



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

Professional Bridging Examination

June 2015 Session

Paper III
PBE Auditing and
Information Systems

Questions & Answers Booklet

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

Philip Wong is an audit manager of a CPA firm, Yik Kan & Co. Recently, Philip was assigned by his firm to be the manager in charge of an existing audit client, AL Limited (the Company). The Company is a local private company engaged in the operation of a florist which provides different kinds of floral arrangements to customers, including walk-in customers and some hotels in Hong Kong. The Company has a shop operates from 6 a.m. to 8 p.m. every day. Floral arrangements include beautiful flowers, fresh flower bouquets, flower baskets and bouquet for events or occasions. In order to cope with the business trend, it plans to develop its online sales system in the year 2016.

The Company was established by the Lau family ten years ago. Mr and Mrs Lau are the directors and owners of the business. Both are experienced and professional florists. They employ six full-time staff on a fixed monthly salary and bonuses are based on annual sales revenue.

The Company buys different types of flowers from suppliers in Hong Kong, mainland China, Taiwan, Japan and the Netherlands. The credit term offered by these suppliers varies from one month to two months. Settlements for purchases from overseas are in foreign currencies invoiced and by bank remittance.

The floral business is subject to seasonal fluctuation, the demand is high in special occasions such as St. Valentine's day, Mother's day, Christmas and Chinese New Year.

The Company has a high wastage of flowers during slack seasons since flowers are perishable and it is not easy to predict the demand for different kinds of flowers. Mr Lau estimated the wastage of flowers in the shop's retail sales is around 50% to 70%. Therefore, the mark up is usually high in order to cover the loss on wastage. A periodic inventory system is maintained. By reviewing the order log book and performing an inventory count at the end of each day, orders are placed with suppliers according to accepted orders and retail needs.

According to the audit working paper file for the year ended 30 April 2015, Philip knows that the Company maintains a simple computer system for the recording of sales transactions with walk-in customers. When a customer places an order, a sales invoice is generated. The invoice with details would be given to the customer. All the payments by walk-in customers are either by cash or credit card. The item description, quantity, delivery date and price are listed on the invoice. At the end of each day, Mrs Lau safekeeps all the cash received during the day in the shop's safe. The money in the safe is banked in by Mrs Lau on the next working day.

For floral arrangements ordered and cash received in advance, the Company keeps a log book which is like a diary with invoice numbers recorded according to delivery date. When orders are delivered, the staff put an "X" next to the invoice number as a record for delivery. Sales revenue is recorded when cash is received. A schedule of unearned revenue is prepared and adjusting entries are made at the year end.

For hotel customers, orders are placed and confirmed via email. Such orders are listed in the log book and then booked in the accounting system as sales upon delivery of floral arrangements. As hotels are long term customers, a credit period of two to six months is offered to different hotels.

Question 1 (40 marks – approximately 72 minutes)

- (a) HKSA315 (Revised) Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment requires the auditor to obtain an understanding of the entity and its environment, including the entity's internal controls. 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.

Required:

What are the matters regarding the business operations of AL Limited that the auditor may consider when obtaining an understanding of AL Limited? (12 marks)

- (b) **State and explain the four assertions for the audit of the balance of trade payables of AL Limited.** (8 marks)
- (c) **Propose your substantive procedures to audit the unearned revenue.** (6 marks)
- (d) AL Limited has a lot of inventories of flowers at the year end date.

Required:

Assess with reasons, the level (high, medium or low) of the inherent risk of material misstatement for the valuation assertion of inventories. Provide explanations. (4 marks)

- (e) For future expansion, Mr Lau is considering to hire an information technology company to develop its online sales system.

Required:

- (i) **What are the advantages of outsourcing the online sales system development?** (6 marks)
- (ii) **What are the risks of outsourcing the system development?** (4 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)

Auditors have to identify and assess the risks of material misstatement at assertion level and financial statements level of an audit and then apply the audit risk model to determine the extent and the nature of further audit procedures.

Required:

- (a) Discuss what business risk of an entity is and why auditors are interested in it. (5 marks)
- (b) Define assurance engagement risk (audit risk) and its three components. (8 marks)
- (c) Discuss the audit risk model and how the assessment of different components affects the extent of substantive procedures performed by auditors. (7 marks)

Question 3 (20 marks – approximately 36 minutes)

Charming Limited ("Charming"), a listed company in Hong Kong, is a garment manufacturing company in China and exports its products to different overseas countries. You are the audit manager responsible for the audit of Charming for the year ended 31 December 2014.

A water leakage occurred and damaged a large portion of garments in Charming's warehouse on 13 February 2015. Consequently, Charming was sued by its customers for late delivery. The management considered that the event happened after the year end date, therefore they determined not to account for nor make any disclosure in the financial statement for the year ended 31 December 2014.

Required:

- (a) List the audit procedures that should be performed to identify all events up to the date of the auditors' report that may require adjustment of, or disclosure in, the financial statements. (8 marks)
- (b) What specific audit procedures regarding the water leakage at the warehouse should be performed? (6 marks)
- (c) For the incident of the water leakage, what audit opinion(s) could be considered? State your assumptions. (6 marks)

Question 4 (20 marks – approximately 36 minutes)

BCZ Company Limited ("BCZ") is engaged in the e-commerce platform provider business. BCZ maintains a market place on the internet, to facilitate shops selling goods to local consumers.

Sellers establish their presence on the internet by hosting their product details on the website maintained by BCZ. Consumers purchase different sellers' products via BCZ's website. You are an audit partner of a CPA firm, ABC & Co, which has been approached by BCZ's directors to be the new auditor of BCZ.

After accepting the audit engagement, BCZ requests your firm to provide an advisory service to enhance its management information system so that financial reporting information could be prepared more timely and efficiently.

Required:

- (a) Describe the types of assurance engagement and discuss how to classify an audit engagement under assurance engagements. (4 marks)
- (b) The Code of Ethics for Professional Accountants states that a professional accountant should, when carrying out his or her duty as an auditor, comply with five fundamental principles. List and briefly explain the five fundamental principles. (10 marks)
- (c) Identify the auditor's independence issues before accepting the engagement to provide the advisory service. What may be the actions taken in response to the issues you have identified? (6 marks)

Question 5 (20 marks – approximately 36 minutes)

Sun Company Limited ("Sun") is a company engages in the manufacturing and trading businesses. Sun has different types of assets in its statement of financial position, and the asset items are as follows:

- (i) Land and building in Hong Kong and mainland China;
- (ii) Motor vehicles;
- (iii) Inventories in transit and in factory;
- (iv) Investment in shares in private and listed companies presented as assets available for sale;
- (v) Golf club membership;
- (vi) Rental deposits paid;
- (vii) Advances to employees; and
- (viii) Cash at bank and in hand.

Required:

Design substantive procedures to test the existence assertion and the rights and obligations assertion of the above assets.

(20 marks)

* * * END OF EXAMINATION PAPER * * *

SECTION A (COMPULSORY) (Total: 40 marks)

Answer 1(a)

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

Nature and sources of revenue – Revenue from sales of floral arrangements is the major source of revenue.

Key customers – AL Limited has a large number of customers, including walk-in customers and hotels in Hong Kong.

Key suppliers – AL Limited buys different types of flowers from different suppliers in Hong Kong, mainland China, Taiwan, Japan and the Netherlands.

Products or services and markets – AL Limited is a private company engaged in the operation of a florist which provides different kinds of floral arrangements to customers in Hong Kong.

Conduct of operation – AL Limited trade in cash and on credit.

In addition, the company receives deposits from walk-in customers. Hotel customers have a credit period which ranges from two to six months.

The Company purchases goods from foreign suppliers on credit. The credit period ranges from one to two months and there is also a foreign currency exposure.

Employment – there were two directors and six full-time staff. The full-time staff salaries are on a fixed monthly basis. There is a bonus system which is based on the sales revenue for the year.

Geographical dispersion – the Company has only one shop operating in Hong Kong.

Answer 1(b)

The assertions are stated as follows:

Existence

Trade payables stated in the financial statements are actually in existence.

Completeness

All trade payables that should have been recorded have been recorded.

Rights and obligations

AL Limited has the obligation to pay for the amount of trade payables stated in the financial statements.

Valuation and allocation

The trade payables are included in the financial statements at the appropriate amounts.

Answer 1(c)

Obtain the schedule of unearned revenue from the client.

Check casting and agree the total to the trial balance.

Select samples from the schedule and check to the log book ensuring that orders are received and settled before the year end date and delivered after the year end date.

Select samples from the log book and check to the schedule ensuring deliveries made after year end and cash received before the year end date are included in the schedule.

Answer 1(d)

Inventories should be stated at the lower of cost and net realisable value. When the inventories' net 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 the management's estimation. The assessment of risk of material misstatement of the inventory at assertion level for valuation should be medium to high as flowers are perishable products and customers' preference is random, making the saleable value hard to determine.

Answer 1(e)(i)

Advantages of outsourcing are as follows:

Cost effectiveness

AL Limited can eliminate the need for having its own IT staff.

Flexibility

AL Limited can avoid the tying up of its own resources for maintaining IT staff. Outsourcing allows AL Limited with its fluctuating needs for computer services to pay for only what it uses.

Access to more advanced technology

Internal IT staff of a small company cannot keep pace with technological changes or innovative business practices.

Improved development time

By outsourcing to industry specialists, the development time is comparatively faster and more efficient.

Answer 1(e)(ii)

Risks of outsourcing are as follows:

Loss of control

If AL Limited lacks experience in negotiating a sound contract, it may be too dependent on the outsourcer. This could lead to high costs or loss of control over the system.

Risk of confidentiality

Trade secrets or proprietary information may leak out to competitors or confidential data may be shared with others.

Being tied to one system

It is expensive to reverse outsourcing. AL Limited may find that it knows nothing about its own system and it is hard to buy back its own data processing facilities. If problems arise during the contract period, the contract may be costly and difficult to cancel.

* * * END OF SECTION A * * *

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

Answer 2(a)

The business risk of an entity is the risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. An understanding of the business risks facing an entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

Answer 2(b)

Assurance engagement risk (audit risk) is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:

- (a) The risk that the subject matter information is materially misstated, which in turn consists of:
 - (i) Inherent risk: The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls; and
 - (ii) Control risk: 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; and
- (b) Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Answer 2(c)

Audit Risk Model

Planned detection risk(PDR)

= Acceptable Audit Risk (AAR) / Inherent Risk (IR) x Control Risk(CR)

Auditors adopt the audit risk model to ensure that audit risk is kept at an acceptably low level. Auditors adjust the level of detection risk according to their combined risk assessment of inherent risk and control risk. There is an inverse relationship between the combined risk assessment and the detection risk acceptable to the auditor. The lower the detection risk can be accepted, the more the substantive procedures to be performed.

Answer 3(a)

According to HKSA560 (Clarified) Subsequent Events:

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest available interim financial statements, budgets, cash flow forecasts and other management reports, if any.
- (e) Making inquiries of the entity's legal counsel concerning litigation and claims.
- (f) Obtaining written representation from the entity's management.

Answer 3(b)

Discuss with the management and find out what exactly happened on the day of the water leakage, especially the total losses to the entity and the significance as to the future viability of the entity.

Obtain the list of destroyed inventory, and consider whether the amount estimated by the management is reasonable or not. Consider if any of such inventory belonged to a previous year end date.

Obtain evidence of the amount of repair work that needs to be carried out for the premises, such as quotation from the contractor. Consider the effect on the business operation of the current year.

Inspect the insurance policy to find out whether there is adequate coverage for all the losses, such as claims by customers for late delivery, repair work to the premises and inventory losses, and if inadequately covered, assess the losses to be borne by the entity. Estimate the claims that may be made by customers. Consider the significance of the amount to the entity's operation.

Assess the going concern issue if the above claims and losses are significant to the company.

Answer 3(c)

It depends on whether the effect of the water leakage on the financial statements is material or not.

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.

Answer 4(a)

Under the Hong Kong Framework for Assurance Engagements, there are two types of assurance engagement:

Reasonable assurance engagement

The objective of which is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the practitioner's conclusion.

Limited assurance engagement

The objective of which is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Audit engagement

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. As the basis for the auditor's opinion, HKSAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. Therefore audit engagement is a type of reasonable assurance engagement.

Answer 4(b)

According to the Code of Ethics (revised), the five fundamental principles are stated as follows:

Integrity

The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

Objectivity

The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

Professional Competence and Due Care

The principle of professional competence and due care imposes the following obligations on all professional accountants:

- (a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and
- (b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

Confidentiality

The principle of confidentiality imposes an obligation on all professional accountants to refrain from:

- (a) Disclosing outside the firm or employing organisation confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and
- (b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

Professional Behavior

The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession.

Answer 4(c)

The provision of the advisory service by ABC & Co to BCZ, which is a financial statement audit client of ABC & Co, may create a self-review threat, since the management information systems that are to be used to generate information form part of BCZ's financial statements. Under the Code of Ethics for Professional Accountants, ABC & Co has an obligation to evaluate the self-review threat to compliance with the fundamental principles.

Given that the self-review threat is not clearly insignificant, ABC & Co should apply safeguards to eliminate the threat or reduce it to an acceptable level, such that compliance with the fundamental principles is not compromised.

If the self-review threat is likely to be too significant, ABC & Co should not accept the engagement.

Safeguards include:

- management to be responsible for the decision making and implementation
- involving an additional professional accountant (not a member of the assurance team) to advise or review the system

Answer 5

- (i) Land and building in Hong Kong and China
 - perform land search
 - review bank confirmation for the amount of mortgage loan outstanding
 - perform physical inspection of the property
 - inspect the title deed
 - inspect the land use right certificate
 - inspect the building ownership certificate
- (ii) Motor vehicle
 - inspect motor vehicle registration book / vehicle licence
 - perform physical inspection of the motor vehicle
- (iii) Inventories in transit and in factory
 - inspect the invoices, subsequent goods received notes and shipping documents
 - review the term FOB
 - attend inventory count performed by client
- (iv) Investment in shares of private and listed companies – available for sale
 - inspect the share certificates
 - send confirmation to the bank if the bank acts as trustee and determine whether the shares are pledged
 - send confirmation to the brokerage house if the brokerage house acts as trustee
- (v) Golf club membership
 - inspect the contract with the club
 - inspect the current monthly statement issued by the club
- (vi) Rental deposits paid
 - inspect receipts issued by landlords
 - inspect the tenancy agreements
 - inspect bank advice / correspondence for rental paid
- (vii) Advance to employees
 - send confirmation to the employee
 - ask the management whether the amounts due are factorised
 - inspect receipt signed by employee
- (viii) Cash at bank and in hand
 - send bank confirmation
 - obtain the cash certificate
 - count the cash in hand
 - examine bank statements and bank reconciliation statements

* * * 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, the assertions for auditing, the assessment of the risk of material misstatement and the audit risk model.

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 the company's operations which were needed to understand its business. Some candidates just provided irrelevant answers such as the considerations for the acceptance of an audit engagement. Part (b), most candidates who attempted this part scored satisfactorily, but some candidates were not able to differentiate the assertions for the class of transactions from the assertions for account balances and therefore answered poorly. Part (c), most candidates had no idea as to what specific information to use from that provided in the case, such as the schedule of the unearned revenue and the log book, to carry out the audit procedures. Part (d), some candidates who attempted this part scored satisfactorily, but quite a number of candidates were not able to provide the rationale behind the assessment. Parts (e)(i) & (e)(ii), most of the candidates who attempted this part scored satisfactorily.

Section B – Optional Questions

Question 2 – 20 marks

This was the least popular optional question, it examined candidates' knowledge of the relationship between business risks, inherent risk, control risk and detection risk.

Most candidates who attempted this question scored satisfactorily but quite a number of candidates did not understand the audit risk model. Part (a), many candidates do not have a good understanding of the relationship between business risk and inherent risk. Part (b), most candidates who attempted this part scored satisfactorily. Part (c), many candidates did not have an adequate understanding of the audit risk model and therefore provided irrelevant answers.

Question 3 – 20 marks

This question examined the candidates' knowledge of general audit procedures to identify all the events up to the date of the auditor's report and specific substantive procedures for a particular event as well as the application of different kinds of audit reports. The performance of candidates was not satisfactory.

Parts (a) & (b), some candidates who attempted this question performed satisfactorily, but quite a large number of candidates could not distinguish between the general audit procedures to identify all the events up to the date of the auditor's report and the specific audit procedures regarding the damage to inventory due to the water leakage event. Part (c), most candidates who attempted this part scored satisfactorily.

Question 4 – 20 marks

This question examined candidates' knowledge of the two types of assurance engagement and consideration of the code of ethics for engagement acceptance.

Part (a), most candidates did not have a good understanding of the two types of assurance engagement and therefore provided irrelevant answers. Parts (b) & (c), most candidates who attempted this question scored satisfactorily.

Question 5 – 20 marks

This question examined the candidates' understanding of the assertions and substantive procedures for auditing different kinds of assets.

Most candidates who attempted this question scored satisfactorily, and this question was the most popular optional question in Section B.

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