



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 2013 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

Do not open this question paper until instructed by the supervisor.

This question paper must not be removed from the examination centre.

## **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**

PS Limited is a private company engaged in the operation of a karaoke café which provides food and beverages to customers in Tsimshatsui. The café operates from 1 p.m. to 3 a.m. the following day. There is a singing stage in the café which is popular with the customers who like singing. A minimum charge per head is set for the customers for different time slots. The minimum charge is HK\$150 per head up to 7 p.m. (day shift) and after 7 p.m. the minimum charge is HK\$300 per head (night shift). There are 2 full-time staff and 1 part-time staff working on each shift. Full-time staff are remunerated on a fixed monthly salary basis. Part-time staff are remunerated on an hourly basis. Staff are required to insert a timecard into the time clock when they start work and finish work. PS Limited has a year end of 31 December. The company is owned by the Chong family and run by one of the directors, Mr. Peter Chong, who has more than 20 years of experience in this industry. Jean Fong is the partner of a CPA firm, XYZ & Co Limited. She was approached by Mr. Peter Chong to be the new auditor of PS Limited.

PS Limited adopted a well-known computerized billing system which is specifically designed for café and restaurants. When customers arrive, the waiter will check and input the total number of customers at each table into the system. When the customer orders food or beverages, the waiter will prepare the food and beverages and will input the code of each dish or drink via a touch screen into the system. Then the food and beverage will be served.

The company has cashing-up procedures at the end of each shift. The total sales report of the day shift is generated from the system at 7 p.m. The day time staff member who is responsible for the cashier function will count the cash and credit card slips in the presence of the night shift staff member who is responsible for the cashier function. Both of them agree the amount for the sales total and sign on the sales total report. At 3 a.m., end of the night shift the cashier will generate the total sales report and agree with the cash and credit card slips and keep them in the safe. The keys of the safe are kept by the night shift cashier and Mr. Chong. The money in the safe is banked by Mr. Chong on the next working day.

This year, the company traded-in a new karaoke and sound system from Tech Limited. Tech Limited provided copyright, maintenance service and a karaoke videos updating service with a fixed monthly charge.

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

- (a) HKSA315 (Revised) required auditors to obtain an understanding of the entity and its environment, including the entity's internal control. An understanding of the nature of an entity enables auditors to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

What are the matters regarding the business operations of PS Limited that the auditor may consider when obtaining an understanding of PS Limited?

(8 marks)

- (b) State and explain the five assertions for the audit of the revenue of PS Limited.

(10 marks)

- (c) (i) What is inherent risk?  
(ii) What is control risk?  
(iii) What is your combined risk assessment for the audit of the revenue of PS Limited? Explain.

(8 marks)

- (d) What are the possible substantive procedures for test of details of the payroll expenses?

(7 marks)

- (e) What are the possible substantive procedures for the test of details of the acquisition of the new karaoke system and the disposal of the old karaoke system?

(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)

PM Limited which is engaged in the retail business of computer and mobile phone accessories, approached an audit firm, BC & Co., to replace the previous auditor.

When negotiating the audit fee, the management of the company indicated that as the company has effective internal control and therefore the audit work can be much reduced.

**Required:**

- (a) **Assess (high, medium or low) with reasons, the inherent risks of material misstatement of inventory of PM Limited. What are the two relevant assertions affected by these inherent risks?**  
(6 marks)
- (b) **What is internal control?** (3 marks)
- (c) **What are the five major components of internal control?** (5 marks)
- (d) **How does the internal control of the company affect the level of substantive tests for inventory?**  
(6 marks)

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

An audit firm, BC & Co. is the incoming auditor of MR Limited which is a company in the business of the extraction of minerals.

During the first meeting with the director of MR Limited, BC & Co is asked to commence the audit immediately because the audited financial statements must be submitted to the bank in ten days for the renewal of a bank loan. In order to compensate the auditor for the increased work load, an additional fee will be paid upon the successful renewal of the bank loan.

**Required:**

- (a) According to HKSA210 (Clarified), auditors shall take steps in order to establish whether preconditions are present before accepting a new engagement. Identify the steps.  
(5 marks)
- (b) Before accepting an engagement, auditors would normally obtain a preliminary knowledge of the industry and of the background of the entity. What are the sources for acquiring knowledge of a client's business and industry?  
(5 marks)
- (c) What are the five fundamental principles in the Code of Ethics for Professional Accountants?  
(5 marks)
- (d) Should the auditor accept the proposed audit fee arrangement, taking into consideration the Code of Ethics for Professional Accountants? What may be the threat to the professional ethics of the CPA firm and what should be the course of action?  
(5 marks)

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

The firm of BBD & Co., in which Bill Chan is employed, is the external auditor of Music Limited. Music Limited is a company engaged in the operation of 8 retail shops selling CDs, DVDs, Blu-rays and some other digital products in Hong Kong. Bill Chan has been in charge of this audit client for a few years.

After the year end of 31 December 2012, both the holding company and Music Limited announced that they had financial difficulties for the continuation of the business and were looking for potential investors for Music Limited.

Bill Chan discussed the issue with the director, Mr. John Ng, of Music Limited. John said that the management believes the holding company can find investors ultimately and therefore the going concern assumption is still applicable for this year's financial statements. However, the market in general believes that Music Limited and the holding company cannot survive in the future as no investor will invest in a declining industry.

**Required:**

- (a) How does the going concern assumption affect a company in the preparation of its financial statements?  
(4 marks)
- (b) What are the responsibilities of external auditors regarding the going concern assumption as used in the preparation of financial statements?  
(4 marks)
- (c) What are the four major types of audit opinions? Please explain.  
(8 marks)
- (d) What kinds of audit reports may be issued in the audit of Music Limited? State your assumptions clearly.  
(4 marks)

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

You have been the manager in charge of the audit for Fashion Limited for several years. Fashion Limited is a company engaged in the manufacturing and retailing of fashion. The directors of Fashion Limited decided to expand its business by developing the online sales system for selling goods to retail customers in different countries. In order to cope with the expansion of the business, the directors discuss with you the information system development strategy and customer relationship management system.

**Required:**

- (a) **Why is it important to integrate the information system with business expansion?**  
(6 marks)
- (b) **Suggest three modules that may be included in the customer relationship management system.**  
(6 marks)
- (c) **What are the stages of a system development life cycle? Please state any four stages and explain.**  
(8 marks)

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

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

**Answer 1(a)**

The key matters of PS Limited's business operations are as follows:

Nature of revenue resource – the company is a private company which provides food and beverages to customers in Tsimshatsui, there is a minimum charge for each customer.

Key customers – the company has customers who like singing.

Products or services and markets – the company has a rather high volume of transactions for providing food and beverages to customers and it is facing keen competition as many companies are providing similar types and standard of service.

Conduct of operation – the company is a private company engaged in the operation of a karaoke café with a singing stage, mainly cash / credit card basis.

Alliances, joint ventures, and outsourcing activities – Tech Limited provided copyright, maintenance service and a karaoke videos updating service with a fixed monthly charge.

Staff – there are approximately 4 full-time staff and 2 part-time staff in the company. Full-time staff are remunerated on a fixed monthly salary basis. Part-time staff are remunerated on an hourly basis.

Geographical presence – the company has only one restaurant located in Tsimshatsui.

No trade receivables, except receivables from credit card issuing banks.

**Answer 1(b)**

Occurrence - revenue transactions that have been recorded have occurred and pertained to the entity.

Completeness - all the revenue transactions that should have been recorded have been recorded and are complete.

Accuracy - amounts relating to recorded transactions have been recorded accurately and appropriately.

Cut off - revenue transactions have been properly recorded in the correct accounting period.

Classification - transactions have been properly recorded and classified in the financial statements.



**Answer 1(c)**

- (i) Inherent risk is the susceptibility of an assertion about a class of transactions, account balance or disclosure to a misstatement that could be material either individually or when aggregated with other misstatements, before consideration of any related controls.
- (ii) Control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.
- (iii) The combined risk of misstatement of revenue of PS Limited is assessed as medium to high when taking into account the following factors:
  - Cash from sales transactions is subject to a high risk of misappropriation.
  - There are numerous transactions which may increase the chance of human errors.
  - Difficult to set up control activities with a small number of employees.
  - The company adopted a well-known computerized billing system specifically designed for cafes and restaurants.

**Answer 1(d)**

Obtain the payroll schedule.

Agree the payroll expenses amount with the trial balance and general ledger.

Inspect the employment contracts.

Select samples of payroll expenses and recalculate the amount.

Agree the hours worked with the clock cards and pay rate (per employment contract).

Check against the employers' returns.

Compare payroll expenses with last year or compare monthly payroll expenses.

Inspect the MPF statements.

Check the bank statement for payroll payments.

**Answer 1(e)**

For the acquisition of the new karaoke system, the test of details is as follows:

Inspect the agreement for the terms of trade-in and the supplier's invoice.

Search for the listed price for the new system and compare the recorded purchase cost with the listed price.

Physically inspect the new system.

Check the authorization by the board of directors.

For the disposal of the old system, the test of details is as follows:

Obtain the disposal of karaoke and sound system schedule from the client.

Check casting and agree the amount of gain or loss on disposal to the trial balance and general ledger.

Based on the listed price of the new system, estimate the trade-in value and compare it with the sales proceeds recorded by the client.

Check the original cost of the disposed system against the fixed asset register.

Check the calculation of the accumulated depreciation up to the date of disposal for the disposed system.

Recalculate the gain or loss on disposal.

Review the disclosure in the financial statements.

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

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

**Answer 2(a)**

The inherent risk in respect of the existence assertion of the inventories balance is considered as medium or high as the computer and mobile phone accessories are small size items and therefore easily subject to misappropriation.

The inherent risk in respect of the valuation assertion of the inventories balance is considered as medium or high as the industry is fast changing. The selling prices of products drop significantly once the products become obsolete.

**Answer 2(b)**

According to HKSA 315 (Revised), internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

**Answer 2(c)**

The five major components of internal control are:

- Control Environment.
- Entity's Risk Assessment Process.
- Information System.
- Control Activities.
- Monitoring of Controls.

**Answer 2(d)**

If the auditor assesses the level of control risk to be at the maximum, the auditor may carry out the substantive approach and rely on substantive tests only.

On the other hand, if the auditor can rely on internal controls, he or she will carry out tests of controls and consider the effects of the results on further substantive procedures.

If the results of the tests of controls support the assessed level of control risk, the auditor can conduct substantive tests of inventory accounts at the planned level.

However, if the auditor judges the control risk to be higher than expected, then he or she will set the detection risk at a lower level and extend the substantive tests.

### **Answer 3(a)**

In order to establish whether the preconditions for an audit are present, auditors shall determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and obtain the agreement of management that it acknowledges and understands its responsibility for the following:

- For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and to provide auditors with:
  - Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - Additional information that auditors may request from management for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom the auditors determine it necessary to obtain audit evidence.

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

The sources are:

- Discussion with the management of the company.
- Discussion with internal auditors and examination of previous internal audit reports.
- Discussion with experts of the industry.
- Publications of the industry.
- Legislations and Regulations applicable to the industry.
- Visits to the entity's premises and plant facilities.
- Internal documents provided by the management, e.g., management accounts, records and internal control manuals.
- Discussion with employees involved in unusual transactions.
- Discussion with in-house legal counsels.
- Discussion with the marketing or sales personnel.

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

A professional accountant is required to comply with the following fundamental principles:

**Integrity** – A professional accountant should be straightforward and honest in all professional and business relationships.

**Objectivity** – A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

**Professional Competence and Due Care** – A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

**Confidentiality** - A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

**Professional Behaviour**- A professional accountant should comply with the relevant laws and regulations and should avoid any action that discredits the profession.

### **Answer 3(d)**

The additional fee is a contingent fee component in the proposed audit fee. Contingent fees are fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm. In this case, the contingent fee component, the additional fee, is based on the success of the renewal of the bank loan.

The contingent fee charged by BC & Co. in respect of the audit engagement creates a self-interest threat that is so significant that no safeguards could reduce the threat to an acceptable level.

Accordingly, BC & Co shall not enter into any fee arrangement with MR Limited for the assurance engagement in which a component of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement. As the renewal of the bank loan is based on financial statements which are the subject matter information of the assurance engagement, BC & Co should not accept such a fee arrangement.

#### **Answer 4(a)**

According to HKSA570 (Clarified), under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future.

General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

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

According to HKSA570 (Clarified), the external auditors' responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

This responsibility exists even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

However, as described in HKSA200 (Clarified), the potential effects of inherent limitations on the auditors' ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Auditors cannot predict such future events or conditions. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

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

According to HKSA700 (Clarified) & HKSA705 (Clarified), the four major types of audit opinion are as follows:

Unmodified opinion

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

### Qualified Opinion

The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

### Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

### Disclaimer of Opinion

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

### **Answer 4(d)**

If the client prepared the financial statements on a break up basis and explained the situation properly in the notes to the accounts, then an audit report with the unmodified opinion and an emphasis of matter paragraph may be issued.

If the client prepared the financial statements on a going concern basis, and the auditor disagrees with the basis on which the financial statements have been prepared, and the misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements, then an audit report with a qualified opinion may be issued.

If the client prepared the financial statements on a going concern basis, and the auditor disagrees with the basis on which the financial statements have been prepared, and concludes that the misstatements, individually or in the aggregate, are both material and pervasive, then an audit report with an adverse opinion may be issued.

If the client prepared the financial statements on a going concern basis, and the auditor is unable to obtain sufficient appropriate audit evidence about whether the going concern assumption is appropriate, and the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, to the financial statements, then an audit report with a qualified of opinion may be issued.

If the client prepared the financial statements on a going concern basis, and the auditor is unable to obtain sufficient appropriate audit evidence about whether the going concern assumption is appropriate, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, then an audit report with a disclaimer of opinion may be issued.

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

The reasons for integrating the information system with business expansion are as follows:

- Information needs will keep on changing to cope with the dynamic business environment.
- The information system supplies information to the business for future business plans.
- The information system provides information for a company to enhance competitive advantages.
- The information system enhances goal congruence among different units.
- The information system is a significant investment and it will be used over a long period of time.

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

Modules that may be included in the customer relationship management system are as follows:

Partner relationship management – enhances collaboration between a company and its selling partners by providing distribution schedules and relevant information.

Employee relationship information – deals with employee issues such as setting objectives, employee performance management, performance-based compensation and employee training.



Sales force automation – helps sales staff to focus their efforts on the most profitable customers. The information generated includes sales prospect and contact information, product information, product configuration capabilities and sales quote generation capabilities.

Customer Service – provides information to increase the efficiency of call centres, help desks and customer support staff.

Marketing – supports direct marketing campaigns by providing capabilities for capturing prospect and customer data, and for scheduling and tracking direct marketing mailings or email.

Other relevant points.

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

The stages of the system development cycle are as follows:

#### **Systems Analysis**

The first step in the process is system analysis where the information needed is gathered, or the problem is analysed, and the nature and scope of the system project requested is investigated.

#### **Conceptual Design**

The main purpose of this step is to prepare a detailed specification outlining what the system is to accomplish and how it is to be controlled.

#### **Physical Design**

During this phase, the broad, user-oriented conceptual design requirements are translated into the detailed specifications.

#### **Implementation and conversion**

This phase starts with an implementation and conversion plan that involves the installation and testing of new hardware and software, hiring employees, training or relocating existing employees, and testing and modifying the processing procedures.

#### **Operations and Maintenance**

During this stage, the new system is periodically reviewed and modifications are made as problems arise or as new needs come from users again. Maintenance includes hardware and software changes, documentation amendments or procedures to a production system to correct errors, meet new requirements or improve processing efficiency.

\* \* \* 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 of candidates was relatively satisfactory compared with previous sessions. However, there were still quite a number of candidates who 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 risk assessment process of audit planning and the application of substantive procedures for different classes of transactions.

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 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 PS Limited's operations needed to understand the business. Part (b), most candidates who attempted this part scored satisfactorily, but quite a number of candidates did not know the five assertions for the class of revenue transactions. Part (c), most candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to define inherent risk and control risk. Parts (d) & (e), most of the candidates who attempted these parts scored satisfactorily.

## **Section B – Optional Questions**

### **Question 2 – 20 marks**

This question examined candidates' understanding of the internal controls, the relationship between the effectiveness of internal control and the extent of substantive procedures, and the inherent risk assessment for the auditing of inventories.

Part (a), most candidates who attempted this part scored satisfactorily, but quite a number of candidates did not know the relevant assertions and were not able to provide the relevant factors for the risk assessments. Part (b), most candidates answered this question well. Part (c), most candidates who attempted this part scored satisfactorily, but quite a number of candidates provided the components of control activities instead of components of internal control. Part (d), most candidates who attempted this part performed satisfactorily, but quite a number of candidates were not able to further elaborate and explain the relationship between the results of the tests of controls and the extent of substantive procedures.

### **Question 3 – 20 marks**

This question examined candidates' knowledge of engagement acceptance and ethical issues.

Part (a), most of the candidates who attempted this part scored satisfactorily, but some candidates misunderstand the question and therefore provided irrelevant answers. Parts (b), (c) & (d), most of the candidates who attempted these parts scored satisfactorily.

### **Question 4 – 20 marks**

This question examined candidates' knowledge of the going concern assumption in the context of auditing, and the application of different kinds of audit reports.

Parts (a) & (b), many candidates who attempted this part scored satisfactorily. Part (c), most candidates who attempted this part scored satisfactorily, but a few candidates mixed up qualified opinion and unmodified opinion. Part (d), some of the candidates who attempted this part scored satisfactorily, but some candidates were not able to state their own assumptions for the decisions made.

### **Question 5 – 20 marks**

This question examined candidates' knowledge of an information system development strategy and customer relationship management system.

Parts (a) & (b), students did not prepare well enough to answer the information system question and performance was poor for these two parts. Part (c), most candidates who attempted this part scored satisfactorily.

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