



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 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

Peter Fan is a technical manager of a CPA firm, KYT & Co. Recently, Peter was assigned by his firm to be the audit manager in charge of an existing client, Chan Kee ("CK"), a private company engaging in the wholesaling and retailing of wine products, such as different types of fine wine, champagne, spirits, and accessories; as well as wine storage. The company has different mark-ups for different lines of products. CK has a head office and 10 retail stores in Hong Kong. The market price of fine wine fluctuates due to changes in the market environment. It buys different types of wine products from different suppliers and it also sources wines direct from the vineyard. In order to cope with the business trend, it plans to start an online sales system in year 2014. The customers of the wholesale business are small wine shops in Hong Kong. It offers a 60-day credit period to some good credit customers while others have to pay in cash upon delivery.

The personnel arrangement in each retail shop is as follows:

- 1 shop manager
- 1 – 2 sales assistants

CK was established by the Chan family twenty years ago. The number of shops has remained the same throughout the year ended 30 November 2013. The total number of staff is approximately 25 and they are remunerated on a fixed monthly salary basis. In addition, there is a bonus system which is based on the performance of each shop.

According to the working paper file for the year ended 30 November 2012, Peter knows that the company maintains a simple computer system for the retail sales. Every item of the merchandise is assigned a stock code. After goods are selected by a customer, the sales assistant who serves the customer will pass the goods to the shop manager. The shop manager performs the role of cashier and he/she will scan the items via the point-of-sale system to generate a sales invoice. The item code, item description, listed price, quantity of each item sold, discount applied, net price for each item and total price of all goods sold are listed on the invoice.

The invoice with details is given to the customer. The customer either pays the amount by credit card or by cash. At the end of each day, the shop manager locks all the cash received during the day in the cash register. A sales assistant banks in the cash receipts on the next working day and the messenger from the head office collects the credit card slips from all the shops daily.

The company has a very good reputation in the wine storage business. The company delivers professional and 5-star private wine storage service conditions and supreme security in its self-owned warehouse. It offers customised wine storage and management solutions to accommodate every customer's needs. Customers have to pay the storage fee in advance on a three-month basis and the minimum storage period is three months.

Question 1 (40 marks – approximately 72 minutes)

- (a) HKSA315 (Revised) requires auditors to obtain an understanding of the entity and its environment, including the entity's internal control.

From what sources can Peter acquire knowledge of CK's business and industry?

(6 marks)

- (b) 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 key matters of CK's operations that are relevant to the auditor?

(10 marks)

- (c) What is control risk? What steps should be taken by the auditors to assess the control risk for the sales and collection cycle?

(5 marks)

- (d) Assume that you are Peter Fan.

What is your assessment of the risk of material misstatement of the valuation of inventory of fine wine? Explain.

(3 marks)

- (e) The company is now considering two options for the online sales system. Option one is to employ a programmer to develop an on-line sales system for the company and a technician to maintain the computer system of the company. Option two is to buy ready-made software from the market.

- (i) Compare the pros and cons of ready-made software by providing three points in favour of ready-made software and three points against the use of ready-made software.

(6 marks)

- (ii) A five-step systems development life cycle (SDLC) is usually followed in designing and implementing a system. The first step in the process is system analysis. What are the activities in this process? Briefly explain.

(10 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)

You have recently joined an audit firm as a trainee and have attended an in-house auditing training programme. You have learnt that audit planning can help to improve the efficiency and effectiveness of an audit. You have also learnt that auditors should obtain sufficient appropriate evidence to support their audit opinion and that all work carried out by auditors should be properly documented.

Currently, you are involved in an audit engagement. The client's principal activities are the wholesaling and retailing of skin care products. You are assigned to audit the inventory section.

You find that there was a sales agreement signed by the client with a third party just after the financial year end date. A huge number of products were sold at a value below cost as these products were soon to expire. The gross loss of all these products amounted to HK\$500,000. The management said that as the products were sold after the financial year end, no adjustment on the inventory value is deemed necessary. The total assets of the company are HK\$100 million. The inventory loss of HK\$500,000 compared with the total assets is clearly immaterial. The management will not consider any write down of the inventories. The profit before tax is HK\$400,000 for the current year according to the draft financial statements.

Required:

- (a) Discuss the benefits of audit planning. (6 marks)
- (b) Comment on the management's argument that the amount of HK\$500,000 is immaterial to the financial statements. (4 marks)
- (c) In the training programme, you have learnt that three types of audit opinion may be relevant to the above situation.
- They are (1) Unmodified Opinion (2) Qualified Opinion and (3) Adverse Opinion. Briefly explain each of them. (6 marks)
- (d) Assuming that no significant issues were noted in relation to the other balances on the financial statements, which audit opinion is appropriate and what are the key elements that would be included in the opinion section of the auditor's report? (4 marks)

Question 3 (20 marks – approximately 36 minutes)

Fashion Limited is an existing client of ABC & Co. It has engaged in the clothing manufacturing business for more than 10 years. The company successfully acquired all the shares of another company, Trendy Limited, which operates clothing retailing chain stores, in cash. The consideration paid is in excess of the fair value of the net assets of the company.

The board of directors of Fashion Limited determined to expand the company's business by opening more shops in mainland China under the brand names of Trendy Limited. In order to finance the launching of the new shops in the coming year, the directors negotiated with the bank for additional banking facilities. The bank requested the audited financial statements of the company of current year 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 fee arrangement with the proposed incentive payment? Explain. (4 marks)
- (b) What are the possible substantive audit procedures for the acquisition of Trendy Limited? (6 marks)
- (c) What are the possible substantive audit procedures for the auditing of purchased goodwill? (4 marks)
- (d) The auditor has decided to use an expert's services regarding the determination of fair value of the assets of Trendy Limited.

What matters should be agreed between the auditor and the auditor's expert? (6 marks)

Question 4 (20 marks – approximately 36 minutes)

You are assigned to audit one of the firm's audit client, Supreme Beauty Limited ("SBL"). The principal activity of the company is the manufacturing and wholesaling of high-end home use facial machines. The company provides a free of charge one-year warranty with all items sold. In addition, customers can purchase extended warranties via the retailers. The retailers charge a commission for selling the extended warranties for SBL.

Required:

- (a) For the sales of home use facial machines, what are the five assertions for this class of transactions? Briefly explain.
(10 marks)
- (b) What are the specific substantive procedures for the valuation of a provision for warranties?
(5 marks)
- (c) What are the specific substantive procedures for the accuracy of commission expenses?
(5 marks)

Question 5 (20 marks – approximately 36 minutes)

You have worked on the audit for Parkes Limited, a company selling digital products to more than one hundred retail shops on credit terms. Customers settled the accounts by sending cheques to the company. You have been the manager-in-charge of this audit client for more than three years. You decided to assign some audit work relating to the cash section and the accounts receivable section to Mary, a fresh university graduate who has no prior audit experience. You need to explain in detail the audit procedures to be performed and the concept of audit sampling to Mary in order to maintain the efficiency of the audit assignment.

Required:

- (a) What are the possible control activities for cheque receipts in the above case?
(4 marks)
- (b) Explain sampling risk in the case of test of controls and in the case of test of details.
(5 marks)
- (c) How does each of the following factors influence the sample size for a test of controls? Briefly explain.
 - (i) An increase in the extent to which the auditor's risk assessment takes into account relevant controls.
 - (ii) An increase in the expected rate of deviation of the population to be tested.(6 marks)
- (d) List the general audit procedures that should be performed on the bank reconciliation statements?
(5 marks)

* * * END OF EXAMINATION PAPER * * *

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

- (i) Review previous year's audit files.
- (ii) Discuss with the management and key employees of CK.
- (iii) Read news related to the wine industry.
- (iv) Visit the shops and head office of CK.
- (v) Review internal documents of CK.
- (vi) Discuss with internal auditor and review internal audit report if an internal audit function is set up.
- (vii) Discuss with specialists, including legal advisors and other knowledgeable people in the wine industry.
- (viii) Review legislation and regulations that significantly affect CK.
- (ix) Latest management accounts of CK.

Answer 1(b)

The key matters of Chan Kee's business operations are as follows:

- (i) Nature of revenue resource – the company is a wholesaling and retailing company which provides wine products as well as wine storage to local customers. The major sources of income are from sales of wine products and rental income from providing wine storage services.
- (ii) Key customers – the company has retail customers and wholesale customers which are small wine shops, buying and storing wine with the company.
- (iii) Products or services and markets – the company has a rather high volume of transactions from the selling of wine products and it is facing keen competition as many companies are selling wine products everywhere in Hong Kong. The company also provides wine storage services to earn rental income.
- (iv) Conduct of operations – a single company sells wine products to customers through its retail shops, the wholesale function and the wine storage services are managed by the head office.
- (v) Employment – there are approximately 25 staff in the company. The monthly salaries are fixed, and there is a bonus system which is based on the monthly performance of each shop.
- (vi) Receivables from wholesales customers and receivables from credit card issuing banks, as well as unearned revenue from wine storage business.

- (vii) Important suppliers of wine products.
- (viii) Location of warehouse and quantities of inventories.

Answer 1(c)

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.

To assess the control risk for the sales and collection cycle, the auditor should adopt the following measures:

- Understand and document internal controls.
- Assess and evaluate the design and implementation of internal controls.
- Set and document control risk.

Answer 1(d)

Inventories should be stated at the lower of cost and net realisable value. When the inventories' realisable value is lower than the cost, the company has to write down the value of 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 the price of fine wine fluctuates due to the changes in the market environment, making the saleable value hard to be determined.

Answer 1(e)(i)

Ready-made software

Reasons in favour of the system:

- (i) Relatively cheaper.
- (ii) They are pre-tested before being marketed so a company does not need to spend lots of time on testing.
- (iii) Easier and quicker to get ready made software
- (iv) Quicker update as more resources can be utilized for research and development by a software development company.
- (v) Vendors tend to supply more on-going maintenance and support for the system.

Reasons against the use of the system:

- (i) It may not match the unique requirements of CK.
- (ii) The organisation does not have full control of system design once the package is purchased.
- (iii) The output format may not be customised to the required presentation style.
- (iv) There may be increased vulnerability regarding the continuity of the vendor's business.

Answer 1(e)(ii)

Initial investigation

Investigate each development activity to define the problem to be solved. Make a preliminary assessment of the feasibility of the project's viability and prepare a proposal to conduct the system analysis if the project is to commence.

Systems Survey

Understand the current system in terms of how it works and analyse its strengths and weaknesses. Identify user needs or determine the extent and nature of the changes needed by means of interviews, questionnaires or observation. A system survey report is required.

Feasibility Study

Determine whether the proposed system is feasible from technical, operational, legal, scheduling and economic standpoints. Several alternative solutions are included in the proposal report that describes costs and benefits, advantages and disadvantages of each alternative.

Information needs and systems requirements

Identify the information needs of users. Determine objectives and constraints of the new system. Document and approve system requirements.

Systems analysis report

The concluding step is to prepare the systems analysis report, which summaries and documents analysis activities. The report contents include, for example, system goals and objectives, system problems and opportunities, project scope, relationship of project to overall strategic IS plan, current system operations, user requirements and system constraints, feasibility analysis, project participants, work plan and recommendations for the new system.

* * * END OF SECTION A * * *

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

Answer 2(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 auditors of components and experts

Answer 2(b)

To determine whether the amount is material or not, consideration has to be given to whether its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

In the above case, the misstatement of inventory, which should be stated at the lower of cost or net realisable value will result in the misstatement of the statement of financial position as well as the income statement. The effect on the income statement is material. After the adjustment of the inventory loss of HK\$500,000, the draft financial statements will report a loss before tax of HK\$100,000 instead of a profit before tax of HK\$400,000. Such misstatement could influence the economic decisions of users of financial statements.

Answer 2(c)

In this case, the management has not applied the appropriate accounting policies consistently with the financial reporting framework. Depending on the materiality of the misstatements, the possible audit opinions are as follows:

Unmodified opinion – The opinion expressed by the auditor 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 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.

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.

Answer 2(d)

The qualified opinion should be expressed as being “except for” the effect of the overstatement of the inventory value to which the qualification relates.

A clear description of all substantial reasons giving rise to the disagreement and a quantification of the possible effects on the financial statements should be included.

Answer 3(a)

The incentive payment on top of the fixed audit fee is a contingent fee component in the proposed audit fee. Contingent fees are fees relating to the outcome of a transaction or the result of the services performed by the firm. In this case, the contingent fee component is based on the success of obtaining the banking facilities.

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

Accordingly, ABC & Co shall not enter into any fee arrangement with Fashion 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 success of obtaining the banking facilities is based on financial statements which are the subject matter information of the assurance engagement, ABC & Co should not accept such a fee arrangement.

Answer 3(b)

The possible substantive audit procedures for the acquisition of Trendy Limited:

- Obtain the schedule of the investment in Trendy Limited and check the calculation.
- Compare the assets and liabilities acquired to the latest audited financial statements and valuation reports of assets and liabilities.
- Inspect the sales and purchase agreement and check that it agrees with the details in the schedule of the investment in Trendy Limited.
- Trace the payment to the cash book / bank statement.
- Inspect the minutes of the board of directors' meeting to check whether the transaction is properly authorized.
- Inspect the share certificates and check that they agree with the number stated in the sale and purchase agreement.

Answer 3(c)

The possible substantive audit procedures for the auditing of purchased goodwill:

- Agree the consideration to sales and purchase agreement by inspection.
- Check whether the calculation of goodwill is correct by examining the bases of valuing the net identifiable assets acquired to ensure they are properly valued, with regard to the reasonableness of valuations and the qualifications and independence of the valuer.
- Review and discuss with the management whether there is any sign of impairment loss on the carrying amount at year-end.
- Ensure that the accounting policy related to goodwill is properly disclosed and complies with accounting standard.

Answer 3(d)

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 4(a)

The five assertions for sales transactions:

- Occurrence : sales transactions that have been recorded have occurred and pertained to the entity.
- Completeness : all the sales transactions that should have been recorded have been recorded.
- Accuracy : amounts relating to recorded transactions have been recorded accurately and appropriately.
- Cut off : sales transactions have been recorded in the correct accounting period.
- Classification : transactions have been recorded in the proper accounts.

Answer 4(b)

The possible substantive procedures are as follows:

Compare the ratio of provision to sales for the current year to that of last year.

Compare the ratio of provision to warranty income for the current year to that of last year.

Discuss with the management the underlying assumptions for the amount of provision made and consider their reasonableness.

Recalculate the amount of the provision based on the management's assumptions and agree to the recorded amount.

Compare prior years' provision with the subsequent actual incurred amount to consider the accuracy of the management's estimation in previous years.

Review after year-end claims, whether these truly reflect the accuracy of the management's estimation of the current year.

(Other relevant answers are acceptable.)

Answer 4(c)

The possible substantive procedures are as follows:

Compare the ratio of commission expense to warranty income with the ratio of last year.

Review the warranty commission contracts with different retailers to estimate the average commission rate.

Estimate the amount of commission expenses using the average commission rate on warranty income and compare with the recorded expenses to check their reasonableness.

Examine the supporting documents, e.g., credit notes to retailers to verify whether the amounts are properly recorded.

Recalculate the amounts of commission expenses in accordance with the contracted commission rate of selected contracts.

(Other relevant answers are acceptable.)

Answer 5(a)

The possible control activities for cheque receipts are as follows:

Segregation of duties in the handling of cheque receipts and recording.

Immediate preparation of incoming cheque listing and endorsement of incoming cheques.

Timely deposit of cheques, preferably on a daily basis.

Cash receipt journal vouchers prepared from cheque listing and pay-in slips and approved by senior accounting staff before input into cash book.

Periodic bank reconciliations prepared by an independent accounting staff members.

Independent review of bank reconciliation.

(Other relevant points are acceptable.)

Answer 5(b)

Sampling risk – The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusion:

In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Answer 5(c)

- (i) The increase in the extent to which the auditor's risk assessment will take into account the operating effectiveness of relevant controls means that if the auditor intends to obtain more assurance from the operating effectiveness of controls, a larger sample size needs to be examined so that the auditor can reduce the chance of forming a wrong risk assessment.
- (ii) The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation.

Answer 5(d)

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 balances stated on the bank reconciliations with the balances on bank confirmations and bank statements.

Agree the balances stated on the bank reconciliations with the balances on the cash accounts schedule and the general ledger.

Trace the amount of the deposits in transit to the cutoff bank statements and to the cashbook. Identify any unreasonable delay in banking-in.

Select a sample of unpresented cheques and trace the amounts to the cut-off bank statements and subsequent bank statements. Identify any unreasonable delay in presentation.

Trace bank transfers for the last week of the financial year under review and the first week of the following year for proper approval. Be aware of any kiting situation.

Identify irregular items and obtain explanations.

* * * 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 many candidates was satisfactory. However, there were still some candidates who had not mastered the fundamental concepts of auditing such as understanding the business operations of an entity for auditing purposes, information system development, sampling risk, the assessment of the risk of material misstatement, the application of substantive procedures for different classes of transactions and accounts balance, and different types of audit reports.

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. This question also included a part for examining candidates' knowledge of information system development

Part (a), most candidates answered this question well. Part (b), 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 matters of CK's operations needed to understand the business. Part (c), some of the candidates who attempted this part scored satisfactorily, but some candidates were not able to state the definition of control risk and the steps for assessing the control risk. Part (d), most candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to distinguish between valuation assertion and existence assertion. Part (e)(i), most of the candidates who attempted these parts scored satisfactorily. Part (e)(ii), candidates did not prepare well enough to answer the information system question and the performance was poor for this part.

Section B – Optional Questions

Question 2 – 20 marks

This question examined candidates' understanding of audit planning, the application of different kinds of audit reports and the concept of materiality.

Parts (a) & (b), candidates who attempted these parts scored satisfactorily. Parts (c) & (d), most candidates who attempted these parts scored satisfactorily, but some candidates were not able to distinguish different types of audit reports and choose the appropriate one.

Question 3 – 20 marks

This question examined candidates' knowledge of ethical issues, auditing the acquisition of business and goodwill, and auditors' expert.

Parts (a) & (b), most of the candidates who attempted these parts scored satisfactorily.

Part (c), many candidates did not have adequate knowledge of the accounting treatment of goodwill and therefore provided irrelevant answers. Part (d), most of the candidates who attempted this part scored satisfactorily.

Question 4 – 20 marks

This question examined candidates' knowledge of the assertion for class of transactions and the substantive procedures for the valuation of provision and accuracy of commission expenses.

Part (a), most of candidates who attempted this part scored satisfactorily. Parts (b) & (c), most candidates who attempted these parts scored satisfactorily, but a few candidates did not pay attention to the specified assertions and provided irrelevant procedures.

Question 5 – 20 marks

This question examined candidates' knowledge of internal controls and sampling risk and substantive procedures for bank reconciliation statements.

Part (a), most of candidates who attempted this part scored satisfactorily. Parts (b) & (c), students did not prepare well enough to answer the questions on the sampling concept and the performance was poor for these two parts. Part (d), most candidates who attempted this part scored satisfactorily.

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