



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 2014 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

Jenny Wong is an audit manager of a CPA firm, Kan Yip & Co. Recently, Jenny was assigned to be in charge of the audit of the accounts ended 31 March 2014 of an existing client, Japanese Beauty Limited (“JBL”), a private company engaging in providing makeup and hairstyling courses, makeup and hairstyling services and selling beauty products. JBL is owned and run by two directors, both are experienced and professional hair and makeup artists. They employ two administrative staff, three full-time artists and several part-time artists. The administrative staff and the full-time artists are remunerated on a fixed monthly basis whilst part-time artists on an hourly basis.

JBL was set up in September 2011 and is located in Causeway Bay. The company provides regular and irregular courses for different styles / levels of Japanese makeup to students. Irregular courses are private lessons provided for individuals or small private groups.

According to the previous year’s working paper file, the company maintained a computer system. For regular courses, students are required to pay tuition fees on a course basis in advance. For irregular courses, students are required to pay after each lesson. One of the administrative staff performs the role of cashier and issues a receipt upon receiving the tuition fees. The course code, course description, course period, number of lessons, dates of lessons, amount of tuition fees and methods of payment are listed on the receipts. The attendance list including the names of students with tuition fees paid for each class is generated by the system. No refund is allowed after payment. However, students may be allowed to change the class to attend at the discretion of the directors. There are two different sets of receipts issued in sequential order. One set for the regular courses offered. Another set is for the provision of makeup and hairstyling services as well as the provision of irregular courses, the selling of learning materials and beauty products. Customers can choose to make payment by cash or credit card.

The revenue accounts are updated with the amount of tuition fees received and sales receipts every day. The computer system maintains a master list of courses provided during the year. The details, such as the name of the artists, artists’ remuneration basis, number of students enrolled, period covered and dates of lessons, and amount of tuition fees of each course are listed on the master record. JBL engaged a part-time accountant, May Poon, to provide accounting services every Saturday. At the end of the accounting year, the part-time accountant will prepare a worksheet based on the master record for the calculation of the unearned revenue and adjusting entries are made accordingly.

Students can bring their own beauty products or buy the beauty products from JBL. JBL keeps all the beauty products in a locked store room. On the last Monday of every quarter, the administrative staff will count the beauty products and arrange the beauty products according to the expiry dates. The inventory record with detailed descriptions including the expiry dates is updated after the physical count. Discounted prices determined by the two

directors are offered for the beauty products near their expiry date. Due to the over estimation of the demand for beauty products at the commencement of the business, JBL maintained too many beauty products. A batch of beauty products will expire within nine months after the year end date.

Question 1 (40 marks – approximately 72 minutes)

- (a) HKSA315 (Revised) requires the auditor 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 the auditor 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 JBL that the auditor may consider when obtaining an understanding of JBL?

(8 marks)

- (b) State and explain the five assertions for the audit of the courses fee revenue of JBL.

(10 marks)

- (c) The amount of cash receipts of regular courses provided by JBL is different from the course fees earned. How might one calculate the course fees earned for the year?

(2 marks)

- (d) State the substantive procedures for auditing unearned revenue liability at year end date.

(8 marks)

- (e) JBL has a lot of inventories of beauty products at the year end date. What should be Jenny's assessment of material misstatement at the assertion level (high, medium or low) for the valuation of these inventories? Please provide explanations.

(4 marks)

- (f) At year end date, the auditor has attended the inventory count and obtained the count sheets which state the quantity of each inventory item. During the field audit, an inventory schedule which states the inventory balance, the quantity, value and expiry date of each inventory item is obtained from JBL. What should be the substantive procedures for auditing the inventories balance?

(8 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)

Currently, most of the famous fast food chain restaurants have acquired a Point of Sale System ("POS") in their operation. POS is the point at which a customer makes a payment to the cashier whereby the sale is recognised and recorded. After making the payment, the cashier will issue a receipt to the customer to redeem food.

The latest version of POS includes advanced features to cater for different functions, such as inventory management, customer relationship management, financials, and warehousing.

Required:

- (a) What are the risks of a computer-based system for internal controls?
(10 marks)
- (b) In the planning stage of such audits, the auditor may consider using a combination of manual procedures and computer-assisted audit techniques ("CAAT") to obtain audit evidence. When making such a decision, what are the factors to be considered by the auditor?
(10 marks)

Question 3 (20 marks – approximately 36 minutes)

Your employer, DM & Co., is the external auditor of East Sun Limited ("ESL") which is a company in the manufacturing and retail business.

You have worked on this audit assignment for a few years and this year you are the senior in charge of the audit. The audit team consists of three members. You decide to let the senior assistant carry out the substantive procedures for the trade receivable balances. The other assistant, Chloe, is a newly recruited accounting graduate, with no practical work experience. Chloe has requested you to assign more tasks to her as she wants to accumulate more experience. She is confident that she can carry out the tasks effectively and efficiently because her uncle works at ESL as the financial controller. She also mentioned that her uncle was in hospital for a few weeks six months ago.

Required:

- (a) State the substantive procedures for auditing trade receivable balances that address the following two assertions:
- (i) Valuation and allocation; and
 - (ii) Rights.
- (10 marks)
- (b) What is the impact on the audit procedures as a result of the sick leave period taken by the financial controller of ESL? Explain.
- (4 marks)
- (c) What is auditor's independence? State the requirements of independence from the Code of Ethics for Professional Accountants.
- (6 marks)

Question 4 (20 marks – approximately 36 minutes)

An auditor applies analytical procedures at three stages of an audit. The three stages, namely risk assessment in the planning stage, execution stage (testing of transactions and account balances), and overall review of financial statements in the audit completion stage.

Required:

- (a) What are the purposes of performing analytical procedures?
(8 marks)
- (b) How are analytical procedures useful to the auditor in the risk assessment in the planning stage?
(4 marks)
- (c) How are analytical procedures useful to the auditor at the execution stage (testing of transactions and account balances)?
(4 marks)
- (d) How are analytical procedures useful to the auditor in the overall review of financial statements in the audit completion stage?
(4 marks)

Question 5 (20 marks – approximately 36 minutes)

You are an audit manager of ABC & Co. You are responsible for the audit of SHE Limited which is a client of ABC & Co. ABC & Co has focused their attention on conducting cost-effective audits by having adequate planning for every audit.

SHE Limited owns many shopping arcades in Hong Kong and mainland China, all are used to earn rental income. A lot of resources are allocated to set up a good internal control system for the collection of rental income.

Required:

- (a) Discuss the benefits of audit planning. (4 marks)
- (b) SHE Limited adopts the Fair Value Model for the accounting of the investment properties. The auditor has decided to use an expert's services regarding the fair value of the investment properties.
- What matters should be agreed between the auditors and the auditor's expert before commencement of service? (6 marks)
- (c) Assess (high, medium or low), with reasons the inherent risk of material misstatement of the existence of SHE Limited's investment properties. (5 marks)
- (d) State the FIVE components of internal control. (5 marks)

* * * END OF EXAMINATION PAPER * * *

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

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

Nature of and sources of revenue – JBL is a private company. Tuition fees, service income and sales of beauty products are major sources of revenue.

Key customers – JBL Limited has a large number of customers, people who like beauty treatments and people who wish to embark on a career as a makeup artist are their potential customers.

Products or services and markets – JBL engages in the provision of makeup and hairstyling courses as well as makeup and hairstyling services, and selling beauty products. It is facing keen competition as there are many companies providing similar kinds of services and goods nowadays.

Conduct of operation – JBL is engaged in a cash sales business, payments are in cash or by credit card. In addition, the company receives advance payments from customers for regular courses. Payment for irregular courses would be made after each lesson.

Employment – there were two administrative staff, three full-time artists and several part-time artists. The salaries of two administrative staff and three full-time artists are on a fixed monthly basis. The salaries of part-time artists are on an hourly basis. The accountant is part-time.

Geographic dispersion – the company has one shop located in Causeway Bay.

Answer 1(b)

Occurrence – courses fee revenue transactions recorded are for makeup and hair styling courses delivered by JBL.

Completeness – all course fee revenue earned by courses delivered by JBL is recorded.

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

Cut-off – revenue from courses delivered have been recorded in the correct accounting period / year.

Classification – courses fee revenue transactions have been properly classified and presented in the financial statements.

Answer 1(c)

Beginning unearned revenue + advance cash receipts of tuition fees – ending unearned revenue

Answer 1(d)

Audit procedures for unearned revenue:

Obtain the worksheet of unearned revenue from the client.

Check casting and agree the total to the trial balance and the general ledger.

Select samples from the unearned revenue worksheet list and check against the master list of courses to ensure these courses are not completed at year end date.

Select samples from the master list of courses and check against the unearned revenue worksheet to ensure uncompleted courses are accounted for.

Recalculate the amounts of unearned revenue and match with the amounts stated on the list to ensure the accuracy of the liability.

Review the list for large and unusual items and verify to ensure the existence and accuracy of the liability.

Review pamphlets used by the company or the official website to identify courses offered during the year, especially those near the year end date.

Review the basis for computing unearned revenue, ensure that it is consistently applied as in the prior year and in accordance with GAAP.

Answer 1(e)

Inventories should be stated at the lower of cost and net realizable value. When the inventories' net realizable value is lower than the cost, the company has to write down the value of the inventory. The amount to be written down is subject to management's estimation. The assessment of risk of material misstatement of the inventory at assertion level for valuation should be medium to high as so many inventories have piled up in the company and the products' market is subject to uncertainty because of fashion trends and the expiry date.

Answer 1(f)

Check casting and agree the total of the inventory schedule against the trial balance.

Select samples from the inventory schedule and check against the count sheets obtained on the inventory count day.

Select items from the inventory schedule and trace them to the relevant purchase invoices to determine if unit cost has been correctly arrived at.

Check whether the calculation of the inventory cost is consistent with the selected costing method by JBL.

Select items to compare the cost used to value inventory to subsequent sales of the respective items to determine if they have been valued at the lower of cost or net realizable value.

Select items that have been valued at net realizable value by the management and trace these to the supporting documents such as sales invoices issued subsequent to year-end.

Inquire and confirm with the management if items have been identified as obsolete and slow-moving and impairment losses have been accounted for.

Review the inventory record to identify beauty products that will soon expire, or have already expired, have either been written off or properly provided for.

* * * END OF SECTION A * * *

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

Answer 2(a)

The risks of a computer-based system on internal controls are as follows:

Reliance on systems or programs that are inaccurately processing data.

Unauthorised access to data that may result in destruction of data or improper changes to data. There is risk of recording unauthorized transactions or inaccurately recording transactions.

The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties.

Unauthorised changes to data in master file.

Unauthorised changes to systems or programs.

Failure to make necessary changes to systems or programs.

Inappropriate manual intervention.

Potential loss of data or inability to access data as required. There is lack of audit trail because of the transient nature or lack of hardcopy evidence.

Answer 2(b)

The following factors should be considered by the auditor:

- (1) The computer knowledge, expertise and experience of the audit team

Auditors should have knowledge of data processing and computer applications together with a detailed knowledge of the audit software and computer files to be used.

- (2) Availability of CAATs and suitable computer facilities

The client entity's computer facility is incompatible or impractical to be used, the auditor may need to plan to use other computer facilities and may need the help of the client's personnel to provide copies of data files in the required format.

- (3) Impracticability of manual audit procedures

It may not be practical for the auditor to perform audit procedures manually if the computer system does not produce hard-copy evidence.

(4) Effectiveness and efficiency

In evaluating the effectiveness and efficiency of CAATs, the auditor should consider the benefit and costs of it.

(5) Timing

Certain computer files may be retained for a short period of time which may affect the timing of carrying out audit procedures. CAATs may be a solution for an audit assignment with a tight time constraint.

Answer 3(a)

(i)

The substantive procedures for auditing trade receivable balances that address the valuation and allocation assertion:

Obtain the ageing analysis from the client and check that the ageing analysis is correctly footed and agree the total amount against the trial balance and the general ledger.

Select some trade receivable balances from the list and trace them to the sales invoices and monthly statements for correct ageing and amount.

Review correspondence files with debtors for any disputes that arise before and after year end to consider the adequacy of the allowance for doubtful debts amount / impairment loss.

Check subsequent to year-end settlements from debtors to determine if there are long outstanding amounts that have not been settled. Ask the client for reasons and consider whether there is impairment of the trade receivable balances not accounted for.

(ii)

The substantive procedures for auditing trade receivable balances that address the rights assertion:

Review minutes or discuss with client if there is such evidence of pledging trade receivable as collateral or factoring arrangement.

Send confirmation to bank and examine correspondence files that may disclose the evidence of client's right to trade receivable.

Answer 3(b)

It would be appropriate to increase the extent of further audit procedures to verify that existing documented systems were properly carried out by other staff during the sick leave period. Any areas which were formerly evaluated as low control risks may require additional testing for that period because the other staff, who acted as the financial controller for such period, may not be fully conversant with the systems and may have been biased in their actions.

Answer 3(c)

Independence requires independence of Mind and independence in Appearance.

Independence of Mind

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

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.

It is important for an auditor to maintain objectivity which means not to allow bias, conflict of interest or the undue influence of others to override professional judgments.

A professional accountant in public practice who provides audit services should be independent of the audit client because the auditor has to act in the public interest.

Answer 4(a)

The purposes of performing analytical procedures are as follows:

To identify areas where there are high risks of misstatements in the account balances.

To analyze the inconsistent relationship between financial data and non-financial data.

To compare the current data with data predicted and information from the previous period and analyzing their variances.

To evaluate the results in the light of other audit evidence obtained.

Answer 4(b)

Analytical procedures are useful to the auditor at the risk assessment in planning stage for:

Obtaining an understanding of the entity and its environment.

Identifying risk areas of the client's business and possible material misstatements.

Assessing whether the client has going concern problem.

Determining the audit approach as well as the timing, nature and extent of further audit procedures

Answer 4(c)

Analytical procedures are useful to the auditor at the execution stage (testing of transactions and account balances) for:

Making comparisons between periods and investigating the reasons for their variances.

Extending the test of details where evidence obtained by analytical review is inconsistent with evidence obtained from other tests.

Reducing the tests of details where the results of analytical procedures indicate a lower risk of material misstatements.

Answer 4(d)

Analytical procedures are useful to the auditor at the overall review of financial statements in audit completion stage for:

Forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Identifying possible misstatements of classes of transaction and account balances by ratio analysis and trend analysis.

Assessing whether the entity is a going concern.

Identifying a previously unrecognized risk of material misstatement.

Answer 5(a)

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 organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of 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 the auditors of components and experts.

Answer 5(b)

The auditor shall agree, in writing when 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.
- The need for the auditor's expert to observe confidentiality requirements.

Answer 5(c)

The inherent risk of material misstatement of the existence of SHE Limited's investment properties should be low to medium.

The reasons are as follows:

- There is no indication of fraud.
- Investment properties are not subject to misappropriation.
- Investment properties are immovable.

Answer 5(d)

The five major components are:

- Control environment
- Entity's risk assessment process
- Information system
- Control activities
- Monitoring of controls

* * * END OF EXAMINATION PAPER * * *

Reference:

- (1) Lisa S.K. Wong, Teresa M.H. Ho, PBE Paper III Auditing and Information Systems, Pearson 2014
- (2) Hong Kong Institute of Certified Public Accountants Members' Handbook, Volume III: Auditing and Assurance Standards, Hong Kong Institute of Certified Public Accountants.

Note: The suggested answers given above are much longer and in greater detail than the ones expected of candidates in the examination. The purpose of the suggested answers is meant to help candidates in their revision and learning. Also, these suggested answers may not include all valid points of each question. Credit should be given to candidates who give valid answers to the questions.

(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 satisfactory. However, there were still some candidates who had not mastered the fundamental concepts of auditing well, such as understanding the business operations of an entity for auditing purposes, the impact of a computerised information system on internal controls, the assessment of the risk of material misstatement, the application of substantive procedures for different classes of transactions and accounts balance.

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. Some candidates were not able to link up their knowledge of auditing with the case details which required analytical thinking.

Part (a), a substantial number of candidates performed well in this part but some candidates were not able to analyse the information; they directly copied the details of the daily operations from the case instead of highlighting the specific details of JBL's operations needed to understand the business. Part (b), most candidates who attempted this part scored satisfactorily, but some candidates were not able to identify the five assertions for the class of revenue transactions and therefore answered poorly. Part (c), most candidates did not have any idea regarding the calculation of unearned revenue at the end of the year. Part (d), some candidates who attempted this part scored satisfactorily, but quite a number of candidates provided irrelevant procedures as they did not identify the relevant information in the case. Part (e), most of the candidates who attempted this part scored satisfactorily but some candidates do not understand the valuation assertion and therefore provided irrelevant answers. Part (f), most candidates did not read the question carefully, they provided the audit procedures to be carried out on the inventory count date instead of the procedures to be carried out on the inventory schedule during the field audit period.

Section B – Optional Questions

Question 2 – 20 marks

This question examined candidates' knowledge of the relationship between internal controls and a computerised information system.

Candidates did not prepare well enough to answer the information system question and very few students attempted this question. However, most candidates who attempted this question scored satisfactorily.

Question 3 – 20 marks

This question examined candidates' knowledge of the assertion for trade receivables and the substantive procedures for the valuation and rights of trade receivables, an understanding of control risk and ethics issues.

Part (a), most candidates who attempted this part scored satisfactorily, but a few candidates did not pay attention to the specified assertions and provided irrelevant procedures. Part (b), many candidates did not have an adequate understanding of control risk and therefore provided irrelevant answers. Part (c), most of the candidates who attempted this part scored satisfactorily.

Question 4 – 20 marks

This question examined candidates' knowledge of analytical procedures at different stages of the audit.

Most candidates who attempted this question scored satisfactorily.

Question 5 – 20 marks

This question examined candidates' understanding of audit planning, the use of experts' services, audit risk assessment and the five elements of internal control.

Parts (a) & (b), candidates who attempted these parts scored satisfactorily. Part (c), most candidates did not pay attention to the specified assertion and therefore provided irrelevant answers. Part (d), most of the candidates who attempted this part scored satisfactorily.

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