



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

June 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

David Lau is a technical manager of a CPA firm, JST & Co. Recently, David was requested by his firm to be the audit manager in charge of an existing client, Best Fashion Limited ("BFL"), a private company engaging in the fashion retailing business, for the accounting year ended 31 December 2008. BFL has 8 retail stores in Hong Kong. It buys different types of clothes from different suppliers, and sells those clothes in its retail stores in Hong Kong.

The personnel arrangement in each retail shop is as follows:

- 1 shop manager
- 2 – 4 sales assistants

BFL was established by Miss Wong in January 2005. The number of shops has remained the same throughout but the business grew steadily till the end of 2007. Due to the outbreak of the Financial Tsunami in the US, which affected the global economy as well as Hong Kong, sales revenue shrank in 2008.

According to the working paper file for the year ended 31 December 2007, David knows that the company maintains a simple computer system. Every item of the merchandise is assigned with a stock code. After goods are selected by a customer, the sales assistant who serves the customer will pass the goods to the shop manager. The shop manager performs the role of cashier and she will scan the items via the point-of-sale system. A sales invoice will be generated. The item code, item description, listed price, quantity of each item sold, discount applied, net price for each item and total price of all goods sold are listed on the invoice.

In the past, promotional sales were offered by BFL from time to time. The same rate of discount was applied to all the items in the shops during the promotional period. The listed prices of the goods were inputted in the computer system and the discount was keyed in by the shop manager when goods were sold during the promotional period.

As the business environment worsened, the company piled up a lot of inventory in the last quarter of 2008. The management of the company decided to use a more aggressive promotional strategy.

A very complicated discounting policy was carried out as follows:

- 20%, 30 % or 50% off knitted clothes
- 50% off jackets and coats
- 10%, 20%, 30%, 50% or 70% off pants and trousers

The discount list included all the items of merchandise and the applicable discount rate for each item. After reviewing the inventory movement list generated by the system at the end of each day, the management changed the discount rates for different items and faxed a new discount list to all the shops every morning.

In order to encourage the customers to buy more products, further bulk purchase discounts were offered.

If two items (of any merchandise) were purchased, an extra discount of 10% off the discounted price would be applied to all items purchased.

If three items (of any merchandise) were purchased, an extra discount of 20% off the discounted price would be applied to all items purchased.

The shop manager had to input the finalised discount for each item to generate the invoice. The invoice with details would be given to the customer. The customers would either pay the amount by credit card or by cash. If the shop manager made any input error for the discount, she had the authority to void the invoice and issue a new one to the customer. The customer copy of the void invoice would be torn and thrown away.

At the end of each day, the shop manager would lock all the cash received during the day in the cash register. Every Monday morning, a sales assistant would bank in last week's cash proceeds and the messenger from the head office would collect the credit card slips from all the shops.

During the audit, David found that most of the shops had to void many invoices during the promotional period. The management explained that this was inevitable as the maintenance of the computer system was outsourced to a service provider. They had to input the discounts manually if they needed to have more pricing flexibility. Although many invoices were void, the system is still fine since the inventory system can be updated immediately.

Question 1 (40 marks – approximately 72 minutes)

- (a) HKSA 315 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement requires auditors to acquire knowledge of client's business before and during an engagement.

From what sources can David acquire knowledge of BFL's business and industry?

(5 marks)

- (b) What is control risk? What steps should be taken by the auditors to assess the control risk for the sales and collection cycle?

(3 marks)

- (c) Indicate three weaknesses in internal control over the sales and cash receipts system.

(6 marks)

- (d) What may be the consequences caused by the weaknesses in the sales and cash receipts system?

(3 marks)

- (e) Recommend an improvement for each of the weaknesses identified.

(6 marks)

- (f) Assume that you are David Lau.

What is your assessment of the risk of material misstatement of the inventory at the assertion level for valuation? Explain.

(2 marks)

- (g) What is your assessment of the risk of material misstatement of sales at the assertion level for accuracy? Explain.

(2 marks)

- (h) List out three substantive procedures that can address the valuation assertion for inventory.

(3 marks)

- (i) BFL is using a ready-made software for its point-of-sale system and the maintenance of the system is carried out by a subcontractor. The company is now considering employing a programmer to develop a point-of-sale system for the company and a technician to maintain the computer system of the company.

- (i) Compare the pros and cons of ready-made software and the employment of an in-house programmer for BFL. Provide three points in favour of the ready-made software and three points for the employment of an in-house programmer.

(6 marks)

- (ii) Compare the pros and cons of using a subcontractor for the maintenance of the system and the employment of an in-house technician for BFL. Provide two points in favour of using a subcontractor for the maintenance of the system and two points favouring the employment of an in-house technician.

(4 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)

An auditor obtains audit evidence by performing audit procedures to draw reasonable conclusions upon which to base the audit opinion. There are three major types of audit procedures, namely risk assessment, tests of controls, and substantive procedures.

Required:

- (a) What are the purposes of each category of the three major types of audit procedure mentioned above?
(3 marks)
- (b) What are the relationships between the three major types of audit procedure mentioned above?
(6 marks)
- (c) What are the three major types of substantive procedure? Elaborate and provide one example of each type for the auditing of a mortgage bank loan and the related expenses.
(6 marks)
- (d) Among the following procedures, which one will not be applied as a risk assessment procedures and which one will not be applied as a test of controls procedure?
 - (i) Management inquiry
 - (ii) Analytical procedures
 - (iii) Inspection of documents
 - (iv) Re-performance
 - (v) Observation(2 marks)
- (e) Identify three aspects an auditor may consider for the measurement and review of an entity's financial performance.
(3 marks)

Question 3 (20 marks – approximately 36 minutes)

The firm of WK & Co., your employer, is the external auditor of East West Limited ("EWL") which is a company that carries out a trading business.

You have worked on this audit assignment for a few years and this year you are the senior in charge of the audit. A newly recruited accounting graduate who has no practical experience is assigned as your assistant. You have already conducted tests of controls for the transaction cycles, and control risks are assessed as medium for these cycles. You decide to let the assistant carry out some substantive procedures for the accounts payable section.

Required:

- (a) What are the analytical procedures for accounts payable?
(3 marks)
- (b) Besides presentation and disclosure, what are the other four assertions for accounts payables? For each of the assertions, provide one test of details procedure.
(8 marks)
- (c) "The tests of transactions procedures for cash payment that address the completeness assertion also address the completeness assertion for accounts payable," said the assistant. Do you agree? Explain.
(3 marks)
- (d) "If there are minor discrepancies between the amounts confirmed by the suppliers and the reported amounts, then we can say that the result is satisfactory and no further audit procedures need to be performed," said the assistant. Do you agree? Explain.
(6 marks)

Question 4 (20 marks – approximately 36 minutes)

An auditor should conduct a final overall review and evaluate the entity's ability to continue as a going concern before forming an opinion on the financial statements.

Required:

- (a) Who has the responsibility to carry out the review?
(2 marks)
- (b) What are the purposes of the final overall review?
(4 marks)
- (c) During the final overall review, the reviewer found that a company did not repay the bank loan which had expired before the year end date. The management of the company considered that it was still appropriate to apply the going concern assumption.
 - (i) What are the responsibilities of auditors regarding going concern? Specify the matters that the auditors should consider when planning as well as during the audit regarding going concern.
(5 marks)
 - (ii) List five other possible financial indicators of a going concern.
(5 marks)
 - (iii) What further procedures should be performed after identifying a delay in the repayment of a bank loan?
(4 marks)

Question 5 (20 marks – approximately 36 minutes)

The commercial world is ever-changing, and more information is required by investors, management, employees, etc..., for decision making. Companies may need to change their information systems to meet decision makers' changing needs. When companies decide to design and implement a new system, they may need to go through the System Development Life Cycle (SDLC). The first step of the SDLC is system analysis. The project development team has to identify information needs and perform an analysis of the existing system for the purpose of designing a new and improved system.

Required:

- (a) Who are the members of a project development team?
(4 marks)
- (b) What are the steps involved during the system analysis phase? Elaborate.
(10 marks)
- (c) How is the accountant involved in the system analysis phase?
(4 marks)
- (d) Why may the internal auditor be involved in the system analysis phase?
(2 marks)

* * * END OF EXAMINATION PAPER * * *

Answers

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

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

- (i) Review previous year's audit files.
- (ii) Discuss with the management of BFL.
- (iii) Read news related to the fashion industry.
- (iv) Visits to the shops and head office of BFL.
- (v) Review internal documents of BFL.
- (vi) Discuss with internal auditor and review of internal audit report – no indication that there is internal audit.
- (vii) Discuss with specialists, including legal advisors and other knowledgeable people in the fashion industry.
- (viii) Review legislation and regulations that significantly affect BFL.

Answer 1(b)

Control risk is the risk where material misstatements will not be prevented or detected by internal controls.

To assess the control risk for the sales and collection cycle, the auditor should adopt the following measures:

Understand and document internal controls over the sales process based on a reliance approach.

Plan and perform tests of controls on sales transactions.

Set and document the control risk for the sales process.

Answer 1(c)

Input errors are easily made as discounts are inputted manually.

Customer copies of the void invoices are destroyed in the shops.

Cash proceeds are accumulated in the shops for too long (too many days).

Answer 1(d)

Input error may be made intentionally by the shop manager for personal benefits, e.g. Conspire with friends or relatives to buy clothes at cheaper prices.

When some customers only buy 1 item by cash, the shop manager may void those invoices and put all those items in one invoice, and the saving from the extra discount can be captured by the shop manager. BFL may lose the cash proceeds via the extra discount amount.

BFL suffers more cash loss when there is burglary.

Answer 1(e)

Change the computer program: the further discounts should be updated in the system by the head office. Improvement of the software program is required.

or

Calculation of extra discounts should be done by the software instead of by the shop managers.

The customer copy of the void invoices should be submitted to the head office for checking to reduce the chance of fraud.

Cash should be deposited daily instead of weekly.

Answer 1(f)

Risk of material misstatement of the inventory at assertion level for valuation is medium to high. Inventory should be stated at the lower of cost or net realizable value "NRV". BFL piled up a lot of inventory, so it may be quite difficult to determine the net realizable value.

Answer 1(g)

The risk of material misstatement of sales at assertion level for accuracy is high. There are numerous sales transactions and many invoices are void. This evidence indicates that the chance of human error is high.

Answer 1(h)

Check the unit cost of each item against the supplier's invoice.

Inquire of management regarding obsolete, slow moving or excess inventory.

Perform a lower of cost or net realizable value test; review subsequent sales of large inventory items that are piled up at year end.

Answer 1(i)(i)

On-the-shelf software:

- (i) Immediately available.
- (ii) Cheaper.
- (iii) Quicker update as more resources can be utilized for research and development by a software development company.

In-house programmer:

- (i) Tailor-made software.
- (ii) Strong communication between the in-house programmer and the staff of BFL. The in-house programmer can modify the software according to the needs of the company.
- (iii) More flexibility to change. For example, the programmer can update software for the discount policy, and manual input by shop managers is no longer required. Business processes are being carried out efficiently and effectively with a fast turnaround time.

Answer 1(i)(ii)

Outside subcontractor:

- (i) Cheaper
- (ii) More support if several sets of point of sales systems break down simultaneously.

In-house technician:

- (i) Faster response if only one set of point of sales systems breaks down
- (ii) Higher confidentiality as technician is an in-house staff member.

* * * END OF SECTION A * * *

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

Answer 2(a)

Purpose of the risk assessment procedures

Obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement at the financial statement and assertion levels.

Purpose of tests of controls

Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Purpose of substantive procedures

Detect material misstatements at the assertion level.

Answer 2(b)

Risk assessment procedures by themselves do not provide sufficient and appropriate audit evidence on which to base the audit opinion. They should be supplemented by further audit procedures in the form of tests of controls and/or substantive procedures.

When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor is required to test those controls to support the risk assessment.

When substantive procedures alone do not provide sufficient and appropriate audit evidence, the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness; for example, a computerised system with no audit trail.

For material classes of transactions and account balances, substantive procedures are mandatory even though tests of controls were performed with satisfactory results.

Answer 2(c)

1. Analytical procedures

Analytical procedures consist of evaluations of financial information via a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

For example, use the beginning balance and ending balance of the mortgage loan together with the contracted interest rate to estimate the total mortgage interest for the year, and then compare the expected amount with the recorded amount.

2. Substantive tests of transactions

Substantive tests of transactions are audit procedures which examine the processing of particular classes of transactions through the accounting system.

For example, detailed checking of the monthly repayments of the mortgage loan to the bank statements and the corresponding accounting entries for the mortgage loan account and the mortgage interest account

3. Tests of details of balances

Detailed test of account balances provide reasonable assurance of the validity of a general ledger balance.

For example, send bank confirmation to verify the mortgage loan balance.

Answer 2(d)

Re-performance will **not** be applied as risk assessment procedures.

Analytical procedures will **not** be applied as test of controls procedures.

Answer 2(e)

- Key ratios and operating statistics
- Key performance indicators
- Employee performance measures and incentive compensation policies
- Trends
- Use of forecasts, budgets and variance analysis
- Analyst reports and credit rating reports
- Competitor analysis
- Period-on-period financial performance (revenue growth, profitability, leverage)

Answer 3(a)

- Scrutinize list of accounts payable for unusual items.
- Calculate the trade payables payment period and compare with that of last year.
- Calculate ratio of accounts payable to current liabilities and compare with that of last year.
- Compare amounts owed to individual suppliers per current year's list with that of last year.
- Compare current year's balances in accounts payable with last year's balances.

Answer 3(b)

Existence

- Send confirmation to a sample of trade payables to confirm the balance at the end of the year.
- Compare the balances with suppliers' statements.
- Check suppliers' invoices and goods received notes.

Rights and Obligations

- Send confirmation to a sample of trade payables to confirm the balance at the end of the year.
- Compare the balances with suppliers' statements.
- Check suppliers' invoices and goods received notes.

Completeness

- Review invoices paid after year end and unpaid invoices on hand to ensure invoices for last year were recorded as appropriate.
- Select goods received notes around the year-end date to ensure the purchases and accounts payables are recorded in the appropriate period.

Valuation and allocation

- Obtain the list of accounts payable from the client, cast the list, check the individual balance against the sub-ledger, and agree the total amount with the amount recorded in the financial statements.
- Agree opening figures to last year's audit file.
- Compare the balances with suppliers' statements.
- Check suppliers' invoices and goods received notes.

Answer 3(c)

Do not agree.

The double entries for cash payments are:

Debit	Accounts payable
Credit	Cash

If a transaction is omitted, it affects the completeness of cash payment transactions and the existence assertion of accounts payable but not the completeness of accounts payable.

Answer 3(d)

Do not agree.

When there are discrepancies, auditors should seek an explanation from the client staff and consider whether any further audit procedures or adjustments to the financial statements are necessary.

The possible reasons are:

- (i) invoices not yet received or not yet processed by the client;
- (ii) payments not yet received by the supplier;
- (iii) goods returned not yet recorded by the supplier;
- (iv) errors made by the client;
- (v) errors made by the supplier; and
- (vi) cheques issued but not yet sent to suppliers.

If there are discrepancies due to cut-off errors i) & vi), there may exist more cut-off errors which are of the same nature. Further audit procedures may be required.

If it is an error made by the client, we should investigate further to see whether there are implications for weaknesses in the internal control system or it is only an isolated error.

Answer 4(a)

The engagement partner who has ultimate responsibility for committing the audit firm when signing the audit report.

Answer 4(b)

To ensure sufficient and appropriate audit evidence is obtained to reduce the risk of material misstatement to an acceptable level.

To ensure the financial statements are in agreement with the accounting records, known facts and comply with the relevant financial reporting framework.

To ensure the financial statements as a whole are consistent with the auditors' understanding of the entity and its environment when forming an overall conclusion.

To ensure adequate audit work is carried out properly.

To ensure the audit opinion on financial statements is supported by the audit evidence gathered.

Answer 4(c)(i)

According to HKSA 570, the auditor's responsibility is to consider:

- the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.
- whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements.

When planning the audit and obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.

The auditor should remain alert for audit evidence of events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern in performing audit procedures throughout the audit.

The auditor should consider the same period as that used by the management in making its assessment under the applicable financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

Answer 4(c)(ii)

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by shareholders and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Answer 4(c)(iii)

Inquire of management whether there are renewal of bank loan, reschedule of loan repayment or any other future actions.

Inspect the agreements or the correspondence from the bank as evidence for the renewal of bank loan or reschedule of loan repayment.

Consider mitigating factors such as current level of the company's financial resources, or its ability to raise additional debt or equity finance.

Seek written representations from the company's management regarding its plan for future actions.

Answer 5(a)

The project team consists of:

- information system specialist;
- managers;
- users; and
- accountants.

Answer 5(b)

Initial investigation

The initial investigation is conducted to gain a clear picture of the problem or need; determine viability, expected cost and payoffs, evaluate scope, extent and nature, and recommend whether to proceed, modify or abandon.

Systems survey

A systems survey involves an extensive study of the existing system by collecting data using questionnaire, observations and system documentation. Objectives are to gain a thorough understanding of the existing system; make preliminary assessments of current and future needs; determine the extent and nature of changes needed; develop working relationships with users and build support; and collect data to identify user needs.

Feasibility study

Involves an in-depth study of the proposed system to determine its feasibility in different aspects, namely, technical feasibility, operational feasibility, legal feasibility, scheduling feasibility and economic feasibility.

Determination of information needs and system requirements

Involves finding out and documenting what users and management need.

Delivery of systems requirements

Involves preparation of a report summarizing the systems analysis work.

Answer 5(c)

The accountant has the advisory role in the following aspects:

- Suggest improvements to be made in the new information system in terms of impact on work flows, data gathering and recording tasks.
- Advise how the accounting function fits into the new information system of an organization.
- Provide help in carrying out the economic feasibility study which involves capital budgeting techniques.
- Express ideas for improving the information system in order to serve the customers in a better way and deliver better products.

Answer 5(d)

The internal auditor may be involved in the system analysis phase:

- To ensure that the system is auditable. The internal auditor should see that there is an adequate audit trail.
- To contribute to better accounting controls that would be installed in the new system.

* * * END OF EXAMINATION PAPER * * *