



Hong Kong Institute of
Accredited Accounting Technicians
香港財務會計協會

Professional Bridging Examination

Paper III PBE Auditing and Information Systems

December 2009 Session (Questions)

Time Allowed	3 hours
Examination Assessment Allocation	
• Section A – The One question is compulsory	40 Marks
• Section B – Answer 3 out of 4 questions	60 Marks

PAPER III – PBE AUDITING AND INFORMATION SYSTEMS

This examination is divided into TWO sections.

- Section A (40%). This consists of ONE compulsory question. You should allocate approximately 1 hour 12 minutes in total for Section A.
- Section B (60%). This consists of four questions, of which you must answer THREE questions only. Each of these three questions is worth 20% of the total marks (making Section B worth 60% of the total marks). You should allocate approximately 36 minutes for each question (that is, 1 hour 48 minutes in total for Section B).

Suggested Time Allocation (by marks):

Marks	Approximate time (minutes)
1	2
2	3
3	5
4	7
5	9
6	11
7	12
8	14
9	16
10	18
11	20
12	21
13	23
14	25
15	27
16	29
17	30
18	32
19	34
20	36

SECTION A (COMPULSORY) (Total: 40 marks)

Answer **ALL** questions in this section. Marks are indicated at the end of each question. Together they are worth 40% of the total marks for this examination.

CASE

In August 2008, BBC & Co (BBC), the auditor of the existing client, China Shine Limited ("CSL"), a garment manufacturing and trading company, assigned Mabel Wong, a newly joined audit manager, as the manager in charge of the audit of the financial statements of CSL for the year ended 31 December 2008. Mabel Wong knew that her husband had invested in the shares of CSL, and the amount of his investment is considered material.

At the first meeting on 4 December 2008, with Rose Cheung, the financial controller of CSL, Mabel was advised that Rose had suffered from a critical illness. Rose took sick leave during the year from August to November. Peter Cheng, the uncle of the major shareholder of the company, acted as the financial controller for that period. Rose and Mabel agreed that the stocktaking would be carried out on 31 December 2008. On 24 December 2008, Rose told Mabel that the stocktaking was not ready. The reason was that several major customers in the US had told them not to deliver the goods to them since the retail market contracted a lot after the financial tsunami. There were many inventories in the warehouse. The stocktaking was delayed until 10 January 2009.

Many of the customers in the US delayed their payments to CSL. Rose considered that there was no impairment of accounts receivable due to their long term relationships with CSL. Rose guaranteed Mabel that all the customers would confirm the amounts due to CSL and therefore, no impairment was required as all the amounts would be confirmed. CSL requested BBC to complete the audit earlier as CSL had to submit its audited financial statements for the renewal of a bank loan which would expire at the beginning of March 2009.

Question 1 (40 marks – approximately 72 minutes)

Required:

- (a) What is auditor's independence? Explain why it is essential for an auditor to be independent of his or her assurance clients.
(4 marks)
- (b) What is the independence issue in this case and how should the issue be solved?
(3 marks)
- (c) How would Rose's sick leave affect Mabel's assessment of control risk?
(2 marks)
- (d) What actions should Mabel take as a result of the sick leave taken by Rose during the year?
(2 marks)

- (e) List out the audit procedures that will be carried out on the stocktaking day.
(5 marks)
- (f) Taking into account that the stocktaking day was 10 January 2009, list out the substantive procedures that can address the completeness and existence assertions for inventory during the annual audit.
(6 marks)
- (g) What should be Mabel's assessment of risk of material misstatement of inventory at the assertion level for valuation? Explain.
(4 marks)
- (h) Do you agree with Rose's argument that there was no need to account for any impairment of the accounts receivable? Explain.
(4 marks)
- (i) List the substantive procedures for the valuation assertion for accounts receivable.
(4 marks)
- (j) After performing the necessary further audit procedures, Mabel considered that a \$6,000,000 allowance for doubtful debts should be accounted for but Rose does not want to adjust the financial statements as this may significantly affect the chance of renewal of the bank loan which is critical for financing the activities of the company.

What would be the possible types of audit opinion in this case? Explain.
(6 marks)

* * * END OF SECTION A * * *

SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)

Answer any **THREE** questions in this section. Each question carries 20 marks. Together they are worth 60% of the total marks for this examination.

Question 2 (20 marks – approximately 36 minutes)

The firm of PF & Co. in which you are employed is the external auditor of Company A which is a company that carries out trading business and investment activities. Company A has different types of assets listed in its statement of financial position. The asset items are listed as follows:

- (i) Investment property in Hong Kong
- (ii) Motor vehicle
- (iii) Inventory in transit
- (iv) Investment in shares of listed companies
- (v) Investment in shares of private companies
- (vi) Golf club membership
- (vii) Rental deposits paid
- (viii) Loan to employees
- (ix) Investment property in China
- (x) Cash at bank and in hand

Required:

Design efficient and effective substantive procedures for testing the existence assertion and the rights and obligations assertion of the above assets.

(20 marks)

Question 3 (20 marks – approximately 36 minutes)

You are the engagement manager of the audit of a listed company, Bright Future Limited. Peter Lee, a newly recruited accounting graduate who has no practical experience, is assigned as your assistant. Peter knows that there is an audit committee and an internal audit department in Bright Future Limited. However, he cannot distinguish the roles of the external auditor, the internal auditor and the audit committee.

Required:

- (a) What are the differences between internal auditing and external auditing?
(8 marks)
- (b) What are the important criteria the external auditor uses to evaluate the internal audit function?
(8 marks)
- (c) One of the functions of the audit committee is to oversee the financial reporting and the internal control procedures. How does the audit committee achieve these functions?
(4 marks)

Question 4 (20 marks – approximately 36 minutes)

The firm of PPG & Co., in which Frankie Yip is employed, is the external auditor of Delicious Limited ("DL") which is a company that carries out a fast food business.

Frankie Yip has been in charge of this audit for a few years. DL had good internal control over employee benefit costs in the past. Frankie has assessed the risk of material misstatement at the occurrence assertion level as low, with an expectation that the relevant internal controls operate effectively during the year.

Required:

- (a) What are the five major types of control activities?
(5 marks)
- (b) What are the possible control activities that may exist in controlling employee benefit costs? Provide one example for each type of control activity.
(5 marks)
- (c) For the occurrence assertion of employee benefit costs, what are the four principal types of further audit procedures that can be performed as tests of controls? Provide four further audit procedures as tests of controls.
(8 marks)
- (d) Provided that Frankie adopts the reliance approach and the tests of controls results are satisfactory, what is the principal type of further audit procedure that will be performed as a substantive procedure for the occurrence assertion?
(2 marks)

Question 5 (20 marks – approximately 36 minutes)

Information systems play a significant role in the success of a business. Companies change their information systems from time to time. These changes range from minor changes to major overhauls. Occasionally, the old system is scrapped and replaced by a new one. There are four types of conversion from an old system to a new system, namely,

- (i) direct conversion;
(Immediately terminate the old system when the new one is introduced.)
- (ii) parallel conversion;
(Operate the old and new systems simultaneously for a period of time.)
- (iii) phase-in conversion; and
(Gradually replace elements of the old system with new ones. The new system is often phased in one module at a time.)
- (iv) pilot conversion.
(Implement a system in just one part of the organisation, e.g., a branch office or a single store. When problems with the pilot system are resolved, new systems can be implemented at the remaining locations.)

Required:

- (a) Provide three benefits that can be created by an information system.
(3 marks)
- (b) Why do companies change their information systems? Provide six reasons.
(6 marks)
- (c) What are the seven major steps of systems implementation before the conversion from an old system to a new system?
(7 marks)
- (d) The basic mechanism of the four types of conversion from an old system to a new system was outlined above. Describe the major advantage and disadvantage of direct conversion and parallel conversion respectively.
(4 marks)

* * * END OF EXAMINATION PAPER * * *

Answers

Paper III
PBE Auditing and
Information Systems
(December 2009 Session)

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

Independence requires independence of Mind and independence in Appearance.

Independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

In the case of an assurance engagement, it is in the public interest and, therefore, required by the Code of Ethics, that members of assurance teams/firms be independent of assurance clients to ensure users' confidence in the auditors' conclusion.

Answer 1(b)

Mabel's husband had an investment in the equity shares of CSL Limited.

This was a personal interest threat. Mabel had a direct financial interest which came from the shareholding of CSL by an immediate family member.

The self-interest threat created would be so significant that the safeguards available to eliminate the threat or reduce it to an acceptable level were as follows:

- (i) Mabel's husband to dispose of the direct financial interest prior to Mabel becoming a member of the assurance team;
- (ii) Mabel's husband to dispose of the direct financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material prior to Mabel becoming a member of the assurance team; or
- (iii) Mabel to request to be removed from the assurance team of this assurance engagement.

Answer 1(c)

The control risk for the audit would probably need to be assessed as higher than normal because Peter Cheng, the acting controller, regardless of competence, might not be able to exercise the existing procedures and control of the accounting system in the same way as Rose Cheung.

Answer 1(d)

It would be appropriate to increase the extent of further procedures of accounting documentation and to verify that existing documented systems were properly carried out by Peter Cheng during the acting period. Any areas which were formerly evaluated as normal control risks may require additional testing for that period because Peter Cheng, who acted as the financial controller for such period, was not fully conversant with CSL systems and may have been biased in his actions.

Answer 1(e)

Audit procedures on stocktaking day:

- Ensure that the client's count teams are following the inventory count instructions.
- Ensure that the inventory tags are issued in sequence.
- Obtain tag control information for testing the client's inventory compilation.
- Test count inventory, from count sheets list to the floor.
- Test count inventory, from floor to the count sheets list.
- Obtain cutoff information.
- Observe the condition of the inventory (noting any obsolete, damaged, slowing moving or excess quantities items).
- Inquire about goods held on consignment.

Answer 1(f)

Existence

- Select samples from the inventory list (with quantity and value) and agree with the count sheets list (with quantity only) which was prepared on stocktaking day and rollback test if there are movements of the stock items.
- Check the stock movements between the year-end day and stocktaking day against goods delivery notes and invoices issued.
- Check the stock movements between the year-end day and stocktaking day against goods received notes and invoices received.

Completeness

- Select samples from the count sheets list and agree with the inventory list and rollback if there are movements for the stock items.
- Check the stock movements between the year end day and stocktaking day against goods delivery notes and invoices issued.
- Check the stock movements between the year end day and stocktaking day against goods received notes and invoices received.

Answer 1(g)

Inventories should be stated at lower of cost and net realisable value. When the inventories' realisable value is lower than the cost, the company has to write down the value of inventory. The amount to be written down is subject to management's estimation. The assessment of risk of material misstatement of the inventory at assertion level for valuation should be high as so many inventories piled up in the company and the economy was under recession, making the saleable value hard to be determined.

Answer 1(h)

External confirmation of an account receivable normally provides reliable and relevant audit evidence regarding the existence of the account receivable as at the year-end date. Confirmation may provide further evidence on the cut-off of sales revenue recognition and cash settlement. However, confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion. The confirmation does not guarantee the ability of the customer to pay the amount due.

Answer 1(i)

Substantive procedures for the valuation assertion for accounts receivable:

- Examine results of the confirmations and review aging analysis and correspondence with debtors for any disputes.
- Discuss the underlying assumptions of the allowance for doubtful debts.
- Recalculate the amount of allowance for doubtful debts based on management's assumptions and agree to the recorded amount.
- Compare the prior years' allowance for doubtful debts and the subsequent actual written off amount to test the accuracy of the management's estimation.
- Obtain a list of aged receivables and investigate the recoverability of the old balances and check whether the long overdue accounts receivables are included in the list of doubtful debts.
- Check subsequent settlement of accounts receivables to ensure recoverability.

Answer 1(j)

There is a disagreement with management regarding the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements.

A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion.

An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Regarding the issue of the renewal of a bank loan which in turn may cast significant doubt on the going concern of the company, the auditor's report may be modified by adding an emphasis of matter paragraph to highlight such a matter.

* * * END OF SECTION A * * *

SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)

Answer 2

Substantive procedures:

- (i) Investment property in Hong Kong
 - perform land search
 - review bank confirmation for the amount of mortgage loan outstanding
 - perform physical inspection of the property
 - inspect the title deed
- (ii) Motor vehicle
 - inspect motor vehicle registration book
 - perform physical inspection of the motor vehicle
- (iii) Inventory in transit
 - inspect the invoices, subsequent receipt of inventory and shipping documents
 - review the term FOB
- (iv) Investment in shares of listed companies
 - inspection of share certificates
 - send confirmation to the bank if the bank acts as trustee
 - send confirmation to the brokerage house if the brokerage house acts as trustee
- (v) Investment in shares of private companies
 - inspection of share certificates
 - perform company search
 - inspect the register of members of the investee
- (vi) Intangible assets – golf club membership
 - inspection of the contract with the club
 - inspection of the current monthly statement issued by the club
- (vii) Rental deposits paid
 - inspect receipts issued by landlords
 - inspect the tenancy agreement
- (viii) Loan to employees
 - send confirmation to the employee
 - inquire the management whether the amounts due are factorised
 - receipt signed by employee
- (ix) Investment in property in China
 - inspection of land use right certificate
 - inspection of the building ownership certificate
 - perform land search
 - physical inspection of the property

- (x) Cash at bank and in hand
- send bank confirmation
 - obtain the cash certificate
 - count the cash in hand
 - examine bank statements

Answer 3(a)

Difference between internal auditing and external auditing:

- The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The external auditor is independent of the client and its management in fact and in appearance.
- The internal audit function's objectives vary according to management's requirements. The internal auditors develop improvements and induce compliance with established policies and procedures. The external auditor's primary concern is whether the financial statements are reliable and free of material misstatements.
- Internal auditing is performed by an employee of the company but external auditing is performed by a practising professional outside of the company.
- The internal auditor's primary concern is to serve the needs of the company but the external auditor's primary concern is the needs of the shareholders.
- Internal auditors serve the company continuously throughout the year but the external auditors only perform periodic evaluations.
- Internal auditors are directly concerned with the prevention and detection of fraud but the external auditors are only incidentally concerned with the prevention and detection of fraud.

Answer 3(b)

According to HKSA 610, when obtaining an understanding and performing an assessment of the internal audit function, the important criteria are the following:

- (i) Organisational status: Specific status of internal auditing in the entity and the effect of its ability to be objective. In the ideal situation, internal auditing will report to the highest level of management and be free from any other operating or reporting responsibility. Any constraints or restrictions placed on internal auditing by management would need to be carefully considered. In particular, the internal auditors will be free to communicate in full with the external auditor.
- (ii) Scope of function: The nature and extent of internal auditing assignments performed. The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

- (iii) Technical competence: Whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors. The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.
- (iv) Due professional care: Whether internal auditing is properly planned, supervised, reviewed and documented. The existence of adequate audit manuals, work programs and working papers would be considered.

Answer 3(c)

To achieve these functions, the audit committee should:

- ensure the external auditor has unrestricted access to the internal auditor
- ensure the internal audit function has sufficient manpower
- ensure the qualification and experience of the staff of the internal audit department
- ensure the internal audit function has appropriate standing in the company
- meet with the internal auditor regularly
- review internal auditor's reports and the management's responses

Answer 4(a)

The five major types of control activities are:

- authorisation
- performance reviews
- information processing
- physical control
- segregation of duties

Answer 4(b)

The possible control activities that may exist:

Authorisation

- authorisation by appropriate personnel for all additions, changes and deletion of personnel records
- authorisation for payments of employee benefit costs

Performance review

- compare actual costs against budgets
- compare current month's costs against previous months'
- relate the number of staff during the month to monthly costs

Information processing

- unique staff number in sequential order to avoid creation of fictitious personnel record
- checking of arithmetical accuracy of employee benefit costs to ensure the amounts are in accordance with employment contracts

Physical control

- restrict access to personnel data
- restrict access to employment contracts

Segregation of duties

- persons authorising employee benefit costs are not responsible for recording
- persons recording employee benefit costs are not responsible for payment

Answer 4(c)

Further audit procedures that can be performed as tests of controls:

- Inspect documentary evidence such as authorisation for all additions of personnel records and authorisation for payments.
- Observe whether the employment contracts are locked.
- Re-perform some control activities, such as follow-ups on unusual monthly fluctuation of employee benefit costs, checking the arithmetical accuracy of employee benefit costs.
- Inquire about and observe the segregation of duties in authorising, recording and making payment of staff costs.

Answer 4(d)

The engagement team may only perform analytical procedures. However, the engagement team may also perform some tests of details to obtain additional audit evidence.

Answer 5(a)

Benefits created by an information system may include:

- Reduction of uncertainty
- Improved decisions
- Improved ability to plan and schedule activities

Answer 5(b)

Companies change their information systems so as:

- To respond to changes in business needs or user needs
- To take advantage of technology changes
- To accommodate improvements in business process
- To gain a competitive advantage
- To lower costs
- To increase productivity
- To accommodate growth
- To accommodate downsizing
- To replace a system that is aged and unstable

Answer 5(c)

Major steps of systems implementation before conversion:

- Develop implementation and conversion plan
- Site preparation
- Develop and test software
- Train personnel
- Test the system
- Prepare documentation ready for approval
- Convert from old to new system and deliver operational system

Answer 5(d)

Direct conversion

Main advantage - It's relatively inexpensive.

Main disadvantage - It has no backup system. There is a high risk of failure unless the new system has been very carefully developed and tested.

Parallel conversion

Main advantage of parallel conversion - It protects the company from errors of the new system with the old one still in place.

Main disadvantage - It is relatively costly and stressful for employees to process all transactions using both systems.

* * * END OF EXAMINATION PAPER * * *