



Hong Kong Institute of
Accredited Accounting Technicians
香港財務會計協會

Professional Bridging Examination

Paper III PBE Auditing and Information Systems

June 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.

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	31
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

CH Limited is a private company engaged in the operation of more than 20 Hong Kong style cafes which provide food and beverages to customers in different districts in Hong Kong and Macau. The cafes operate from 6 a.m. to 2 a.m. the following day. The company has more than 400 full-time staff and 200 part-time staff working for the day and night shifts. Full-time staff are remunerated on a fixed monthly salary basis. Part-time staff are remunerated on an hourly basis. CH Limited has a year end of 31 December. The company is owned by the Chan family and run by two directors, Mr. Larry Chan and Mr. Kevin Chan, both with more than 20 years' experience in this industry. Charlotte Pan is a partner of a CPA firm, PAQ & Co Limited. She was approached by Mr. Larry Chan to be the new auditor of CH Limited. CH Limited planned to be listed in Hong Kong in order to raise funds to expand their business by establishing cafes in different provinces in mainland China.

Larry Chan advised that the company has effective internal control and therefore the auditors' work can be greatly reduced. CH Limited adopted a computerized billing system which is designed for restaurants. When a customer orders food, the waitress assigns a new card to the table and scans the barcode of the card into the system. Afterwards, the waitress inputs the code of each dish via a mobile device into the system. The staff in the kitchen prepares the dish according to the order shown on the screen of the system and then inputs it after it is delivered. After finishing the meal, the customer brings the card provided by the waitress to the cashier. The cashier scans the barcode of the card and a bill is issued by the system based on the ordered items. The cashier then presents the bill to the customer for cash settlement. A daily exception report with the details of unpaid orders is generated by the head office. Any shortfall in the amount will be endorsed by the shop manager and compensated by all the staff of that shift.

The company has cashing-up procedures at the end of each shift. The sales total report of each shift is generated from the system by the head office. At the end of the shift, the cashier takes out the cash register drawer containing money. The shop manager counts the money in the presence of the cashier and agrees the amount to the sales total informed by the head office. Every day, two staff, instructed by the shop manager would go to the bank together to bank-in the sales total amounts of the day shift and night shift of the previous day. Cash will be banked-in the next working day if the day concerned is a public holiday or Sunday.

Everyday, the bank-in slips are scanned and emailed to the head office. The original copies are kept in the safe and collected by the staff from head office at the end of each month. There are two safes in each shop, one safe is for the day shift and the other one is for the night shift. Cash is kept in the safes before banking in. The keys of each safe are held by the day shift and night shift managers respectively.

Larry Chan was concerned about a law suit case regarding a customer who slipped, fell down and broke his leg in one of the restaurants before the year end date. The company compensated the customer with a sum of money after the year end date. Larry Chan advised Charlotte that the company did not report the case in its financial statements as it was settled after the year end date.

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Question 1 (40 marks – approximately 72 minutes)

- (a) What should be considered by a CPA firm when accepting a new audit engagement?

(5 marks)

- (b) HKSA 315 (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 the entity 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 CH Limited's business operation that the auditor may need to understand at this stage?

(6 marks)

- (c) (i) What is internal control?

(3 marks)

- (ii) What are the five components of internal control?

(5 marks)

- (iii) Assess with reason, the level of (high, medium or low) the inherent risk of material misstatement of the completeness of cash sales. How does the risk of material misstatement for cash sales in this case affect the extent of the auditor's substantive procedures of the sales revenue?

(4 marks)

- (d) List four examples of control activities in the cafes of CH Limited relating to cash sales and receipts systems.

(4 marks)

- (e) List three possible control activities that would be carried out by the head office of CH Limited relating to cash sales and receipts systems.

(3 marks)

- (f) What are the possible analytical procedures for the sales revenue of CH Limited to be performed by the auditor?

(4 marks)

- (g) If the directors insist on not making any changes to their financial statements regarding the particular lawsuit stated above, what are the possible audit opinions to be issued?

(6 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)

FLK Limited is an existing client of ABC & Co, a CPA firm. FLK Limited has engaged in the manufacturing business for more than 10 years. The company successfully developed a new product in 2011 and the board of directors determined to expand their business by investing in new machinery and equipment. They acquired high valued machinery in 2011 and 2012 by means of finance leases. In order to finance the launching of the product in more markets in 2013, 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) Should the audit firm, ABC & Co, accept the proposed incentive payment on top of the fixed audit fee? Please explain. What are the threats to independence that may be created to the audit firm, ABC & Co?
(4 marks)
- (b) What are the two major types of substantive procedures? Elaborate and provide one example of each type for the auditing of the finance lease and interest expenses of FLK Limited for the year ended 31 December 2012.
(6 marks)
- (c) What are the five assertions for the acquisition transactions for machinery?
(5 marks)
- (d) Describe five substantive audit procedures for the acquisition for machinery.
(5 marks)

Question 3 (20 marks – approximately 36 minutes)

For the audit of inventory, auditors have to plan for the attendance of the physical inventory count and perform audit procedures on inventory counting day.

Required:

- (a) Why is the audit of inventory important?
(3 marks)
- (b) What should be considered in planning attendance at physical inventory counting?
(7 marks)
- (c) List the audit procedures that will be carried out on the inventory counting day.
(10 marks)

Question 4 (20 marks – approximately 36 minutes)

You are the manager in charge of the audit for Company A, a company selling skincare products to more than two hundred retail shops on credit terms. You decided to assign the audit work relating to the cash at bank section and the trade receivables section to a fresh accounting graduate.

Required:

- (a) What are the audit procedures that should be applied in relation to debtors' confirmation? What controls should be maintained over the external confirmation?
(10 marks)
- (b) Why is the audit of cash at bank an important part of an audit?
(4 marks)
- (c) List the audit procedures that should be performed on the bank reconciliation statements.
(6 marks)

Question 5 (20 marks – approximately 36 minutes)

PAN Limited has been engaged in the manufacturing of kitchen utensils for more than 10 years. The board of directors of the company decided to expand their business and therefore to penetrate into mainland China market two years ago. The sales increased tremendously last year and the board of directors determined to expand their business. In order to cope with the expansion of their business, they would like to purchase a reputable enterprise resource planning ("ERP") system from one of the ERP vendors. Most employees are resistant to the adoption of the ERP system, which is considered by them to be a complicated system.

Required:

- (a) Why does PAN Limited choose to use a ready-made ERP system instead of employing programmers to develop a tailor-made one? (3 marks)
- (b) Why does PAN Limited make changes to the existing information system? Provide six reasons. (6 marks)
- (c) What are the major steps of systems implementation? (5 marks)
- (d) Provide three measures that can deal with and / or reduce employees' resistance. (6 marks)

* * * END OF EXAMINATION PAPER * * *

Answers

Paper III
PBE Auditing and
Information Systems
(June 2013 Session)

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

The auditors when accepting a new audit engagement have to consider:

The reasons for the change in appointment of auditors.

The integrity of the two directors of CH Limited.

Illegal activities undertaken by the client company, if any.

Whether PAQ & Co is competent to perform the audit engagement such as whether PAQ & Co is familiar with the restaurant industry.

Whether PAQ & Co has adequate time and resources to complete the audit on time.

Whether PAQ & Co and the engagement team can comply with the ethical requirements.

Answer 1(b)

The matters regarding the business operations of CH Limited that the auditor may consider are as follows:

Nature of revenue sources - CH Limited operates more than twenty Hong Kong style cafes which provide food and beverages to customers in Hong Kong and Macau.

Key customers - large number of customers across the whole population.

Products or services and markets - CH Limited has a high volume of transactions from provision of food and beverages and it is facing keen competition.

Conduct of operations - CH Limited operates a cash sales business with a computerized billing system.

Employment – there are approximately 400 full-time staff and 200 part-time staff in CH Limited. The salaries of the full-time staff are on a fixed monthly basis. The salaries of the part-time staff are on an hourly basis.

Geographical dispersion – there are more than twenty cafes located in different districts in Hong Kong and Macau. There is no presence in mainland China.

Answer 1(c)(i)

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 1(c)(ii)

The five major components are:

Control environment.

Entity's risk assessment process.

Information system.

Control activities.

Monitoring of controls.

Answer 1(c)(iii)

The assessment of inherent risk of material misstatement of the cash sales at assertion level for completeness should be high as cash is subject to misappropriation. Sales may not be recorded if cash is misappropriated.

If the risk of material misstatement is high, then the auditor would set a lower acceptable detection risk level. A lower acceptable level of detection risk implies that the auditor would conduct a more detailed investigation of the sales revenue.

Answer 1(d)

Examples are listed as follows:

The shop manager of the day shift counts the cash from daily sales and matches the amount against the sales amount informed by the head office.

The shop manager and the cashier of the night shift sign off the cash count slip.

Safes are used to keep the cash from daily sales receipts.

Cash is banked-in every day in order to reduce the potential loss from theft.

Bank-in slips are scanned and emailed to head office for daily checking.

Shop managers have custody of the safes' keys.

Cash is banked-in by two staff instructed by shop managers.

Other relevant answers.

Answer 1(e)

The possible control activities are as follows:

Match the bank-in slip against the daily sales report generated from the system every day.

Prepare the daily / weekly / monthly sales analysis report and request an explanation from the shop manager when there is a significant change.

Prepare the bank reconciliation statements regularly.

Compare the cost of sales to sales of each cafe to consider whether sales are reasonable.

Review the exception reports and compare daily / weekly / monthly total amount of unpaid orders of each cafe and carry out an investigation.

Conduct regular visits to each cafe to count cash on hand.

Other relevant examples.

Answer 1(f)

The possible analytical procedures are as follows:

Compare reported sales income with budgeted sales income.

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

Compare the ratio of sales income to the size of different cafes.

Analyse the trend of the daily / weekly / monthly income of the cafes. Investigate fluctuations between daily / weekly / monthly sales and ask for reasons.

Compare cost of sales to sales of each cafe to consider whether sales are reasonable.

Compare the gross profit percentage of each cafe for this year to that of last year.

Other relevant answers.

Answer 1(g)

In this case, there is a disagreement as to accounting treatment between the management and the auditor. Depending on the materiality of the misstatements, the possible audit opinions are as follows:

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

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

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

* * * END OF SECTION A * * *

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

Answer 2(a)

There is a contingent fee component in the proposed audit fee. Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. In this case, the contingent fee is based on the success of the application of the banking facilities.

A contingent fee charged by a firm in respect of an assurance engagement creates self-interest that cannot be reduced to an acceptable level by the application of any safeguard.

Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter information of the assurance engagement. As the application of the banking facilities is based on the financial statements which are the subject matter information of the assurance engagement, ABC & Co should not accept such a fee arrangement.

Answer 2(b)

1. Analytical procedures

Analytical procedures consist of evaluations of financial information via a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations or relationships that are inconsistent with other relevant information or differ from the expected values by a significant amount.

For example, use the beginning and ending balance of the finance lease payable together with the effective interest rate to estimate the total interest expense for the year, and then compare the expected amount with the recorded amount.

2. Test of details of transactions / account balances

Test of details procedures are tests for testing certain assertions of classes of transactions and account balances in the financial statements.

For example, detailed checking of the monthly repayments of the finance lease to the finance lease statements and the corresponding accounting entries for the finance lease payable account and the interest expense account.

Another example, send confirmation to the lessor to verify the total outstanding installments balance.

Answer 2(c)

The five assertions are occurrence, completeness, accuracy, cutoff and classification.

Occurrence - recorded acquisitions are for machinery authorised and received by the company.

Completeness - all acquisitions of machinery are included in the asset-machinery account.

Accuracy - acquisitions of machinery are correctly recorded and calculated in accordance with the relevant accounting principles.

Cutoff - all acquisitions are recorded in the correct accounting period.

Classification - capital expenditure and revenue expenditure are properly classified.

Answer 2(d)

The possible substantive procedures are as follows:

Select samples from the additions list and check the purchase invoice.

Examine goods receiving report and / or goods received notes confirming delivery of the items prior to the year end.

Examine purchase order / board approval for acquisitions.

Physically inspect the item.

Analyse the repair and maintenance account to ensure the correct classification of capital expenditure.

Review machinery account to ensure no revenue expenditure item is wrongly classified as capital expenditure.

Match the amount of additions in the disclosure note of the financial statements to the additions list.

Answer 3(a)

The audit of inventories is important as it is a significant component of the current assets in the statement of the financial position. Also, the amounts for beginning and the closing inventories affect the cost of goods sold, the gross profit and the net income/loss for the year.

Answer 3(b)

The matters relevant in planning attendance at a physical inventory counting are as follows:

The risks of material misstatement related to inventory.

The nature of the internal control related to inventory.

Whether adequate procedures are established by the management and proper management instructions are issued for physical inventory counting.

The timing of physical inventory counting.

Whether the entity maintains a perpetual inventory system.

The location at which inventory is held, including the materiality of the inventory and the risks of material misstatement and the size of the warehouse, in deciding the number of audit staff to attend the inventory count.

Whether the assistance of an auditor's expert is needed.

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 existence of the inventory.

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 4(a)

Audit Procedures that should be applied in relation to debtors' confirmation include:

Select sample of receivables to be circularised.

Inform client of intended list of those to be circularised.

Consider implications if client objects to any of the accounts selected being circularised.

Record names and amounts circularised.

Record replies received and consider implications of any accounts not agreed.

For non-replies, perform alternative procedures so as to obtain sufficient appropriate audit evidence for trade receivable balances.

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

Determine the information to be confirmed or requested;

Select the appropriate confirming parties.

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

Send the requests from the auditors, including follow-up requests when applicable, to the confirming party.

Answer 4(b)

Audit of cash is an important part of an audit. The reasons are as follows:

Most business transactions are ultimately settled by cash. The audit of cash also provides evidence to the audit of other sections, other assets and liabilities as well as revenue and expenses.

Cash is highly liquid and with a relatively high risk of misappropriation. The inherent risk for the existence of cash is high.

Answer 4(c)

The audit procedures that should be performed on the bank reconciliation statements are as follows:

Check the mathematical accuracy of the bank reconciliations.

Agree the balance on the bank reconciliations with the balances on bank confirmations and the bank statements.

Agree the balance on the bank reconciliations with the cash book balance and general ledger.

Trace the amount of the deposits in transit to the cutoff bank statements and to the cashbook, note in particular the dates such deposits were included in the bank statements.

Trace a sample of unpresented cheques to the cutoff bank statements and subsequent bank statements, note in particular the dates of clearance of these cheques.

Trace bank transfers for the last week of the financial year and the first week of the following year for proper approval.

Identify irregular items and obtain explanations.

Answer 5(a)

The reasons are as follows:

Immediately available.

Cheaper.

Quicker update as more resources can be utilized for research and development by a reputable software supplier.

Proven quality.

Answer 5(b)

The reasons are as follows:

To respond to changes in business needs or user needs.

To cope with technology changes.

To accommodate improvements in business process.

To gain a competitive advantage.

To lower costs.

To increase productivity.

To accommodate growth.

Answer 5(c)

The major steps for systems implementation are as follows:

Develop implementation plan.

Site preparation.

Develop and test software.

Conversion of old files to new system.

Write up system documentation.

Write up the user manual.

Train personnel.

Test the system.

Post-implementation review

Answer 5(d)

Measures that can deal with and / or reduce employees' resistance are as follows:

Open communication helps prevent the spread of rumours and misunderstandings. Users should be fully informed of the implementation of the new systems and the reasons for such changes. This helps ensure that employees understand the company's efforts to improve the system and that they are still the key players for the company's future development.

Management should provide assurance that they will provide adequate training to the staff. In addition, detailed information of the system should be provided to the staff to help them form realistic expectations of the system. Relevant explanations should be presented to address users' concerns.

The organisation should provide assurances, as far as possible, regarding job security and that no major job losses or shifts in responsibility will occur.

* * * END OF EXAMINATION PAPER * * *

Examination Panelist's Report

Paper III
PBE Auditing and
Information Systems
(June 2013 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 was relatively satisfactory compared with previous exams. However, there are still quite a number of candidates who have not mastered the fundamental concepts of auditing such as understanding of the business operations of the entity for auditing, the components of internal control, different types of audit reports, the purposes of planning for physical inventory count 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 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 and the case details which required analytical thinking.

Part (a), most of the candidates who attempted this part scored satisfactorily. Part (b), quite a 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 operation from the case instead of highlighting the specific details of CH Limited's operation needed for understanding the business. Part (c), most of the candidates who attempted this part scored satisfactorily. However, some candidates did not have a good understanding of internal control and therefore provided irrelevant answers. Parts (d), & (e), most of the candidates who attempted these parts scored satisfactorily but quite a number of candidates were unable to distinguish the control activities to be performed in the cafes from those to be performed by the head office. Parts (f), & (g) most candidates who attempted these parts scored satisfactorily.

Section B – Optional Questions

Question 2 – 20 marks

This question examined candidates' understanding of the ethical issues, assertions and substantive procedures for auditing the acquisition of machinery.

Part (a), most candidates who attempted this part scored satisfactorily. Part (b), most candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to identify analytical procedures as a type of substantive procedure. Part (c), most candidates were unable to distinguish assertions for account balances from those for classes of transactions. Part (d), most candidates who attempted this part scored satisfactorily.

Question 3 – 20 marks

This question examined candidates' knowledge of auditing inventory.

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 of planning for attendance at the inventory count and therefore provided irrelevant answers. Part (c), most candidates did not distinguish between the procedures for inventory count date and the procedures to be performed after the inventory count date and therefore provided irrelevant answers.

Question 4 – 20 marks

This question examined candidates' knowledge of sending debtors' confirmation and auditing cash.

Part (a) many candidates who attempted this part scored satisfactorily, but quite a number of candidates had no idea 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 provided the procedures for preparing the bank reconciliation statements instead of the audit procedures that should be performed on the bank reconciliation statements.

Question 5 – 20 marks

This question examined candidates' knowledge of computerized information system issues.

Most candidates who attempted this question performed satisfactorily.

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

