



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 2012 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 in 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

Jane Lee is an audit manager of a CPA firm, HKG & Co Limited. She is the audit manager in charge of an existing client, WH Limited, a private company engaged in the operation of a hot pot restaurant. WH Limited has a year end of 31 December. The restaurant is owned and run by two directors, Mr. Chan and Mr. Wong with experience in this industry. Originally, the restaurant was located in Wanchai. In March 2011, the company received a letter from a property development company, TS Limited as the new owner of the property where the restaurant was located. TS Limited planned to demolish the property and requested an early termination of the rental agreement. WH Limited negotiated with TS Limited and obtained good terms for the early termination of the contract by moving out on 30 June 2011. WH Limited leased a property in Kowloon City to continue the operation of business.

WH Limited commenced a new lease in Kowloon City with a cheaper rent and larger space. The commencement date of the lease is 1 April 2011. WH Limited engaged a company to renovate the property and planned to re-commence business in July 2011.

All the furniture of the old restaurant was sold to a third party. Due to the delay in the delivery of furniture from a mainland China supplier, the business commenced in the new restaurant on 6 September 2011.

The company increased the number of staff from ten to twenty. In order to attract more customers, WH Limited signed a contract with a group buying company, BZ Limited. BZ Limited sold coupons via its website on behalf of WH Limited. Each HK\$100 coupon is sold for HK\$50, customers who bought coupons can use the coupons to redeem services of the restaurant. The campaign was so successful that 6,000 coupons were sold. 3% is charged as commission on each coupon sold by BZ Limited. 80% of the remaining cash receipts were paid to WH Limited before 31 December 2011 and 20% was paid on 29 February 2012. According to one of the directors, Mr. Wong, the gross profit margin of their business is approximately 60% on the listed price. They sold the coupons at such a low price because they believed that this is a good way to advertise. Also, they may earn more as some of the customers may not redeem the service before the expiry date of the coupons. According to the terms, coupons can be redeemed during the period from 1 November 2011 to 29 February 2012. Coupons cannot be redeemed after the expiry date, 29 February 2012.

There is a unique identification number for each coupon. For each redemption, there is no limit on the number of coupons to be redeemed. All the coupons cannot be refunded. Customers have to make bookings two days in advance. When customers redeem the coupons, the cashier will check the identification number of each coupon against the control list provided by BZ Limited to ensure no duplication of redemption. The cashier puts down the redemption date of each coupon on the control list once a coupon is redeemed.

The company acquired a computerized billing system which is designed for restaurants. When a customer orders food, the waitress inputs the code of each dish via a mobile device into the system. The staff in the kitchen prepare the dish according to the order shown on the screen of the system and then input it as delivered. When customers at a table finish their meal, the waitress asks the cashier to print out the bill by keying in the table number and then presents the bill to the customer for settlement. Customers have to pay a 10% service charge on the total amount of the bill. Half of the amount of the service charge and all extra tips are distributed to the staff based on a predetermined ratio.

Question 1 (40 marks – approximately 72 minutes)

- (a) An understanding of the nature of the entity and the entity's selection and application of accounting policies enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

What are the key matters of WH Limited's operations that are relevant to the auditor?

(7 marks)

- (b) Jane, the audit manager, assessed that the inherent risk in respect of the completeness of sales revenue is high, but the combined risks assessment is medium when the company carries out its business in the shop located in Kowloon City.

Suggest reasons for her assessment.

(4 marks)

- (c) What are the possible substantive procedures for the compensation received on the early termination of the old tenancy agreement?

(2 marks)

- (d) What are the possible substantive procedures for the gain or loss on disposal of fixed assets?

(6 marks)

- (e) Why did WH Limited acquire the new billing system for sales transactions?

(6 marks)

- (f) What are the major steps WH Limited should take in acquiring and implementing the new billing system used at the new location?

(6 marks)

- (g) How might Jane determine the amount of unearned revenue at the year end?

(2 marks)

- (h) State the substantive procedures for auditing the unearned revenue.

(7 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 PC & Co., your employer, is the external auditor of Great Mind Limited ("GML") which is a company that carries out a trading business.

As the manager in charge of the audit of the financial statements of GML, you have worked on this audit assignment for a few years. The company employed a new accountant in June 2011, James Chow, an accounting graduate from a University, as the previous accountant resigned. A newly recruited junior is assigned as your assistant. You decided to let the assistant carry out some audit procedures regarding the sales cycle and trade receivables.

GML has a year end of 31 December 2011.

Required:

- (a) How does the change in the accountant at GML affect the extent of test of controls and test of details? (2 marks)
- (b) What are the analytical procedures for trade receivables? (6 marks)
- (c) Besides presentation and disclosure, what are the other four assertions for trade receivables? For each of these four assertions, provide two tests of details procedures. (10 marks)
- (d) What are the possible substantive procedures for sales cut off? (2 marks)

Question 3 (20 marks – approximately 36 minutes)

You are the manager in charge of the audit of the financial statements of Lucky Moon Limited ("LML"). LML is a private company engaged in the fashion wholesale business. This is the first time you have worked on this audit assignment. You have to prepare the planning for the audit of the financial statements of LML for the year ended 31 December 2011. The client sent you an email and advised that the Christmas and New Year holidays are peak seasons for their business and therefore the inventory count date has to be delayed until 5 January 2012.

Required:

- (a) Why is the audit of inventory important?
(3 marks)
- (b) What are the benefits of audit planning?
(5 marks)
- (c) What are the audit procedures as at the inventory count date?
(8 marks)
- (d) What are the additional procedures if the inventory count date is after the year end date?
(4 marks)

Question 4 (20 marks – approximately 36 minutes)

The firm of WWP & Co., your employer, is the external auditor of Jensen Limited which is a company in the wholesale business.

You have worked on this audit assignment for a few years and this year you become the senior in charge of the audit. You have already conducted tests of controls for the transaction cycles, and control risks are assessed as medium for these cycles. You decide to assign an audit assistant to perform some analytical procedures for trade payables and to send confirmation requests to these accounts.

Required:

- (a) What controls should the auditors maintain over the external confirmation procedures?
(5 marks)
- (b) What are the possible reasons for discrepancies between the amounts confirmed by the suppliers and the reported amounts?
(5 marks)
- (c) The auditors found that Jensen Limited understated the amount of trade payables by HK\$500,000. The total assets of the company and net income before tax are HK\$100,000,000 and HK\$600,000 respectively. The audit assistant believes that no adjustment is necessary as the misstatement of trade payables only accounted for 0.5% of the total assets. Comment.
(5 marks)
- (d) If the management insists on not adjusting the financial statements regarding the understatement of trade payables, what are the key elements that should be included in the audit report?
(5 marks)

Question 5 (20 marks – approximately 36 minutes)

BK Limited is an existing client of ABC & Co. It has engaged in the manufacturing business for more than 10 years. The board of directors determined to expand their business by investing in properties in Hong Kong as the property market was quite stable during the second half of 2011. They acquired some investment properties in September 2011 by means of mortgage loans. In order to acquire more investment properties in 2012, the directors negotiated with the bank for additional banking facilities. The bank requested the audited financial statements of the company for such banking facilities approval. The directors proposed to ABC & Co an incentive payment on top of the fixed audit fee for the successful application of the banking facilities.

Required:

- (a) What should be considered for the continuance of an existing audit? (4 marks)
- (b) Should the audit firm, ABC & Co, accept the fee arrangement with the said incentive payment? (4 marks)
- (c) What are the possible substantive audit procedures for the mortgage loan and interest expenses? (6 marks)
- (d) What are the possible substantive audit procedures for the acquisition of investment properties? (6 marks)

* * * END OF EXAMINATION PAPER * * *

Answers

Paper III
PBE Auditing and
Information Systems
(December 2012 Session)

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

The key matters of WH Limited's operations that are relevant to the auditor are as follows:

Nature of revenue sources – WH Limited operates a hot pot restaurant. The restaurant business is the only source of income.

Key customers – WH Limited has a large number of customers, people who like hot pot are their potential customers.

Products or services and markets – WH Limited engages in the provision of food and services, and it is facing keen competition as there are many restaurants providing different kinds of food nowadays.

Conduct of operation – restaurants are engaged in cash sales business. In addition, the company sells coupons via group purchase companies to customers. Customers make a prepayment for service by buying coupons.

Outsourcing activities – the company sells coupons via agents, a group buying company, and paid commission to the agents.

Transaction with related parties – no indication that related party transactions are extensive.

Employment – there were approximately 10 staff in the company at the beginning of the year and the number was increased to 20 during the year, the salaries of the staff consist of basic salaries, service charge and tips.

Geographical dispersion – the company has one restaurant which was located in Wanchai at the beginning of the year and relocated to Kowloon City during the year.

Early termination of rental agreement.

Answer 1(b)

The inherent risk of the completeness of revenue for a cash sales business is high mainly due to two reasons:

Firstly, there are numerous transactions for a restaurant and the chances of human error are high.

Secondly, cash is subject to a high risk of misappropriation. Staff will not report the sales if cash is misappropriated.

However, the control risk is considered as medium to low as the company has installed the computerized billing system to prevent the omission of sales transactions.

There is adequate segregation of duties and the computerized system can help to reduce human error.

Answer 1(c)

The possible substantive procedures are as follows:

Inspect the original tenancy agreement for terms relating to compensation of the tenancy agreement, if any.

Review the terms of the agreement with the new owner for the early termination of the tenancy agreement.

Inspect the final settlement agreement for moving out with the new owner.

Check against the bank statement for the receipt of the compensation.

Answer 1(d)

The possible substantive procedures are as follows:

Obtain the disposal of furniture schedule from the client.

Check casting and agree the net amount to the trial balance.

Check the sales proceeds to sales agreement.

Check whether the depreciation of the furniture is accounted for up to the date of disposal.

Check the cost and the accumulated depreciation of the assets disposed to the previous year's financial statements and this year's addition/disposal before moving out.

Recalculate the amount of gain or loss on the disposal of the furniture.

Check against the bank statements for the sales proceeds.

Answer 1(e)

The possible reasons for adopting the new system are as follows:

Respond to the changes in business needs, the increase in the expected number of transactions due to the increase in the size of the restaurant.

Assure accuracy of the sales data as the new system can reduce human error.

Improve efficiency in operations as the system links to production in the kitchen.

Reduce error in transmitting information from frontline staff to the kitchen.

Avoid loss / misappropriation of assets.

Answer 1(f)

The major steps are:

Obtain information of different suppliers of point of sales system and compare them in order to identify the appropriate one for the company.

Matters for comparison are:

- features and functions, e.g. programmed controls,
- cost,
- reputation of the supplier/system,
- after sales service,
- maintenance cost,
- system testing.

Provide information to the supplier and prepare the site for installation.

Train the staff to use the new system;

Provide staff with user manual;

Post implementation review.

Answer 1(g)

Unearned revenue = number of unused coupon X coupon price.

Answer 1(h)

The possible substantive procedures are as follows:

Obtain the list of unearned revenue from the client.

Check casting and agree the total to the trial balance.

Select samples from the unearned revenue list and check to the control list.

Select samples from the control list and check to the unearned revenue list.

Reconcile the number of unearned revenue coupons to the earned revenue coupons.

Check the coupon price to a coupon.

Recalculate the unearned revenue.

* * * END OF SECTION A * * *

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

Answer 2(a)

As the new accountant may not be familiar with the accounting system, the risk of material misstatement increases, the sample size of test of controls and test of details for the period from June 2011 to December 2011 should be increased.

Answer 2(b)

The analytical procedures are as follows:

Review the list of trade receivables and compare with last year's balance to identify unusual balances.

Compare the total balance of trade receivables with that of last year.

Compare the debtor turnover ratio with that of last year and compare it with credit policy.

Compare the debtor turnover ratio with industry data.

Compare bad debt expense as a percentage of sales revenue with that of last year.

Compare bad debt expense as a percentage of sales revenue with industry data.

Compare the ratio of allowance of doubtful debts to trade receivables with that of last year.

Compare the ratio of allowance of doubtful debts to trade receivables with industry data.

Aging analysis of outstanding balances. Compare with previous year and note any drastic changes.

Answer 2(c)

Existence

Send confirmation to selected samples of trade receivables.

Select samples of trade receivables and vouch to shipping documents and invoices.

Completeness

Send confirmation to the selected samples of trade receivables.

Select samples of goods delivery notes/shipping documents and trace to related invoices and to sales day book.

Rights and obligations

Discuss with management to determine the existence of any pledge/factorization of trade receivables.

Examine bank confirmation, loan agreements and minutes of directors' meetings, to see if any trade receivables are pledged as security for loan and debentures.

Valuation

Check the subsequent settlement of trade receivables.

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

Recalculate the allowance for doubtful debts.

Review the aging analysis of trade receivables.

Answer 2(d)

Select a sample of goods delivery notes / shipping documents and respective invoices immediately prior to the year end and immediately after the year end to ensure they have been recorded in the correct period.

Answer 3(a)

The audit of inventory is important in a wholesale business because the inventory is normally a significant item under the current asset on the statement of financial position. The overstatement or understatement of inventory will affect the amount of cost of goods sold and gross profit, which in turn will affect the decision-making of the users of financial statements.

Answer 3(b)

According to HKSA300 (Clarified), adequate planning benefits the audit of financial statements in several ways, including the following:

Helping the auditor to devote appropriate attention to important areas of the audit.

Helping the auditor to identify and resolve potential problems on a timely basis.

Helping the auditor to properly organize and manage the audit engagement so that the audit is performed in an effective and efficient manner.

Assisting in the selection of the engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

Facilitating the direction and supervision of engagement team members and the review of their work.

Assisting, where applicable, in the coordination of work done by auditors of components and experts.

Answer 3(c)

The audit procedures as at the inventory count date are as follows:

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting.

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of slow moving, obsolete and damaged items.
- Control over the movement of inventory between areas and the delivery and receipt of inventory before and after the cut-off date.

Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented.

In addition, the auditor may obtain copies of cut-off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures for the accounting for such movements at a later date.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or aging inventory.

Performing test counts, for example, by tracing items selected from the management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Answer 3(d)

The additional procedures are as follows:

Select samples from the inventory list (with quantity and value) and check they agree with the count sheets (with quantity only) which were prepared on the inventory count date and perform roll back test.

Select samples from count sheets and match them with the inventory list and perform roll back test.

Roll back test:

- check the inventory movements between the year end date and inventory count date against goods delivery notes and invoices issued.
- check the inventory movements between the year end date and inventory count date against goods received notes and invoices received.

Answer 4(a)

HKSA 505 (Clarified) requires the auditor, when using external confirmation procedures, to maintain control over external confirmation requests, including:

Determining the information to be confirmed or requested;

Selecting the appropriate confirming party;

Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

Sending the requests, including follow-up requests when applicable, to the confirming party.

Answer 4(b)

The possible reasons are as follows:

Invoice issued by the supplier not yet received or processed by the client.

Payment not yet received by the supplier or not yet processed by the supplier.

Errors made by the client.

Errors made by the supplier.

Goods returned not yet recorded by the supplier.

Cheques sent to suppliers are in transit at year end date.

Answer 4(c)

To determine whether the amount is material or not, we need to consider whether such misstatement could influence the economic decisions of users taken on the basis of financial statements.

For the misstatement of trade payables and purchases, we have to consider the impact on the misstatement of the statement of financial position as well as the income statement. The understatement of purchase will lead to understatement of cost of goods sold and overstatement of profit. The effect of the error on the income statement is material as the income before tax of HK\$100,000 is misstated as HK\$600,000. The gross profit margin is misstated as well. Such misstatement could influence the predictions and the economic decisions of the users.

Answer 4(d)

The qualified opinion should be expressed as being "except for" the effect of the understatement of the cost of goods sold and overstatement of the profit to which the qualification relates. A clear description of all substantial reasons giving rise to the disagreement and a quantification of the possible effects on the financial statements.

Answer 5(a)

For the continuance of an existing client, the following factors should be considered:

The integrity of the principal owners, key management and those charged with governance of the entity.

Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.

Whether the firm and the engagement team can comply with relevant ethical requirements.

Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

Answer 5(b)

In this case, the incentive payment is based on the successful application of the banking facilities which is related to the outcome of the result of the audit work performed.

The incentive payment being a contingent fee received by ABC & Co in respect of the audit engagement creates a self-interest threat that is so significant that no safeguards could reduce the threat to independence to an acceptable level. Therefore, ABC & Co should not accept such a fee arrangement.

Answer 5(c)

The possible substantive audit procedures for the mortgage loan and interest expenses are as follows:

Obtain the mortgage loans schedule from the client.

Check casting and agree the total to the trial balance.

Review minutes for the approval regarding the application of bank loans.

Review the statutory records and annual returns filed with the Company Registry.

Agree details of loans recorded to the loan agreements and loan statements.

Send bank confirmations regarding these loans.

Check the apportionment of current and non-current liabilities regarding these mortgage loans.

Review the disclosures regarding the mortgage loans in the notes to the financial statements.

Agree interest expenses to the loan statements.

Recalculate the interest expenses and accrued interest.

Develop expectations for the interest expense and compare the expected amount with the actual amount.

Review any covenants in place over loans to ensure that the entity has not breached the covenants of any loans in place during the year. Ensure adequate disclosure is made in the notes to the financial statements and consider whether further audit procedures are required for the going concern issue.

Answer 5(d)

The possible substantive audit procedures for the additions of investment properties are as follows:

Obtain the list of investment properties purchased.

Review the minutes for the approval regarding the purchase of properties.

Inspect the sales and purchase agreement.

Inspect the solicitor's statement for fees charged regarding the purchase of properties.

Recalculate the amount of stamp duties paid and inspect the receipt of payment.

Inspect the receipt of agency fees paid.

Agree the amount of the additions to the disclosure notes in the financial statements.

Perform land search.

* * * END OF EXAMINATION PAPER * * *

Examination Panelist's Report

Paper III
PBE Auditing and
Information Systems
(December 2012 Session)

(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 of candidates was relatively satisfactory compared with previous cohorts. However, there were still quite a number of candidates had not mastered the fundamental concepts of auditing such as understanding the business operations of an entity for auditing purposes, different types of audit reports, the purposes of audit planning and the application of 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 involving a practical scenario. Candidates were asked to apply their knowledge to practical auditing and information system issues. Most candidates were not able to link up their knowledge of auditing with the case details which required analytical thinking.

Part (a), quite a substantial number of candidates performed well in this part but some candidates did not read the requirements carefully; they directly copied the details of the daily operations from the case instead of highlighting the specific matters of WH Limited's operations needed to understand the business. Part (b), most candidates were not able to provide the relevant factors for the risk assessments. Parts (c), (d), & (e), most of the candidates who attempted these parts scored satisfactorily. Part (f), many candidates provided the major steps for developing a system instead of acquiring a system. Parts (g), & (h), quite a number of candidates who did not have a good understanding of the accounting concepts of unearned revenue gave irrelevant answers.

Section B – Optional Questions

Question 2 – 20 marks

This question examined candidates' understanding of the internal controls and substantive procedures for the auditing of accounts receivable and sales.

Part (a), most candidates who attempted this part scored satisfactorily, but quite a number of

candidates did not know the impact of the change in the accountant on the internal controls. Part (b), most candidates answered this question well. Part (c), most candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to provide the relevant test of details procedures for different assertions. Part (d), most candidates who attempted this part scored satisfactorily.

Question 3 – 20 marks

This question examined candidates' knowledge of analytical procedures and ethical issues.

Part (a), most of the candidates who attempted this part scored satisfactorily. Part (b), some candidates who attempted this part scored satisfactorily, however, some candidates did not have a good understanding of the purpose for audit planning and therefore provided irrelevant answers. Part (c), most candidates did not distinguish between the procedures for the inventory count date and the procedures to be performed after the inventory count date. Part (d), quite a number of candidates who attempted this part scored satisfactorily.

Question 4 – 20 marks

This question examined candidates' knowledge of auditing accounts receivable, the application of different kinds of audit reports and the concept of materiality.

Part (a) many candidates who attempted this part scored satisfactorily, but quite a number of candidates lacked an understanding of control over sending confirmations and gave irrelevant answers. Part (b), most candidates who attempted this part scored satisfactorily. Part (c), most candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to apply the concept of materiality in this situation. Part (d), some of the candidates who attempted this part scored satisfactorily, but some candidates were not able to distinguish between different types of audit reports.

Question 5 – 20 marks

This question examined candidates' knowledge of the ethic issues and substantive procedures for mortgage loan and interest expenses as well as for the acquisition of investment properties.

Parts (a), (b) & (c), most of the candidates who attempted these parts scored satisfactorily. Part (d), most candidates who attempted this part performed satisfactorily, but quite a number of candidates provided audit procedures for auditing the account balances of investment properties at the year end date instead of audit procedures relating to the acquisition of investment properties.

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

