



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 2011 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

## **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**

Established in 1990, Kindo Parking Services Limited (KPSL), owned by 5 shareholders, is an experienced car park operator in Hong Kong with around 80 car parks and more than 13,000 parking spaces under its management. KPSL includes a board of 10 directors and more than 200 staff members.

KPSL owns several properties, all of which are used as car parks to provide parking spaces to customers. KPSL also rents some properties from third parties to carry out its car park business.

Customers can lease the car parking spaces on different bases, monthly, daily and hourly.

In September 2010, KPSL introduced a cashless payment system and a high-tech digital security and automated access control system. No further cash payment was accepted from October 2010 and onwards.

The KPSL then implemented a parking promotion programme. For some of the car parks where the utilisation rate was low, any customer leasing a car parking space for six months, could enjoy a 50% discount of the monthly rental for the sixth month.

In April 2011, Bobby Chung, a partner of a 5-partners firm, CBA & Co, was approached by KPSL to replace the previous auditor, ZYX & Co. ZYX & Co retired in February 2011, after submitting the auditor's report for KPSL's financial statements for the year ended 30 June 2010, wherein ZYX & Co expressed an unqualified opinion.

The CEO of KPSL, Peter Cheung, who is also the major shareholder, is the brother-in-law of an audit manager, Kelvin Ko in CBA & Co. Bobby Chung intended to assign Kelvin Ko as the manager in charge of this audit as Kelvin might have better communication with Peter Cheung. However, Kelvin Ko was sick throughout the auditing period and therefore May Law was assigned to this assurance engagement.

**Question 1** (40 marks – approximately 72 minutes)

- (a) What matters should be considered by CBA &Co for the acceptance of a new client? (4 marks)
- (b) During the planning stage of an audit, the auditor shall obtain an understanding of the information system, including the related business process, relevant to financial reporting. What areas of the information system relevant to financial reporting should the auditor consider? (4 marks)
- (c) How do computerised systems enhance internal control? (4 marks)
- (d) What are general IT controls? Provide two examples. (4 marks)
- (e) What are the four categories of application controls? (4 marks)
- (f) What are the information needs of marketing and sales managers for setting the parking fees? (5 marks)
- (g) What are the possible analytical procedures for auditing the parking space rental income? (5 marks)
- (h) What are the possible substantive procedures for auditing the rental expenses on properties rented from third parties? (7 marks)
- (i) Is it appropriate to assign Kelvin Ko as the manager in charge of this audit assignment? Please explain. (3 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 FM & Co. is the external auditor of a digital product trading company, DP Limited.

Peter Pan has worked on this audit assignment for several years and this year he is the senior in charge of the audit. After conducting the test of controls for the sales and purchases transaction cycles, he assessed the control risks as medium for the transaction cycles. He instructed his assistant to carry out some substantive procedures for trade payables and trade receivables. Peter told the assistant that the partner will perform the overall review after one month.

**Required:**

- (a) What are the possible analytical procedures for trade payables? (3 marks)
- (b) What are the assertions for trade receivables? (4 marks)
- (c) What are the possible substantive procedures for the valuation assertion for trade receivables? (6 marks)
- (d) If all confirmations of trade receivables are returned and confirmed, there is adequate audit evidence for the valuation assertion. Do you agree? Please explain. (3 marks)
- (e) What are the objectives of performing the final overall review? (4 marks)

**Question 3** (20 marks – approximately 36 minutes)

The firm of BBD & Co., in which James Pong is employed, is the external auditor of Cafe Limited (CL), which is a listed company that operates many cafe shops in Hong Kong.

James Pong has been in charge of this audit for a few years. CL employs full time and part time employees. In the past, CL was assessed as having good internal control over employee benefit costs. After discussion with the Human Resources Director, Anna Yuen, James formed an expectation that the relevant internal controls still operate as effectively as in the past.

Anna Yuen told James that CL granted some share-based remuneration to some senior management people during the year. Some shares options for the senior management people will be vested if they meet the service and performance conditions in the future. Having noted this issue, James discussed with the partner to see whether an expert's services are required.

**Required:**

- (a) What are the five major types of control activities in general? (5 marks)
- (b) Provide one example of test of controls for payroll and personnel cycle for each of the following five assertions of employee expenses.
1. Occurrence
  2. Completeness
  3. Accuracy
  4. Cut-off
  5. Classification
- (5 marks)
- (c) James instructed an assistant to perform analytical procedures for the audit of employee benefit costs excluding share-based payments. Comparing the employee benefit costs of this year with the amount of employee benefit costs of last year, there is an increase of 15%. What are the potential factors that may lead to the increased employee benefit costs? (6 marks)
- (d) The partner decided to use an expert's services regarding the fair value of the share options of the share-based payment scheme. What matters should be agreed between the auditors and the expert? (4 marks)

**Question 4** (20 marks – approximately 36 minutes)

Intelligent Limited is a mobile phone manufacturer and wholesaler. The company produces and sells different models of mobile phones in different price ranges. A new model was launched in late June 2011, and many people bought this new model for their own use and as gifts for their friends. In early July 2011, quite a number of customers complained that the signal receiver of this model is not good and this news was spread around via the internet. Also, some magazines have published unfavourable comments on this new model phone.

Many retailers returned mobile phones of this model to Intelligent Limited in July 2011. Although no return term is provided in the sales agreement, the management accepted the return of these products due to consideration of the brand's reputation. The year end date for Intelligent Limited is 30 June 2011. The management decided not to record the sales returns in year ended 30 June 2011 as all the goods were returned by the customers after the year end date. No other adjustment is considered necessary. The auditor disagrees with the accounting treatment adopted by the management.

**Required:**

- (a) List the general audit procedures to identify events occurring after the balance sheet date.  
(8 marks)
- (b) What specific audit procedures regarding the defects of the new phone model should be performed?  
(6 marks)
- (c) What kinds of audit reports may be issued? State your assumptions clearly.  
(6 marks)

**Question 5** (20 marks – approximately 36 minutes)

ABC Limited is an investment holding company. The company holds shares of several listed companies and owns a property which was purchased several years ago and is used as its own office. The company trades the shares of the listed companies frequently for profit. The company adopts the cost model for the accounting of the property.

You are the manager in charge of the audit of ABC Limited for this year.

**Required:**

- (a) What are the substantive audit procedures for the property held by the company?  
(6 marks)
- (b) What are the possible substantive audit procedures for the two assertions, occurrence and cut off, of shares transactions? Provide one substantive audit procedure for each assertion.  
(4 marks)
- (c) What are the substantive audit procedures for test of details of the shares balances at the year ending date?  
(10 marks)

\* \* \* END OF EXAMINATION PAPER \* \* \*

**SECTION A (COMPULSORY) (Total: 40 marks)**

**Answer 1(a)**

For the acceptance of a new client, CBA & Co has to consider the following:

- (1) The integrity of the new client
- (2) The competency of the audit firm to perform the audit and whether the audit firm has the capabilities, time and resources to perform the audit
- (3) Whether the firm can comply with ethical requirements

**Answer 1(b)**

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following:

- (1) The classes of transactions in the entity's operations that are significant to the financial statements;
- (2) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (3) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; these include the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (4) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (5) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
- (6) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

**Answer 1(c)**

Computerised systems enhance internal controls by:

- (1) Incorporating computer-performed controls in day to day transaction processing activities.
- (2) Replacing manual procedures with programmed controls that apply checks and balances to each processed transaction.



- (3) Establishing online security controls in applications, databases, and operating systems.
- (4) Encouraging the management to develop good internal control practices in order to implement and maintain a complex computer system.
- (5) Providing the management with more information and more effective analysis.

**Answer 1(d)**

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls.

Examples: control over software acquisition and maintenance; physical and online security over access to hardware and data; policies over backup and recovery ,etc.

**Answer 1(e)**

Application controls can be categorised as follows:

Input Controls designed to ensure that information being processed by the computer is valid, accurate, and complete.

Processing Controls to prevent and detect errors when transaction data are processed so as to ensure all data is accurately processed.

Output Controls to focus on detecting errors after processing is completed, and ensure outputs are distributed only to authorised persons.

Error Correction Controls designed to ensure proper error correction procedures and errors are accumulated in a file for subsequent follow-up actions.

**Answer 1(f)**

The information needs of marketing and sales manager for setting the parking fees are as follows:

The income earned by different car parks.

The number of motor vehicles registered to estimate the change in parking needs

The utilisation rate of parking spaces of different car parks.

The parking fees of car parks operated by competitors.

Information about customer satisfaction.

(Other relevant answers are acceptable)

**Answer 1(g)**

The possible analytical procedures are as follows:

Compare reported rental income with budgeted income.

Compare the rental income of this year with the income of last year, on a weekly or monthly basis.

Compare rental income to the utilisation rate reported by each car park.

Analyse the trend of the monthly income of different car parks.

Investigate fluctuations between months and ask for reasons, e.g. seasonal and events surrounding the car parks.

(Other relevant answers are acceptable)

**Answer 1(h)**

Obtain the list of rental expenses for those car parks rented from third parties.

Agree the total amount of rental expenses with trial balance or ledger.

Inspect the rental agreements of the rented car parks and agree to the rental expenses as listed.

Review each rental agreement to see whether there is a rent free period or rental incentive arrangement.

Re-compute the rental expenses for the year and check whether the rental expenses are calculated on a straight line basis.

Ensure accrued rental expenses are accounted for.

Review the disclosure notes in the financial statements.

Perform analytical procedures, e.g. compare rental expenses of this year with the expenses of last year.

**Answer 1(i)**

No, it is not appropriate to assign Kelvin Ko as the manager in charge of this audit assignment.

Kelvin has a close relationship with the major shareholder of the client and there would be a self interest threat. This threat would jeopardise the independence issue.

\* \* \* END OF SECTION A \* \* \*

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

**Answer 2(a)**

The possible analytical procedures are as follows:

Scrutinise the list of trade payables for unusual balances, for example, a debit balance.

Compare ratios of trade payables to purchases with those of last year.

Calculate the trade payables payment period and compare it with that of last year.

Compare the individual trade payable balance with that of last year.

Compare the current year's total balance of trade payables with last year's balance.

**Answer 2(b)**

The key assertions for trade receivables are completeness, existence, rights and obligations, as well as valuation and allocation.

**Answer 2(c)**

The possible substantive procedures are as follows:

Compare receivables' turnover and receivables' days to those of last year, and the company's credit period policy.

Review lawyers' letters to debtors, if any, for consideration of impairment of trade receivables.

Discuss with the management the underlying assumptions of the allowance for doubtful debts.

Recalculate the amount of the allowance for doubtful debts based on management's assumptions and agree to the recorded amount.

Compare prior year's 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 by discussion with management and review of customer correspondence, and check whether long overdue trade receivables are included in the list of doubtful debts.

Check subsequent settlement of trade receivables to ensure recoverability.

**Answer 2(d)**

External confirmations of trade receivables provide reliable and relevant audit evidence regarding the existence of the trade receivables as at the year-end date.

Confirmation may provide further evidence on the cut-off of sales revenue recognition and cash receipts.

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 2(e)**

The objectives of performing the final overall review are as follows:

To ensure audit work is carried out properly and adequately, and that 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, audit evidence, and known facts, and that they 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 the audit opinion on financial statements is supported by the audit evidence gathered.

(Other relevant points are acceptable)

**Answer 3(a)**

The five major types of control activities are:

- (1) authorisation
- (2) performance reviews
- (3) information processing
- (4) physical controls
- (5) segregation of duties

### **Answer 3(b)**

#### Occurrence

Observe and evaluate proper segregation of duties; e.g. persons authorising employee benefit costs are not responsible for recording, and persons recording employee benefit costs are not responsible for payment.

Check the authorisation by appropriate personnel for all additions, changes and deletions of personnel records and the authorisation for payments of employee benefit costs.

#### Completeness

Inspect clients' records to see whether they have any procedures for checking the numerical sequence of the work records and whether the reconciliation of the payroll summary is reviewed by appropriate personnel.

Inspect clients' performance review documents such as:

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

#### Accuracy

Examine the client's record to see whether the client has checked the arithmetical accuracy of employee benefit costs to ensure the amounts are in accordance with employment contracts.

#### Cut-off

Examine indications of internal verification and test procedures for processing work records and recording liabilities.

#### Classification

Review client's procedures and inspect their records to verify there has been proper classification of employee benefit costs.

### **Answer 3(c)**

The possible reasons are as follows:

Increase in number of shops and therefore increase in the number of staff.

Change in the composition of part time and full time staff.

Change in government regulations for the minimum wage rate and therefore increase in the hourly rate.

Increment of salaries and wage rate for inflation adjustment.

Increment of salaries and wage rate for experience.

(Other relevant answers are acceptable)

**Answer 3(d)**

The auditor shall agree, in writing where appropriate, on the following matters with the auditor's expert:

The nature, scope and objectives of that expert's work;

The respective roles and responsibilities of the auditor and that expert;

The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

The need for the auditor's expert to observe confidentiality requirements.

**Answer 4(a)**

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report requiring adjustment of, or disclosure in, the financial statements have been identified.

General audit procedures include:

Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings of which minutes are not yet available.

Reading the entity's latest subsequent interim financial statements, if any.

Reading the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

Inquiring, or extending previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

Reviewing or testing of accounting records or transactions occurring between these periods.

#### **Answer 4(b)**

Discuss with the management and find out more details regarding this issue.

Inspect the sales agreements to review the terms.

Obtain a list of total goods returned from the management, and recalculate the amount of goods returned.

Consider whether there will be a further return of goods not included in the list provided.

Identify the amount of inventory of this model for estimating the amount of impairment.

Estimate the income statement effect of the goods returned but not recognised.

Estimate the effects on the statement of financial position, the amount of accounts receivable as well as inventory.

Consider the materiality of the error of misstatement.

#### **Answer 4(c)**

If the auditor concludes that the financial statements are prepared, in all material aspects, in accordance with the applicable financial reporting framework, an unmodified opinion should be expressed.

If the auditor disagrees with the accounting treatment adopted by the management and concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements, the auditor should express a qualified opinion.

If the auditor disagrees with the accounting treatment adopted by the management and concludes that misstatements, individually or in the aggregate, are material and pervasive to the financial statements, the auditor should express an adverse opinion.

#### **Answer 5(a)**

The substantive procedures for property held are as follows:

Obtain a list of property details.

Check the opening balance of the gross book value, accumulated depreciation and net book value with last year's audited financial statements.

Check the closing balance with the general ledger.

Perform a land search.

Re-calculate depreciation and casting of the closing net book value.

Review reasonableness of depreciation rates.

Review the disclosure notes in the draft financial statements.

Review bank confirmation and land search document for rights and obligations.

Consider whether there is any impairment issue by searching the market value and taking into account the estimated recoverable amount.

#### **Answer 5(b)**

The substantive procedures for the occurrence assertion:

Trace to bought and sold notes.

Review the periodic trading reports provided to the board of directors.

The substantive procedures for the cut off assertion:

Review purchases and sales of securities for a few days before and after the end of the reporting period to determine if there are unrecorded investment activities at year end.

#### **Answer 5(c)**

Obtain the list of investments in shares from the client.

Agree the total balances to the general ledger.

Check the casting and calculation of the list.

Obtain confirmation from the bank / broker or other custodian.

Review confirmations received so as to identify those securities that have been pledged.

Reconcile information contained in the confirmation with the client's investment records.

Review dividend income received and identify non-recorded transactions.

Search unrecorded transactions of purchase or disposal of securities by examining transactions for a few days after year-end.



Trace fair values to published quotation for securities or bank / broker statements.

Inquire of management and examine board minutes and other supporting documents so as to identify those securities that have been pledged under margin trading accounts.

Review the draft financial statements to determine that all disclosures have been made.

\* \* \* END OF EXAMINATION PAPER \* \* \*

*(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)*

### **General Comments**

The performance was relatively satisfactory when compared with previous exams. However, there are still quite a number of candidates who had not mastered the fundamental concepts of auditing such as the assertions for auditing, understanding the information system of business operations of the entity for auditing, different types of audit reports, application of analytical procedures, test of control procedures as well as substantive procedures for different classes of transactions and account balances.

Many candidates failed to apply their knowledge to real-life issues in order to demonstrate the expected level of analytical thinking. In particular, they did not read the questions carefully.

Quite a number of candidates wrote illegibly and made spelling and grammatical mistakes. Illegible handwriting and poor English inevitably affected the assessment.

### **Specific Comments**

#### **Section A – Compulsory Questions**

##### **Question 1 – 40 marks**

This was a case of a practical scenario. Candidates were asked to apply their knowledge to practical ethical, auditing and computerised information system issues. Most candidates were not able to link up their knowledge of auditing and the case details which required analytical thinking.

##### **Part (a)**

Many candidates scored satisfactorily in this part. However, some candidates did not read the question carefully and therefore incorrectly provided the specific details of KPSSL's operations as their answer.

##### **Part (b)**

Most candidates were not able to tell the areas of the information system related to auditing, some candidates just provided the major types of controlling activities as answer.

##### **Parts (c), (d) & (e)**

Some candidates who attempted these parts of the question scored satisfactorily. However, many candidates, who did not have a good understanding of general controls and application controls of computerised systems, provided irrelevant answers.

##### **Part (f)**

Many candidates performed well in this part.

Part (g)

Most candidates performed well in this part. However, many candidates provided the test of details procedures to be performed by auditors instead of the analytical procedures required.

Part (h)

Most candidates scored satisfactorily in this part. However, some candidates only provided a few relevant procedures and many basic substantive procedures were missing.

Part (i)

Most candidates scored satisfactorily in this part.

### **Section B – Optional Questions**

#### **Question 2 – 20 marks**

This question examined the candidates' understanding of the assertions, substantive procedures for the auditing of account balances of accounts payable and accounts receivable, as well as the objectives of performing the final overall review.

Part (a)

Most candidates who attempted this part scored satisfactorily, but quite a number of candidates provided the test of details procedures instead of the analytical procedures required.

Part (b)

Most candidates who attempted this part scored satisfactorily, but quite a number of candidates did not know the meaning of all the assertions and mixed up the assertions for sales and the accounts receivable.

Parts (c) & (d)

Most candidates who attempted these parts scored satisfactorily, but quite a number of candidates did not understand the meaning of valuation assertion and provided irrelevant test of details procedures in part (c).

Part (e)

Most candidates who attempted this part scored satisfactorily, but some candidates did not know the major objectives of performing the final overall review.

#### **Question 3 – 20 marks**

This question examined the candidates' knowledge of controlling activities, test of control procedures, analytical procedures, and the use of expert services.

Part (a)

Most candidates who attempted this part scored satisfactorily. However, some candidates who did not have a good understanding of controlling activities provided irrelevant answers.

Part (b)

Most candidates did not distinguish between the test of control and substantive procedures and therefore provided irrelevant answers.

Part (c)

Many candidates who attempted this part scored satisfactorily.

Part (d)

Some candidates who attempted this part scored satisfactorily, but quite a large number of candidates only provided factors to be considered for the auditors to choose an expert instead of the matters to be agreed between the auditors and the expert.

Question 4 – 20 marks

This question examined the candidates' knowledge of audit procedures to identify events occurring after the balance sheet date and specific substantive procedures for a particular event as well as the application of different kinds of audit reports.

Parts (a) & (b)

Some candidates who attempted this question performed satisfactorily, but quite a large number of candidates could not distinguish between the general audit procedures to identify events occurring after the balance sheet date and the specific audit procedures regarding the defects of the new phone model.

Part (c)

Most candidates who attempted this part scored satisfactorily, but quite a number of candidates could not distinguish between different types of audit reports.

Question 5 – 20 marks

This question examined the candidates' knowledge of substantive audit procedures for the auditing of owner used property and investment in shares.

Part (a)

Most candidates who attempted this part scored satisfactorily.

Parts (b) & (c)

Some candidates who attempted these parts performed satisfactorily, but quite a large number of candidates could not distinguish between the auditing of the class of transactions, sale and purchase of shares transactions, the auditing of the account balance, and investment in shares as at the year end date.

\* \* \* END OF EXAMINATION PANELIST'S REPORT \* \* \*