Recap

- Interpretation of questions requirements
  - identify the issue to be discussed
  - manage time for each question properly

- Application of technical knowledge
  - understand the standard requirement
  - **exercise judgment in selecting the proper accounting standards** to apply
  - conclude or advise with justifications

# Key Points Recap

- Structure of answers
  - discuss specifically in accordance with the question requirement/case facts
  - apply accounting standard requirements with reference to relevant case facts
  - DON'T just copy the standard requirements or case facts without any linkage

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# Thank you!

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# Marker 2

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# Sharing of common weakness

- Misinterpretation / misunderstanding of question and requirements
- Technical knowledge

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# Dec 2017 session – Paper II – Q1(b)

**<u>Question 1(b)</u> (6 marks – approximately 11 minutes)**

b) Since the Group expected certain financial covenants will be breached, the senior management are concerned as to whether the Group would face financial distress in the foreseeable future.

(i) Based on Modigliani and Miller's (MM) theory, explain whether the issue of financial distress should be considered by the management to determine the capital structure. (3 Marks)

(ii) Based on the trade-off theory, explain whether it is possible for the Group to reach the optimal amount of debt in the capital structure. (3 Marks)

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# Dec 2017 session – Paper II – Q1(b)

**Answer 1(b)(i)**

Modigliani and Miller's ("MM") theory ignores the issue of financial distress in the capital structure. In a world with corporate tax, MM theory argues that firms should maximise the amount of debt in their capital structure because of the tax saving benefit of debt. However, in reality, firms would not adopt an all-debt financing strategy because the management would worry about financial distress.

***Student answer:***

- ❑ **Stated the definition of MM theory**
- ❑ **Further discuss with tax and without tax**
- ❑ **Not to the point (i.e. Should not consider)**

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Example 1

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# Dec 2017 session – Paper II – Q1(b)

**Observation**

- The candidates' performance was less than satisfactory. Most candidates stated the definition of Modigliani and Miller's theory and failed to relate their answers to the question being tested and candidates were unable to relate their answers to the **reality** that the firm would worry about financial distress.

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Example 1

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# Dec 2017 session – Paper II – Q1(b)

## Answer 1(b)(ii)

Based on the trade-off theory of the capital structure, it is possible to reach an optimal amount of debt for the firm. It argues that a capital structure decision involves a trade-off between tax benefit of debt and cost of financial distress. If the amount of debt in the firm's capital structure rises, then the marginal costs of debt will increase. At a certain level, the marginal costs of additional debt will outweigh its marginal tax benefits. Therefore, there is an optimal level of debt at the point where the marginal tax benefits of the debt will be equal to the marginal increase in financial distress costs.

However, in reality, it is not possible to achieve an optimal debt level because financial distress costs cannot be presented precisely and so no equation is available to determine a firm's optimal debt level exactly.

Example 1



# Dec 2017 session – Paper II – Q1(b)

***Student answer:***

- ❑ **Stated the definition of or explain what is trade-off theory**
- ❑ **Some mentioned bankruptcy cost and agency cost (limitations)**
- ❑ **Not to mention possible or not to reach the optimal amount of debt**
- ❑ **Not to mention increasing amount of debt vs the cost of debt**

## Observation

The candidates' performance was unsatisfactory. Most candidates stated the definition of Trade-off theory and failed to relate the answers to the question being tested and most candidates could not elaborate with regard to the dynamics between the increasing amount of debt against the cost of debt.

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Example 2

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# Dec 2017 session – Paper II – Q2

**Question 2 (6 marks – approximately 11 minutes)**

**In the market, a rights issue is one of the popular ways for companies to raise capital. Explain why corporate management often undertake rights issues instead of seasoned offerings (cash offers) to raise capital.**

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Example 2

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# Dec 2017 session – Paper II – Q2

## Answer 2

- The management would like to use a rights issue **because it can minimise the selling costs** and **give a chance to existing shareholders to maintain their ownership**.
- In general, **the rights offering is cheaper than a cash offer**.
- **The cost of the seasoned offerings (cash offers) is higher** and the firm needs to pay gross spread, underwriting discount, filing fee, legal fee and other costs which are used to prepare the prospectus.
- It is **time consuming** to conduct the seasoned offerings as management need to spend a lot of time on the documentation and preparation.

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# Dec 2017 session – Paper II – Q2

***Student answer:***

- ❑ Too general
- ❑ Shareholder's perspective only

## Observations

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 company's perspective.

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Example 3

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# Dec 2017 session – Paper I – Q4

**Question 4 (5 marks – approximately 9 minutes)**

**(a) Explain the main limitation of using financial ratios to assess the company's performance; and how the Balanced Scorecard (BSC) system could overcome the limitation. (2 marks)**

**(b) Identify the main advantages of the BSC and a key factor to make the BSC implementation successful. (3 marks)**

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# Dec 2017 session – Paper I – Q4

## Answer 4 (a)

Financial ratios only reflect the historical financial performance of a company such as profitability and costing performance but they do not cover any non-financial factors, such as customer satisfaction and employment performance which are also important for the success of a company.

BSC can overcome this limitation by providing a company with a wide-ranging context that considers a coherent set of financial and non-financial performance measurements, such as customer satisfaction, skill levels of employees and number of pollution complaints.

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Example 3

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# Dec 2017 session – Paper I – Q4

## Answer 4 (b)

The advantages of the application of Balanced Scorecard system are shown below:

- provide a clear measurement and specification of company's goals; and
- improvement on the business planning and operational processes, alignment of company strategic goals with business development, proficient communication, better team building and knowledge sharing and clearer accountability for results.

The key factor for the successful implementation of the Balanced Scorecard in the organisation is the top management's commitment to the BSC approach.

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# Dec 2017 session – Paper I – Q4

***Student answer:***

***4(a)***

- ***Not to mention How?***

***4(b)***

- ***Describe the nature of BSC (i.e. 4 internal and external factors)***
- ***Key factor = Identify clearly the goals and measures (can apply to all cases)***

**Observations 4(b)**

The candidates' performance was less than satisfactory. Most candidates defined the Balanced Scorecard System and failed to relate their answers to the question requirements tested and thus marks were not awarded. This demonstrated that candidates lacked practical experience and could not apply their technical knowledge to the facts provided.

Example 4



# Dec 2017 session – Paper I – Q5

**Question 5 (4 marks – approximately 7 minutes)**

**Explain whether the practice of corporate social responsibility (CSR) will affect the firm's value and the share price.**

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Example 4

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# Dec 2017 session – Paper I – Q5

## Answer 5

Yes, the practice of Corporate Social Responsibility ("CSR") could raise the company's value and share price in the long run because:

- The practice of CSR may raise the public and shareholders' investment confidence in the company and lead to more buy-side activities and finally increase the share price.
- This also may make the company become more environment-friendly and pay attention to resource saving. This may help the company save power consumption and reduce paper wastage. As a result, this could possibly reduce the operation costs of the business and increase the company's value and its share price.
- It is believed that a socially responsible corporation is positively associated with a company's value and shareholder's wealth.

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Example 4

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper I – Q5

***Student answer:***

- ❑ **Not answer whether CSR will affect (increase of decrease?) the firm's value or share price**
- ❑ **Too general, just explaining what is CSR**

***Observations:***

The candidates' performance was fair. Candidates demonstrated their knowledge that corporate social responsibility would attract investors. However, candidates could not further elaborate their answers with regards to the impact on the share price and stated the definition of corporate social responsibility which was not required by the question.

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Example 5

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper II – Q6

**Question 6** (4 marks – approximately 7 minutes)

The new sales director of Brighten, Ms Agnes Ho, proposed to Dr Susan Lo to set up a staff retirement plan in order to attract more young expertise to join the company. As such, Agnes proposes to invest HK$15,000 per annum, of which HK$10,000 is to be invested in a stock account and HK$5,000 in a bond account, for each younger staff to save for their retirement over the next 30 years. The return of the stock account is expected to be 12% and that of the bond account will be 7%. When the younger staff retire, the amount of stock investment and bond investment will be combined into a bank account with a 9% annual return rate. With this plan, the company targets to allow each of their younger staff receiving an annual withdrawal amount of HK$350,000 with a 25-year withdrawal period after 30 years.

**Required:**

**Evaluate if the target could be achieved based on the current proposed arrangement.**

# Dec 2017 session – Paper II – Q6

## Answer 6

$$\text{FV of Annuity} = P\left[\frac{(1+r)^n - 1}{r}\right]$$

- P = Periodic Payment
- r = rate per period
- n = number of periods
- FV of annuity payment (FVA)in Stock account:
- N = 30 years, r = 12%, P = HK$10,000, FV annuity factor = 241.33
- FVAstock = HK$10,000 X FV annuity factor
- FVAstock = HK$10,000 X 241.33 = $2,413,300
- FV of annuity payment (FVA) in Bond account:
- N = 30 years, r = 7%, P = HK$5,000, FV annuity factor = 94.461
- FVAbond = HK$5,000 X FV annuity factor
- FVAbond = HK$5,000 X 94.461 = $472,305
- So, the total amount saved at retirement is:
- = HK$2,413,300 + HK$472,305
- = HK$2,885,605

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Example 5

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper II – Q6

## Answer 6

$$P\left[\frac{1-(1+r)^{-n}}{r}\right]$$

- Solving for the withdrawal amount in retirement
- P = Periodic Payment
- r = rate per period
- n = number of periods
- N = 25 years, r = 9%, PV = HK$2,885,605, PV annuity factor = 9.8226
- Annual withdrawal amount per staff (P) = HK$2,885,605 / 9.8226 = HK$293,772
- The annual withdrawal amount per staff is HK$293,772 which cannot achieve the expected annual withdrawal amount of HK$350,000. **Brighten may need to consider increasing the annual investment per staff if it wishes to achieve the expected withdrawal amount of HK$350,000.**

# Dec 2017 session – Paper II – Q6

***Student answer:***

- ***Not attempt***
- ***Future value of the stock and bond investment (i.e. one-off investment and hold for 30 years)***
- ***Careless calculation (e.g. incorrect annuity factor due to early rounding)***

## Observations

The candidates' performance was unsatisfactory. Most candidates did not attempt the question or did so with irrelevant calculations. Most candidates showed a weak understanding and application of the technical knowledge to the facts provided in the question and candidates were not familiar with an annuity calculation, especially a Future Value Annuity.

# Dec 2017 session – Paper I – Q8

**Question 8 (12 marks – approximately 22 minutes)**

DaiPang is considering to expand its business and invest HK$16 million in the US market this year and then invest HK$5 million in the UK market next year. It is expected that the new investments will generate annual earnings of HK$3 million in perpetuity, beginning two years from now. Assume cash flows take place at the end of the year and growth rate is insignificant.

**a) Calculate the expected stock price per share if DaiPang does not undertake any new investment, assuming DaiPang can maintain the expected earnings of HK$65 million per year. (3 marks)**

**b) Consider and evaluate whether DaiPang should undertake the new investment in the US and UK markets. (5 marks)**

**c) If DaiPang undertakes the new investments in the US and UK markets, calculate the revised expected stock price per share and consider the impact of the new investments on the stock price. (4 marks)**

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Example 6

Hong Kong's CPA Qualification
香港會計師專業資格

# Dec 2017 session – Paper I – Q8

## Answer 8(a)

Given DaiPang will not undertake any new investment and continues current operations, the total value of DaiPang, is the present value of the future earnings, which are in perpetuity, would be:

Value of the company = Expected earnings per year / rate of return

Value of the company = $65,000,000 / 0.10

Value of the company = $650,000,000

The expected value per share stock price is:

Share price = $650,000,000 / 15,000,000

Share price = $43.33

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Example 6

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper I – Q8

## *(a) Student answer:*

- ***Don't know the relationship between expected return and value of the company***

## Observations

(a) The candidates' performance was unsatisfactory. Most candidates showed a poor understanding and application of technical knowledge to the facts provided in the question and were unable to calculate the expected stock price per share correctly.

# Dec 2017 session – Paper I – Q8

## Answer 8(b)

To evaluate whether to undertake the new investments, we need to determine the NPV of the new investment in the US and UK markets. The NPV of the new investment is:

NPV = - $16,000,000 – 5,000,000 / (1 + 0.10) + ($3,000,000 / 0.10) / (1 + 0.10)

NPV = $6,727,273

DaiPang should undertake the new investments as the project generates positive NPV.

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Example 6

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper I – Q8

## *(b) Student answer:*

- ***Wrong counting the number of years for cash inflows and annual earnings omitted the highlighted part*** ($3,000,000 / 0.10) / (1 + 0.10)
- ***Wrong counting the number of years for cash inflows and outflows by taking all cashflows with*** / (1 + 0.10)

## Observations

(b) The candidates' performance was unsatisfactory. Most candidates showed a poor understanding and application of technical knowledge to the facts provided in the question. Many candidates were weak in terms of their analytical skills and had a poor grasp of the concept of counting the yearly discounting factor.

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Example 6

Hong Kong's CPA Qualification 香港會計師專業資格

# Dec 2017 session – Paper I – Q8

**Answer 8(c)**

The revised stock price per share should take into account the NPV of the new investment in the US and UK markets. As such we need to calculate the NPV of the new investment on a per-share basis.

- NPV of new investment per share = $6,727,273 / 15,000,000
- NPV of new investment per share = $0.45

The revised expected stock price per share if the company undertakes the new investment is:

- Share price = $43.33 + 0.45
- Share price = $43.78

Hence, the impact is positive as the new investments in the US and UK market can raise the stock price of DaiPang.

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Example 6

Hong Kong's CPA Qualification
香港會計師專業資格

# Dec 2017 session – Paper I – Q8

***(c) Student answer:***

- ***Not attempt***
- ***Not able to quantify the impact to share price for an investment***

## Observations

c) The candidates' performance was unsatisfactory. Many candidates did not attempt this question. Many candidates were unable to apply their technical knowledge regarding how to calculate the revised expected stock price per share and failed to reach a conclusion as to the impact on the new investments as specified in the question.

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Hong Kong's CPA Qualification 香港會計師專業資格

# Thank you

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Hong Kong's CPA Qualification
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# Marker 3

Example 1

# December 2017 session (Paper I) – Q1(b)

**Consider and evaluate the impact on the objective, scope and approach of the audit if DaiPang is highly dependent on its various in-house developed integrated systems.** (7 marks)

Example 1



# Observation (Paper I) – Q1(b)

- Some students did not know the differences between "Objective" and "Scope"

- Under "Approach", some students tend to analyse what to consider for the audit work (instead of what to do), which is NOT required by the question. Examples are as follows
  - Whether the team has the required IT skill?
  - Whether the team has the required experience?

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Example 1

Hong Kong's CPA Qualification
香港會計師專業資格

# Suggested answer (Paper I) – Q1(b)

- Objective - > Form an audit opinion -> NO change
- Scope - > NO change
- Approach - > Change
  - Computer-assisted audit techniques, in combination with manual audit procedures, have to be used to obtain the audit evidence. As such, the auditors have to ensure they have the competency to understand the systems and to use the computer-assisted audit techniques.
  - The auditor has to assess the impact of any findings identified in the audit of the systems on the related business processes and financial reporting areas.
  - The auditors have to perform audit procedures to test the completeness and accuracy of the manual inputs.

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Example 2

Hong Kong's CPA Qualification
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# December 2017 session (Paper I) – Q1(c)

Explain and identify **two** possible risks that are related to DaiPang's in-house developed integrated systems, and suggest **one** information technology general / application control to address each of the risks identified.

(6 marks)

Expected Structure of your answer

(i) Risk 1 plus One IT General Control/Application Control

(ii) Risk 2 plus One IT General Control/Application Control

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Example 2

Hong Kong's CPA Qualification
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# Observation (Paper I) – Q1(c)

- Some Students analyse the risks related to the Group but NOT specifically for the in-house developed integrated system. Examples are as follows
  - Management's override to the system
  - Lack of staff training

- Some students did not match the IT general control/Application control with the respective risk (i.e. answer did NOT follow the expected structure)

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Example 2

Hong Kong's CPA Qualification 香港會計師專業資格

# Suggested answer (Paper I) – Q1(c)

- **Risk 1:** System can be assessed by different types of people
- **Suggestion:** Firewall/ username and password etc.

- **Risk 2:** System was linked to all service centre of the Group. Data may not be timely transferred/shared within the network
- **Suggestion:** Exception report is reviewed

- **Risk 3:** System maintained a large volume of data. A risk of data overflow
- **Suggestion:** Data should be backup regularly

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Example 3

Hong Kong's CPA Qualification
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# December session (Paper I) – Q2

Based on the information provided in the case,

(i) identify two risks at the assertion level for each of accounts receivable and deferred revenue and

(ii) propose one specific substantive audit procedure that should be performed to address each of the risks identified.

(12 marks)

Expected structure of the answer

(a) For Accounts receivable

- (i) Risk 1 at assertion level plus one substantive audit procedure
- (ii) Risk 2 at assertion level plus one substantive audit procedure

(b) For Deferred revenue

- (i) Risk 1 at assertion level plus one substantive audit procedure
- (ii) Risk 2 at assertion level plus one substantive audit procedure

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Example 3

Hong Kong's CPA Qualification 香港會計師專業資格

# Observation (Paper I) – Q2

- Some students proposed more than 1 substantive procedure for one risk
  - Only the first substantive procedure would be scored

- Some students only provided generic answers without linking up with each risk. The following are some examples for those risks being discussed generically
  - Calculation of deferred revenue is complicated and involved many calculation
  - Accounts receivable balance decreased by 30% while revenue increased by 10%

- Some students only listed out the relevant assertions and or substantive procedure without identifying any risks as required

Example 3

# Suggested answer (Paper I) – Q2

- Accounts Receivable
  - Risk 1: Accounts receivable is automatically recognised by the system once the order is confirmed and thus accounts receivable is overstated because the products have not been delivered to and accepted by customers.
  - Assertion : Existence
  - Substantive Procedure: Arrange confirmations

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Example 3

Hong Kong's CPA Qualification 香港會計師專業資格

# Suggested answer (Paper I) – Q2

- Accounts Receivable (continued)
  - Risk 2: Accounts receivable is derecognised after the Accounting Team has reconciled the cash receipts on a weekly basis. Accounts receivable may not be timely derecognised.
  - Assertion : Cutoff
  - Substantive Procedure: Cutoff test by tracing to the bank statements during the risk period to check whether accounts receivable has been properly derecognised before the year end and the cash account has been debited.

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Example 3

Hong Kong's CPA Qualification 香港會計師專業資格

# Suggested answer (Paper I) – Q2

- Deferred revenue
  - Risk 1: Deferred revenue is automatically recognised by the system once the order is confirmed and thus deferred revenue is overstated if cash is not received in advance from the customers.
  - Assertion : Existence
  - Substantive Procedure: Trace to bank statements to check whether payments have been received.

Example 3



# Suggested answer (Paper I) – Q2

- Deferred revenue (continued)
  - Risk 2: Deferred revenue may be overstated because the Courier Team did not send the signed goods receipt acknowledgement to the Operations Team.
  - Assertion : Cutoff
  - Substantive Procedure: Cutoff testing by tracing to the delivery reports prepared during the risk period prepared by the Courier Team to check whether the products have been delivered and deferred revenue has been derecognised and the revenue account has been credited.

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Example 4

Hong Kong's CPA Qualification
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# December 2017 session (Paper II) – Q8(a)

**State, with reference to the relevant standard, <u>four</u> matters that AAA & Co have to address before accepting the engagement to become the auditor of the Group.**

**Identify <u>any concerns</u> raised related to these four matters and provide <u>one suggestion</u> as to how AAA & Co should respond to each of the concerns identified. (9 marks)**

Expected structure of the answer

- **(i) Matter 1 with (a) concerns and (b) 1 suggestion**
- **(ii) Matter 2 with (a) concerns and (b) 1 suggestion**
- **(iii) Matter 3 with (a) concerns and (b) 1 suggestion**
- **(iv) Matter 4 with (a) concerns and (b) 1 suggestion**

Example 4

# Observation (Paper II) – Q8(a)

- Students did not know what the difference is between Matters and Concerns
  - Matters are more generic while Concerns are more case specific

- Some students did not link up the suggestion with the specific matters and concern

- Some of the concerns raised by students are invalid. Examples are as follows
  - Change of auditors showed an integrity issue
  - Audit fee for AAA & Co. is similar to that for XYZ & Co.

Example 4



# Suggested answer (Section B) – Q2

- **Matter 1**: Consider the integrity of the entity and does not have information that would lead it to conclude that the entity lacks integrity
- Concern: Based on the information provided in the case, there is no concern raised over the integrity of the entity.
- Suggestion: AAA & Co should perform a detailed background search of major shareholders, directors and senior management members, and consider whether there is any indication of money laundering or other criminal activities committed by management.

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Example 4

Hong Kong's CPA Qualification 香港會計師專業資格

# Suggested answer (Section B) – Q2

- **Matter 2**: Ensure it is competent to perform the engagement
- Concern: AAA & Co should consider whether it has any experience with clients operating in the health care industry.
- Suggestions: It has to conduct industry and market research, or recruit auditors with relevant background and experience.

# Suggested answer (Section B) – Q2

- **Matter 3**: Ensure it has the capabilities, time and resources to perform the engagement

- Concern: AAA & Co should consider whether it has adequate time and staff to take up the audit of the Group as its size is around 30% larger than XYZ & Co while the Group is undergoing continuous business expansion.

- Suggestions: It has to plan the resources to ensure there is sufficient time scheduled and competent staff are assigned to the engagement and there is an appropriate review to ensure the work done is fully in accordance with relevant standards.

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Example 4

Hong Kong's CPA Qualification
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# Suggested answer (Section B) – Q2

- **Matter 4**: Comply with relevant ethical requirements

- Concern: Since Patrick Fu is a partner of AAA & Co as well as a nephew of Susan Lo, CEO of the Group, self-interest / familiarity / intimidation threats may be created if this engagement is taken up by Patrick Fu

- Suggestions: AAA & Co should avoid Patrick being involved in the acceptance assessment as well as the audit of the Group.

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Example 5

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session (Paper II) – Q8(b)

Assume AAA & Co has accepted the engagement to become the auditor of the Group for the year ending 31 March 2017.

**Based on the information provided in the case, identify four specific areas that should be focused on in order to address the risks from the overall financial statement's perspective (i.e. rather than considering the risks of individual financial statement line items). For each of the specific areas identified, list two items that you have to remind the engagement team regarding how that area should be addressed.**

Note: Detailed audit procedures are not required to be set out for the purpose of answering this question. **(12 marks)**

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Example 5

Hong Kong's CPA Qualification
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# Observation (Paper II) – Q8(b)

- Some students did not read the question carefully and copied the same responses from question 8(a)
  - Question 8(a) is for “Preliminary Engagement Activity”
  - Question 8(b) is for “Audit Planning Stage”

- Many students only listed out a number of reminders without linking to the specific risks

- Students still consider the risk of individual financial statement line items even it is NOT required. Examples are as follows
  - The recoverability of the accounts receivables
  - Completeness of the Trade payable balance

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Example 5

Hong Kong's CPA Qualification
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# Suggested answer (Paper II) – Q8(b)

- First-year audit of the Group
  - ensure professional clearance is obtained from XYZ & Co and EFG & Co
  - ensure the accounting policies are consistently applied
  - obtain evidence regarding the opening balances

- Acquisition of 100% equity interest in Brighten Skincare Solutions Limited
  - ensure the acquisition is properly accounted for according to the relevant accounting standards
  - ensure the goodwill is properly recognised

Example 5



# Suggested answer (Paper II) – Q8(b)

- Laws and regulations in relation to medical aesthetic services
  - obtain an understanding on laws and regulations relevant to the industry
  - assess whether there is any non-compliance regarding those laws and regulations that may have a fundamental effect on the operations of the Group and therefore may have a material effect on the financial statements
  - consult legal experts where necessary

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# Thank you!

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# Marker 4

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Hong Kong's CPA Qualification 香港會計師專業資格

# Key points recapped

- Interpretation of the requirements
- <u>Understanding and application of knowledge</u>
- Structure of the answer
- Time management

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Example 1

Hong Kong's CPA Qualification
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# December 2017 session – Paper I – Q10

The Finance Director, Mr Tim Tang, heard of the tax benefits of setting up the Corporate Treasury Centre ("CTC") in Hong Kong, and intends to use DaiPang as a CTC for the future US and UK operations.

In other words, DaiPang would borrow money to lend to associated corporations in the US and UK to meet the finance needs of the US and UK group entities.

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Example 1

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session – Paper I – Q10

The income tax rates and withholding tax rates on interest for the US and UK for non-treaty countries are listed as follows:

| | US | UK |
|---|---|---|
| Corporate income tax rate | 35% | 20% |
| Withholding tax rate on interest | 30% | 20% |

There is no Double Taxation Agreement between Hong Kong and the US.

Example 1

# December 2017 session – Paper I – Q10

Below is an extract (modified) of the tax treaty between Hong Kong and the UK:

*"Article 11 Interest"*

*There is no withholding tax where*

*a) the interest is beneficially owned by (i) the Government of the Hong Kong Special Administrative Region including the Hong Kong Monetary Authority; (ii) an individual; (iii) a listed company; (iv) a pension scheme; (v) a financial institution which is unrelated to and dealing wholly independently with the payer; or (vi) any other company which was accepted by the UK authority that its establishment, acquisition or maintenance does not have as its main purpose or one of its main purposes to secure the tax benefits of no withholding tax on interest; or*

Example 1



# December 2017 session – Paper I – Q10

*b) the interest is paid: (i) by the Government of the Hong Kong Special Administrative Region including the Hong Kong Monetary Authority; (ii) by a bank in the ordinary course of its banking business; or (iii) on a quoted Eurobond."*

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Example 1

Hong Kong's CPA Qualification
香港會計師專業資格

# December 2017 session – Paper I – Q10

You are the tax adviser of DaiPang. Prepare a memo to the Finance Director, Mr Tim Tang, with necessary assumptions, to advise

(a) whether generally it is tax efficient to set up a CTC in Hong Kong;

(b) whether it is tax efficient for a CTC in Hong Kong to charge interest to the US and UK group entities; and

(c) whether DaiPang is the appropriate entity to take up such CTC functions.

Explain with reasons to justify your answers.

Mark(s) will be awarded for proper memo format with logical presentation. **(15 marks)**

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Example 1

Hong Kong's CPA Qualification
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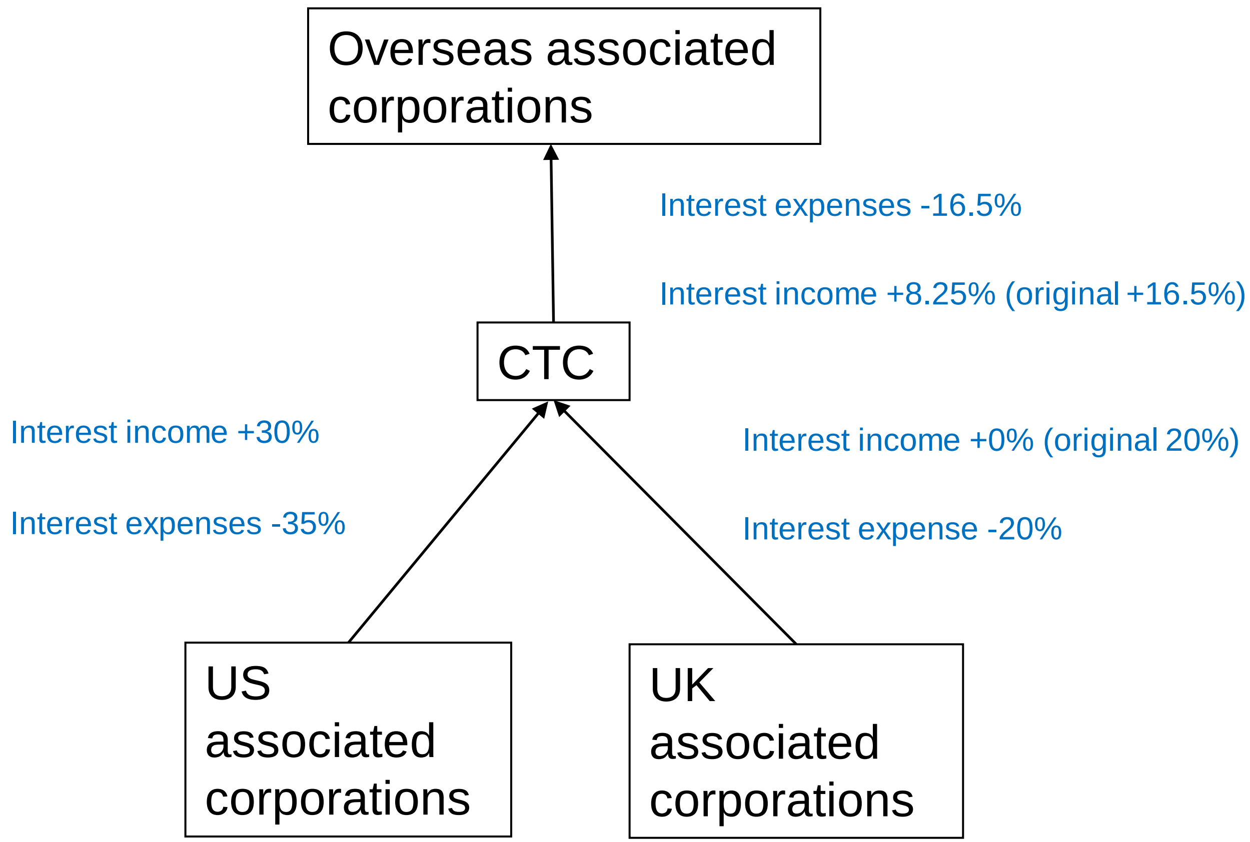
# December 2017 session – Paper I – Q10



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Example 1

Hong Kong's CPA Qualification
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# December 2017 session – Paper I – Q10(a)

**Suggested answer**

Date: xx/xx/xx

To: Finance Director of DaiPang

From: xxx, Tax Adviser

Subject: Hong Kong tax implication of setting up Corporate Treasury Centre ("CTC")

Example 1



# December 2017 session – Paper I – Q10(a)

a) It is tax efficient to set up a CTC from a tax perspective, because the CTC may then enjoy the following tax advantages:

(i) Reduced withholding tax rate under the applicable double taxation agreements ("DTAs").

(ii) There may be off-set of foreign tax credits or exemption of relevant interest income depending on the wordings of applicable DTAs.

Example 1



# December 2017 session – Paper I – Q10(a)

(iii) Interest paid to overseas group companies, if any, is deductible provided the recipient is a beneficial owner; the interest income is subject to tax overseas which is not lower than the reference rate (16.5% or 8.25%); and the interest expense was incurred in generating intra-group financing activities under s.16(2)(g).

(iv) Reduced profits tax rate of 8.25% on interest income from overseas group companies under *s.14D(1)* as a qualifying CTC.
To qualify as a CTC, inter alia, the entity in Hong Kong must carry on intra-group financing; besides, where interest is charged to/by associated entities, it should be at arm's length.

Example 1



# December 2017 session – Paper I – Q10(b)

**Suggested answer**

b) Nevertheless, it is, however, not necessarily tax efficient to charge interest on all inter-company loans.

For instance, due to the lack of DTA between Hong Kong and the US, the charging of interest income would result in double taxation in the US as well as Hong Kong of 30% and 8.25% respectively.

The resultant additional tax cost is 3.25% (30% + 8.25% - 35%), assuming that (i) there is no turnover tax on the interest in the US; and (ii) the interest is deductible in computing the US corporate income tax.

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Example 1

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session – Paper I – Q10(b)

In contrast, there is a tax saving of 11.75% (20% - 8.25%) for charging interest to the UK, assuming that the CTC is a Hong Kong tax resident (by satisfying the condition under the DTA that it does not have one of its main purposes to secure the benefits of *Article 11*), and that

(i) there is no turnover tax on the interest in the UK; and

(ii) the interest is deductible in computing the UK corporate income tax.

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Example 1

Hong Kong's CPA Qualification
香港會計師專業資格

# December 2017 session – Paper I – Q10(b)

From the Hong Kong profits tax perspective, the interest income is taxable under *s.15(1)(ia),* and the corresponding interest expense paid is deductible under

- *s.16(1)(a)* and *s.16(2)(c)* (if the corresponding interest income is taxable in Hong Kong);
- *s.16(2)(d)* (if the lender is a financial institution) or
- *s.16(2)(g)* (if the interest is taxable overseas at a rate not lower than the prevailing tax rate of the Hong Kong entity),
- assuming the conditions under *s.16(2A) and s.16(2B)* are not contravened.

Example 1



# December 2017 session – Paper I – Q10(b)

Deduction on interest expenses would be available in respect of the funds for the loans lent to both the US and UK entities, as long as the relevant conditions are satisfied. There is no difference in interest deductibility in respect of the loans to the US entities as compared to the UK entities.

From a transfer pricing perspective, there should be a consistent and justifiable basis for the charge of interest on inter-company loans. Although it may not be tax efficient to charge interest to the US, the CTC still needs to charge interest to both the UK and US.

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Example 1

Hong Kong's CPA Qualification
香港會計師專業資格

# December 2017 session – Paper I – Q10(c)

**Suggested answer**

c) DaiPang is not the appropriate entity to become the CTC, because a qualifying CTC needs to satisfy one of the following conditions during the relevant year of assessment:

(i) It carries out only corporate treasury activities (s.14D(3) refers);

(ii) It satisfies the safe harbour rule under s.14E, i.e. either having CTC assets or profits of not less than 75% for one year or on average on a three year basis; or

(iii) It has obtained the CIR's determination under s.14F(1) that it is a qualifying CTC.

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Example 1

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session – Paper I – Q10(c)

As DaiPang is a listed entity in Hong Kong, it will unlikely be able to satisfy these conditions (assuming that it would not be able to obtain a CIR's determination).

DaiPang should set up a new Hong Kong subsidiary to only carry out the corporate treasury activities.

The subsidiary should be managed and controlled in Hong Kong in order to be a Hong Kong tax resident for the purpose of enjoying the DTAs with other jurisdictions, and also qualify as a qualifying CTC.

Yours faithfully,
Tax Advisor

# Sample answer I

Not understand the threshold of carrying on business in Hong Kong

Memo
To: Mr Tim Yang
From: Tax Advisor
Date: 5 December 2017
Re: CTC Enquiry

(a) Set up CTC in Hong Kong

After the enactment of Inland Revenue (Amendment) (No. 2) Ordinance in 2016, a qualified CTC which satisfies the condition under *s.14D* can enjoy the following:

Not familiar with the requirements of CTC

# Sample answer I

With effect from 1 April 2016, the interest income is chargeable on worldwide basis under *s. 15(1)(ia)* on a half of normal profit tax rate (8.25% = 16.5% / 2) under *s. 14D(1).*

The definition of interest expense of a CTC is governed by *s.16(2)(g), s.16(2CA) and s.16(2CC).*

*s.16(2)(g)* provides that if the recipient (a non-resident associated company) of a CTC is chargeable to tax in its own home country, the interest expense paid by a QCTC is deductible under profits tax.

*s. 16(2CA)* privies that the tax rate of the recipient must be equal or more than the reference rate (i.e. Hong Kong profits tax rate). This is the interest diversion test.

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Not familiar with the requirements of CTC

# Sample answer I

*s.16(2CC)* provides that the chargeable income in the home country should not be affected by any loss that the interest income may not be chargeable at reference rate. This is the loss shifting test.

Before all these, deduction of interest expense is not allowed under *s.16(2)(c)* and *s.16(2)(e),* and interest income depends with provision of credit test under *s.15(1)(f).*

Therefore, it is tax efficient to set up a CTC in Hong Kong to enjoy the concessionary tax rate and deductible expenses.

Not familiar with the requirements of CTC

## Sample answer I

b) If DaiPang receive interest income from US which is not a tax treaty country, the interest income will be subject to 8.25% tax rate in Hong Kong and the US companies will need to withhold 30% on behalf of DaiPang for US Profits tax purposes.

It is not tax efficient to charge interest to US companies.

For company in the UK, since DaiPang is a listed company in Hong Kong Stock Exchange, under Article 11 of the tax treaty between Hong Kong and UK, withholding tax is exempted on the interest income received by Hong Kong company from UK company.

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Not familiar with the requirements of CTC

# Sample answer I

The interest income is just subjected to concessionary tax rate of 8.25% in Hong Kong.

Thus it is tax efficient to charge interest to UK.

CPA Hong Kong Institute of Certified Public Accountants 香港會計師公會

Not familiar with the requirements of CTC

# Sample answer I

c) To determine if DaiPang is an appropriate entity to take up CTC functions, the following needed to be satisfied:

The corporation is a CTC which is in substance an in house lending institution, if in that year of assessment under *s.14D(5)*:

(i) The central management and control of the corporation is exercised in Hong Kong;

(ii) The activities that produce qualifying profit in year are carried out in Hong Kong by the corporation or arranged by the corporation to be carried out in Hong Kong. This is the substantial activity requirement.

Not familiar with the requirements of CTC

# Sample answer I

Assuming that most of DaiPang's CTC activities occurred in Hong Kong, it will satisfy this requirement.

If DaiPang has made an election in writing, which is irrecoverable. That half rate concession applies to it.

Then DaiPang would be an appropriate entity to take up CTC function.

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Not familiar with the requirements of CTC

# Sample answer I

<u>*s.14D(1)*</u> provide the following activities are applicable to <u>8.25% tax rate</u>:

(1) Assessable profit from qualifying lending transaction.

(2) Assessable profit derived from corporate treasury service or

(3) Assessable profits derived from qualifying corporate treasury transaction.

Hope this help!

Best regards
Tax Advisor

Hong Kong Institute of Certified Public Accountants
香港會計師公會

Example 2

Hong Kong's CPA Qualification
香港會計師專業資格

# December 2017 session – Paper II – Q10

You are the tax advisor to Brighten.

Write a letter to the Board of Brighten about the Hong Kong and PRC tax implications in respect of the new business strategy to <u>provide skincare advisory services to high net worth individuals in mainland China</u> (Hong Kong salaries tax and individual income tax in mainland China should be excluded).

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Example 2

Hong Kong's CPA Qualification
香港會計師專業資格

# December 2017 session – Paper II – Q10

Recommend the measures that should be taken to mitigate both the taxes in Hong Kong and mainland China.

You should state the potential arguments of both the tax authorities and Brighten with supporting legislation(s) and / or tax case(s).

Mark(s) will be awarded for proper letter format with logical presentation.

**(15 marks)**

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Example 2

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session – Paper II – Q10

**Suggested answer**

The Board of Directors of Brighten

Date

Dear Sirs

We would be pleased to advise on both the mainland China tax and Hong Kong tax implications of the arrangement:

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Example 2

Hong Kong's CPA Qualification 香港會計師專業資格

# December 2017 session – Paper II – Q10

Hong Kong Tax

Under *s.14 of the IRO*, a taxpayer will be subject to Hong Kong profits tax if it (a) carries on a business in Hong Kong; (b) derives profits from that business; and (c) the profits are sourced in Hong Kong.

According to the "operations test", the test to determine whether the profits are sourced in Hong Kong is "where do the operations take place from which the profits in substance arise?".

Example 2



# December 2017 session – Paper II – Q10

Nevertheless, the IRD will likely disagree with this approach because the sales team would need the data generated by the Hong Kong research team to provide the services (*TVB International case* refers).

A fall-back approach would be to do an apportionment of profits as *DIPN 21* also allows an apportionment of services where part of the services is rendered in Hong Kong and the other part is rendered outside Hong Kong, as supported by the *Hang Seng Bank case*.

A possible basis of apportionment could be 50:50, or based on the costs incurred in Hong Kong and mainland China respectively as per *DIPN 21*.

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Example 2

Hong Kong's CPA Qualification
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# December 2017 session – Paper II – Q10

Mainland China Tax

Assuming Brighten is a Hong Kong tax resident (i.e. being a Hong Kong incorporated company as well as normally being managed or controlled in Hong Kong), it should be entitled to the benefits under the Double Taxation Agreement between Mainland China and Hong Kong ("Mainland China – HK DTA").

The DTA, however, does not cover turnover tax. Brighten is therefore subject to Value Added Tax of 6% on the relevant consultancy fee.

Example 2



# December 2017 session – Paper II – Q10

For Corporate Income Tax ("CIT"), if Brighten does not have a permanent establishment ("PE") in Mainland China, it would not be subject to CIT there.

Accordingly, Brighten should take the following measures in order to avoid having a PE in mainland China as defined under *Article 7* of Mainland China – HK DTA:

Agnes Ho and her team should not have a "fixed place of business" in mainland China, e.g. having a rented office or regularly using a fixed office provided by a group company in mainland China, or having a business name card with a fixed office in mainland China as per *Departmental Interpretation and Practice Note ("DIPN") 44*.

Example 2



# December 2017 session – Paper II – Q10

Agnes Ho and her team should keep track of their itinerary record in mainland China such that the "aggregate time" they spend in mainland China does not exceed 183 days within any 12-month period in mainland China so as to avoid a "services PE" as per *DIPN 44*.

Brighten, Agnes Ho and her team should not appoint any agent in mainland China such that the agent could act on behalf of Brighten and habitually exercise an authority to conclude contracts in the name of Brighten in order to avoid an "agency PE".

# December 2017 session – Paper II – Q10

Tax credit

If both CIT and Hong Kong profits tax are paid on the same consultancy fee income (e.g. there is a PE in mainland China and the offshore claim fails), it is possible for the CIT (25%) to be treated as tax credit for off-set against the Hong Kong profits tax payable (up to 16.5%) according to the DTA and pursuant to *s.50 of the IRO*.

Yours faithfully
Tax Advisors

Discussion focused only on the service PE

# Sample answer I

To: The Board of Brighten
From: Mr A, tax advisor
Re: Tax implication in the new business strategy

Profits tax implication

The board guiding principle in determining the source of profits is that “one looks to see what the taxpayer has done to earn the profits in question and where he has done it.

Specifically the following principles are relevant in determining the locality of service income (*para 17, DIPN No. 21).*

Discussion focused only on the service PE

# Sample answer I

(i) The relevant operation providing the service income and where those operation took place should be ascertained

(ii) The operation in question must be the operation of the taxpayer

(iii) The operation do not comprise the whole of the activities of the taxpayer carried out in the course of its business, but only those which produce the service income

(iv) If service ae perform in both HK and overseas, apportionment may be appropriate

(v) The absence of an overseas permanent establishment to facilitate the provision of the services outside HK does not of itself mean that the service income must be sourced in HK.

Discussion focused only on the service PE

# Sample answer I

In this case, Ms Agnes Ho decided to go to mainland china to provide skincare advisory services. Therefore, in this sense, the service income <u>may not likely to be taxable in HK</u>.

However, according to the <u>*Kwong Mile case*</u>, IRD will focus on effective cause of the profit producing transactions without being distracted by antecedent or incidental matter.

Discussion focused only on the service PE

# Sample answer I

In this case, the support from HK research team to produce analysis of personal data relating to their customer may be challenged by IRD, in which the service provided by HK team is also effective cause of profit producing transaction. And therefore the service income may be apportioned into onshore and offshore sourced portion may subject to the availability of an appropriate basis.

And the expense incurred by the HK team may be deductible under *s.16(1)* if the HK team generate chargeable income in HK. The expense deductibility would be to the extent incurred in the production of assessable profit. While, if it is not generating chargeable profits, the expenses are not deductible.

Discussion focused only on the service PE

# Sample answer I

PRC tax

According to the *DTA Article 7*, profits of an enterprise on one side (HK) shall be taxable only in that side unless the enterprise carries on business in other side (PRC) through PE situate therein.

Therefore, we look at the *Article 5*, the permanent establishment include space, time and function.

As Ms Agnes Ho is going to provide service in mainland china. It is likely constitute a PE. Therefore the service income is taxable in PRC.

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Discussion focused only on the service PE

# Sample answer I

As Brighten is neither incorporated in PRC nor having effective management in PRC. Hence it is regarded as non-PRC tac resident for PRC Corporate Income Tax (CIT).

And Brighten are regarded to pay CIT on PRC sourced income which effectively connected with its establishment in PRC at 25%.

According to *Guoshifa (2010),* non resident enterprise should set up accounting book in accordance with the *Tax Collection and Administrative Law.*

Discussion focused only on the service PE

# Sample answer I

<u>Double Taxation</u>

In case double taxation arises on the same amount of profits, tax credit is available under *<u>Article 21 of DTA</u>*<u>, subject to</u> *<u>s.50(3) and s.50(5) of IRO</u>*.

Mr A
Mr A, Tax Advisor

Knowledge of the DTA is insufficient

# Sample answer II

Dear Board of Brighten

New Business Strategy – Skincare Advisory

HK Profits tax implication

According to *s.14 of the IRO*, since Brighten is a HK company, it is likely that Brighten is carrying on a business in Hong Kong and the profit arising from the skincare advisory is subject to HK Profits tax.

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Knowledge of the DTA is insufficient

# Sample answer II

According to *DIPN 21*, the operations test is relevant in determining the source of services fee received. Place where the services are performed which give rise to the payment of fees.

In order to minimize HK Profits tax, Brighten should perform all the service outside HK. Then the service income for the advisory of skincare will exempt from HK Profits tax. Relevant cases are *CIR v Macquarie, CIR v Kim Eng*.

However, this may be challenged by the IRD based on *s.61 or s.61A*.

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Knowledge of the DTA is insufficient

# Sample answer II

*s.61* state that if the assessor think the transaction is artificial or fictitious, he may disregard any such transaction.

*s.61A* state that when the assessor think that the transaction is of a sole or dominant purpose of obtaining tax benefit.   He may treat the transaction or any part thereof had not been entered into or carried out.

We also have to argue that the HK research team's effort to provide analysis of personal data of customers is not the profit generating activity, and is incidental to the service fee received.

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Knowledge of the DTA is insufficient

# Sample answer II

Effective from 1 May 2016, the VAT reform programme has expanded its scope of VAT to all services previously covered under BT.

The skincare advisory service should be under the category of lifestyle service – education and medical care services which subject to 6% of VAT rate.

A taxpayer engaged in provision of taxable service which have annual taxable service turnover below RMB 5 million would be classified as small scale taxpayer, and subject to 3% VAT rate with no input VAT can be claimed for deduction.

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Knowledge of the DTA is insufficient

# Sample answer II

For CIT, since Brighten is non-PRC tax resident, only PRC sourced income will be taxable for CIT.

The CIT tax rate is 25% if Brighten is with establishment in the Mainland. Brighten may enjoy 20% tax rate if it is eligible for a small scaled enterprise.

Brighten may also not to set up an establishment in Mainland and the tax rate will be 10% of the gross income on withholding basis.

However, such arraignment may be challenged by PRC SAT anti-avoidance notice *Guoshuihan [2009] No. 601* issued in 2009.

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# Summary of Examination Techniques

Hong Kong's CPA Qualification
香港會計師專業資格

- Don't panic
- Manage your time (1.8 mins./mark)
- Attempt all questions and review your answers at last
- Read question requirements and identify the issues carefully
  - Highlight key words (e.g. Calculate / Advise / Propose etc…)
- Pay attention to specific format requirement (e.g. Memo)
- Give relevant answers
- Write clearly and check for careless mistakes
- Apply technical knowledge and don't copy from LP

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CPA Qualification
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# Thank you!

# Part 5:
# Q & A Session