



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



Qualification Programme

Module 13 Business Assurance

Pilot Examination Paper

Time Allowed	3 hours
Examination Assessment Allocation	
Section A – Case Questions	50 Marks All FOUR questions are compulsory
Section B – Essay / Short Questions	50 Marks All FIVE questions are compulsory

Copyright © 2021 Hong Kong Institute of Certified Public Accountants

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording and/or otherwise, without the prior written permission of the copyright owner.

Published in March 2021

Module 13 – Business Assurance

This examination is divided into TWO sections.

- Section A (50%). This consists of FOUR compulsory case questions. You should allocate approximately 1 hour and 30 minutes in total for Section A.
- Section B (50%). This consists of FIVE compulsory essay / short questions. You should allocate approximately 1 hour and 30 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	13
8	14
9	16
10	18
11	20
12	22
13	23
14	25
15	27
16	29
17	31
18	32
19	34
20	36

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

CASE

DaDa Wine Solutions Limited ("Dada") was established in Hong Kong in July 2019, and was founded by a group of mid 30's young professionals.

Wine collection has become more popular in Hong Kong. While most wine is consumed within a short period of time after purchase, fine wines are often set aside for long-term storage. Wine is one of the few commodities that can improve with age, but it can also rapidly deteriorate if it is kept in inadequate conditions. Therefore, storage of wine is an important consideration for wine that is being kept for long term aging. Particularly in Hong Kong, people generally do not have enough space for proper storage of wine at home. The founders, who are also the wine collectors, therefore set up Dada to provide solutions for wine collectors.

Dada started its business in a leased premise located in the Kwun Tong industrial area. Dada is principally engaged in the provision of wine collection services comprising wine sourcing, storage, and delivery of wines. Because of its founders' extensive network, Dada is able to source wide range of wines from different countries with different vintages. Dada also offers flexible storage packages to its customers ranging from daily, weekly, monthly and yearly rental plans. Dada does not require its customers to enter into a minimum lease term storage contract. It also does not impose any minimum consumption for the purchase of wine. However, Dada is committed to making every delivery within 24 hours. Accordingly, although Dada is operating at loss, its business has grown significantly and continues to expand.

Dada self-developed an ERP system which is fully integrated from ordering to delivery. Customers are only required to log on Dada's website and the system will process their requests. The ERP system is linked to the warehousing and logistic system which enables real time access to the stock availability and delivery status. Dada has developed a tracking system to help its customers check the status of each individual order. Dada has capitalised the costs incurred for the development of this ERP system as an intangible asset and amortised it on a straight-line basis over 10 years.

Dada also self-constructed a giant refrigerated wine cooler system to store the wines for its own inventories and for customers' storage. This cooler system was designed by a founder who is an engineer. The cooler system is constructed inside the factory premises. Dada classified the refrigerated wine coolers system as fixtures and depreciated it over 30 years.

As it was the start-up stage, Dada did not offer attractive remuneration packages for its employees. Instead, Dada remunerated its staff by granting its shares to them. Dada accounted for this share-based payment as staff cost. The amount of share-based payment is measured at fair value based on an internal valuation done by the management. The principal assumptions used in the valuation of the share-based payments are:

Annual growth rate for the first five years	15%
Discount rate	12%
Interest rate of financing	4%

Dada has appointed Lee & Co as its first auditor. You are the audit manager of Lee & Co and are responsible for the audit of Dada's financial statements for the period since its incorporation to 31 December 2020.

During the audit planning, the audit team has prepared the following narratives for Dada's sales process:

Dada has three types of revenue: (i) sales of wine (ii) storage service and (iii) delivery service. All three types of revenue are recognised when the customers make online payments.

- For sales of wine, sales are recognised when customers place order and make payments online. As most of the customers choose to store their wines in Dada's warehouse, no delivery is required. The system will record the sales upon receipts of the payments from the customers.
- For storage and delivery service charges, Dada requires the customers to prepay these charges upfront, for the sake of simplicity, revenue is recognised when payments are made by the customers. The system will record these types of income upon receipts of the payments from the customers. In order to amortise the revenue over the lease period, the accounting team will post a journal entry at each month end to adjust any deferred revenue.

Below is the extract of the management accounts of Dada:

As at 31 December 2020

	<u>HK\$'000</u>
Property, plant and equipment	10,500
Intangible assets	8,000
Deposits and other receivables	4,000
Inventories	10,000
Cash and bank balances	<u>8,000</u>
Total assets	<u>40,500</u>
Accruals, deferred revenue and provisions	26,500

For the period ended since 1 July 2019 (date of incorporation) to 31 December 2020

	<u>HK\$'000</u>
Revenue	89,000
Cost of sales	(39,000)
Staff cost	(21,210)
Cost on delivery, rental and utilities	(22,950)
Office and administrative expenses	(6,240)
Depreciation and amortisation charges	<u>(8,600)</u>
Loss for the period	<u>(9,000)</u>

Question 1 (12 marks – approximately 22 minutes)

As part of the audit procedures, each of the engagement team members is required to file a declaration stating if he/ she has any direct or indirect financial interest in or other relationship with Dada. Upon the receipt of the declarations, you note the following four exceptions:

An audit senior states that her husband is one of Dada's shareholders holding 2% of shareholdings in Dada. The audit senior and her husband are financially independent to each other.

An audit junior states that his brother is one of Dada's shareholders holding 5% of shareholdings in Dada. The audit junior and his brother are financially independent to each other.

A tax manager states that he works as a part time tax consultant giving tax advice to Dada.

A tax senior states that his wife is working as a marketing event planner at Dada.

Required:

Prepare a memo to your audit partner to analyse and explain the independence in each of the above engagement team members' situations and propose safeguards, if any, to reduce the threats to an acceptable level for each situation.

Note: A maximum of 2 marks for communication skill and 2 marks for the five-step process in addressing ethical dilemmas will be awarded.

(12 marks)

Question 2 (8 marks – approximately 14 minutes)

(a) State the auditor's objective to review the depreciation and amortisation policies applied by an entity.

(2 marks)

(b) Advise procedures to audit the depreciation policy and amortisation policy adopted by Dada on:

(i) Refrigerated cooler system;

(3 marks)

(ii) ERP system.

(3 marks)

Question 3 (13 marks – approximately 23 minutes)

- (a) Evaluate the risk of material misstatements relating to the valuation assertion of Dada's share-based payment in its financial statements. (5 marks)
- (b) Propose audit procedures to address the risk of material misstatements identified in Question 3(a). (8 marks)

Question 4 (17 marks – approximately 31 minutes)

The audit team started to evaluate the control environment of Dada's self-developed ERP system applied in the revenue recognition process. Based on the audit team's evaluation, the general control of Dada's self-developed ERP system is considered effective. The audit team is now planning for more detailed control testing.

Required:

- (a) Evaluate the risks of material misstatements on Dada's revenue for the period ended 31 December 2020. (7 marks)
- (b) Advise on the application and other internal controls that Dada can implement in the revenue recognition process with respect to the following:
- (i) Data input on completeness, accuracy, authorisation and the processing of transactions. (6 marks)
- (ii) Valuation and its master file data such as unit price or formula for the revenue amortisation. (4 marks)

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer **ALL** of the following questions. Marks will be awarded for logical argumentation/ calculation and appropriate presentation of the answers.

Question 5 (10 marks – approximately 18 minutes)

TrueFact Limited ("TrueFact") is a marketing and advertising company with business in South Asia and China. Mr Wong is the Executive Director and Chief Executive Officer of TrueFact and owns 80% of the company. The rest of the company is owned by senior management and certain employees of TrueFact. TrueFact is now preparing for an initial public offering ("IPO") in Hong Kong and would like to strengthen the company's controls and corporate governance.

TrueFact has established an audit committee. Mr Wong chairs the audit committee. The audit committee consists of Mr Wong and two non-executive directors. Mr Wong and the two non-executive directors are thought leader in the marketing and advertising industry and have been serving in this industry over 30 years. Recently, TrueFact recruited a senior manager from a CPA firm for setting up their own internal audit team. The internal audit senior manager reports to the Chief Financial Officer directly.

Required:

- (a) In respect of the information presented in the case, advise possible improvements to TrueFact's audit committee for IPO preparation and explain your reasons. (6 marks)
- (b) List the main roles and responsibilities of an audit committee. (4 marks)

Question 6 (13 marks – approximately 23 minutes)

ABC Limited ("ABC") is a fabric manufacturer with operations mainly located in Vietnam and Hong Kong. Most of the end customers of ABC are large international garment brand owners. Many fabric manufacturers, in view of the increase competition in the fabric industry and pressure from the large brand owners, have started looking for cleaner and more cost efficient fabric manufacturing technology in recent years.

In October 2020, ABC acquired 60% equity interest of High Tech Limited. High Tech Limited is principally engaged in developing a new technology relating to fabric cleaning and owns certain patented technical know-how which are internally developed.

For accounting and financial statements preparation purposes, ABC engaged a valuer to perform a valuation of the technical know-how at the acquisition date and the valuer concluded that the technical know-how was worth HK\$40 million. As at 31 December 2020, management of ABC did not prepare separate asset impairment assessment of High Tech Limited and relied on the valuation performed at the acquisition date and the technical know-how of HK\$40 million was recognised in the statements of financial position of ABC. The valuer is the cousin of ABC's owner and a professional qualified surveyor in Hong Kong.

Required:

- (a) Assume that you are the auditor of ABC, propose audit procedures on evaluating the competence and objectivity of the valuer. (6 marks)
- (b) Assume that the valuer's competence, capabilities and objectivity are satisfactory, propose audit procedures on ascertaining the valuation assertion of the technical know-how as at 31 December 2020. (7 marks)

Question 7 (7 marks – approximately 13 minutes)

XYZ Limited ("XYZ") is a property management and leasing company in Hong Kong. Patrick & Co is the auditor of XYZ. XYZ has its financial year end at 31 December. There was no significant change of business of XYZ during the year. However, with the change of the Chief Operating Officer ("COO") in the year, certain manual revenue billing processes were changed.

In the past, to promote consistency and simplicity, rental period agreed with the tenants usually started from the first day of each month. Rental invoices were usually issued and sent to the tenants at each month end after the approval of the COO. During the year, to encourage more flexibility with the tenants, for newly accepted leases, the rental period may start any day in the month. Rental invoices are issued and sent to the tenants on a monthly basis after the approval of the COO. Based on the enquiry with the COO, there are 30 units of properties with lease contracts newly entered or renewed during the year.

XYZ manages over 100 units of properties and has only one accountant who assists the COO in handling the rental billing and related financial records of XYZ. All financial reporting processes are manual. The financial statements and the related financial information are prepared using Excel.

In view of the change of the revenue billing processes, Patrick & Co decided to perform the revenue cut-off test. The result of the test indicated that three out of ten samples were with revenue cut-off errors. The three errors identified were all related to either the newly accepted or renewed leases during the year.

Required:

Assume that you are the audit senior in charge in the audit of XYZ, propose follow up audit procedures in view of the audit findings identified.

(7 marks)

Question 8 (10 marks – approximately 18 minutes)

Day Sport Company Limited ("DDS") is a listed company in Hong Kong selling sportswear and footwear of different international brands. DDS has over 60 retail stores in Hong Kong and Macau as at 31 December 2020. DDS expanded very fast in the last two years with ten new retail stores opened in Hong Kong and Macau respectively, with lease contracts locking up at a relatively higher rental level.

For the year ended 31 December 2020, due to the reduction of tourists and poor consumer sentiment in Hong Kong and Macau, management considered that the change of economic trend may adversely impact the recoverable values of the assets used in the retail stores which was a triggering event for impairment review. Therefore, management performed an impairment assessment of the property, plant and equipment of the retail stores, and assessed if a write-down of inventories is necessary. As a result of the assessment, DDS recognised an impairment loss of property, plant and equipment of HK\$25 million and a write-down of inventories of HK\$10 million. The profit before tax of DDS for the year amounted to HK\$2 million. The matter was discussed in the audit committee meeting with the auditor of DDS, and management explained to the audit committee their assessment basis in the meeting.

There were no significant changes of business, operations and controls of DDS during the year. There was also no change of senior management of DDS in the year.

Required:

- (a) List the factors that the auditor of DDS should take into account in determining the key audit matters to be included in the auditor's report of DDS. (5 marks)
- (b) Analyse and explain whether the impairment loss of property, plant and equipment of the retail stores and the write-down of inventories described in the case would be considered as key audit matters in the auditor's report of DDS. (5 marks)

Question 9 (10 marks – approximately 18 minutes)

Motorazer Inc ("Motorazer") is a motor vehicle manufacturing and trading company with operations and business worldwide. You are the group auditor of Motorazer and notice the following situations.

- (a) Over 20% of the motor vehicle manufacturing and trading business of Motorazer is located in the United Kingdom, which is considered a significant component and audited by another reputable well-known CPA firm (i.e. component auditor). There is a recent scandal that the quality of the component auditor is questioned by the local regulators.
- (b) Motorazer has outsourced its payroll function to a third party service provider. Motorazer maintains minimal resources in payroll function to oversee the work performed by the third party service provider.

Required:

Propose relevant audit plan in each of the above situations.

(10 marks)

* * * END OF EXAMINATION PAPER * * *

Module 13

Business Assurance

Answers

The suggested answers are longer than what candidates are expected to give in the examination. The purpose of the suggested answers is meant to help candidates in their revision and learning. The suggested answers may not contain all the correct points and candidates should note that credit will be awarded for valid answers which may not fully covered in the suggested answers.

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

To: Audit Partner
From: Audit Manager
Date: Exam Date

Subject: Independence of the engagement team members for the audit of DaDa Wine Solutions Limited ("Dada").

Upon the receipt of the declarations from our engagement team members, four exceptions are noticed. I provide below analysis on threats and proposed safeguards for each of the exceptions.

The audit senior

The audit senior states that her husband is one of Dada's shareholders holding 2% of shareholdings in Dada.

Regardless whether the audit senior and her husband is financially independent of each other, the *Code of Ethics for Professional Accountants (Revised)* defines an immediate family member as a spouse (or equivalent) or dependent.

Accordingly, in this situation, the husband's financial interest in Dada creates self-interest threats to the audit senior to compliance with the fundamental principles of objectivity.

The threat is so significant that can only be reduced to an acceptable level by removing the audit senior from the engagement team.

The audit junior

The audit junior states that his brother is one of Dada's shareholders holding 5% of shareholdings in Dada.

The brother is not a dependent of the audit junior and therefore not an immediate family member of the audit junior. However, he may be a close family member to the audit junior depending on the closeness of their relationship.

Accordingly, in this situation, his brother's financial interest in Dada creates self-interest threats to the audit junior to compliance with the fundamental principles of objectivity.

The threat is so significant that can only be reduced to an acceptable level by removing the audit junior from the engagement team.

The tax manager

The tax manager states that he works as a part time tax consultant giving tax advice to Dada.

The tax manager is expected to perform audit work on the tax related matter during the audit. Despite the fact that he is not a full time employee of Dada, his work as a tax consultant would appear to have or would have a direct impact on Dada's financial statements.

Accordingly, the situation creates self-interest threats to the tax manager to compliance with the fundamental principle of objectivity. It also brings negative impact to the audit firm's independence.

The threat can be reduced to an acceptable level by asking the tax manager to resign from Dada as the tax consultant. If he decline to do so, then remove him from the audit engagement team to eliminate the threat.

The tax senior

The tax senior states that his wife is working as a marketing event planner at Dada.

Although the tax senior's wife is an immediate family member of an engagement team member, her position as a marketing event planner does not exert significant influence over the preparation of Dada's accounting records or the financial statements.

Therefore, no significant threats are created or fundamental principles are violated in such situation. It should be fine for the tax senior to stay on with the engagement team.

Please feel free to let me know if you have any questions regarding the above.

Best regards,

Audit Manager

[Note: The assessment rubric for awarding marks for core enabling competences is attached at the end of the suggested answers.]

Answer 2(a)

The determination of depreciation policy and amortisation policy of an entity's non-current assets involve significant accounting estimates which could impact the financial statements of an entity. Management has to estimate these assets' respective useful lives, residual values, and methodologies of depreciation or amortisation in order to determine the respective policies. The auditor's objective in reviewing an entity's depreciation or amortisation policy is to ensure that the depreciation or amortisation charges and the net book value are fairly presented in accordance with the relevant accounting standard.

Answer 2(b)(i)

Dada's refrigerated wine cooler system is depreciated on a straight line basis over 30 years.

As the refrigerated wine cooler system is self-constructed, the useful lives and the residual value may require special consideration. The auditor should enquire Dada's engineers to evaluate its basis to determine the useful lives of 30 years.

Since the cooler system is a fixture constructed inside the factory premises and the factory premises are leased property with limited tenure, the auditor should evaluate whether there will be possible obsolescence when the lease term expires.

Answer 2(b)(ii)

Dada's intangible asset comprises its self-developed ERP system which is amortised on a straight-line basis over 10 years.

As it is a self-developed computerised system, the auditor should enquire Dada's technical personnel to ascertain its basis to determine its useful lives. Given the fast changing technology, the auditor should be mindful if the amortisation rate is too low which may indicate the useful lives are too long.

The auditor should also compare the amortisation rate used by Dada to the industry practice to ascertain if it is within the range adopted by other entities in the same industry.

Answer 3(a)

The risk of material misstatement relating to valuation assertion involving the fair value measurement of the share-based payment is considered high.

The principal assumptions, such as the annual growth rate used by the management's valuation, involve significant management estimates and judgments.

The valuation is considered complex because Dada is a private entity whose share price is not publicly and readily available in the market.

Dada's internal personnel who performs the valuation may not be competent enough as the valuation is complex.

The valuation may involve a lot of uncertainties because Dada has just started up its business which does not have proven track records to support the estimates being used in the valuation model.

There is a possibility of management bias by selecting a point estimate that may indicate a pattern of optimism or pessimism.

Answer 3(b)

HKSA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements.

The auditor's objective is to obtain sufficient appropriate audit evidence about whether the accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.

The auditor should consider the experience and competence of those who make the accounting estimates and controls.

The auditor should consider the completeness, relevance and accuracy of the data used by management.

The auditor should enquire the management if there is internal process involved for the review and approval of accounting estimates and obtain relevant evidences.

The auditor should enquire whether there is segregation of duties of those managing Dada and those responsible for making the accounting estimates and obtain relevant evidence.

The auditor should understand how management assesses whether the assumptions are relevant and complete.

The auditor should consider whether the assumptions used are consistent throughout the period.

The auditor should evaluate whether the assumptions used conform with the Dada's business plans and environment.

The auditor should test the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.

The auditor can use its internal expert to ascertain if the methodology used by the management is appropriate or to recalculate the valuation independently to compare with the management's valuation.

The auditor can develop a point estimate or a range to evaluate whether management's point estimate may be an appropriate treatment.

Answer 4(a)

Dada has three different types of revenue where the recognition of each type of revenue is different, the risk of material misstatements is relatively higher when compared to a single revenue stream.

The risk of material misstatement on its accuracy is relatively higher because different pricing models are adopted by three types of revenue. The selling prices of wines vary among different countries and different vintages, different storage charges are applied on different storage plans, and different delivery charges are applied on different locations.

The risk of material misstatement on its occurrence is relatively higher because all types of revenue are recognised when customers' payments are received. There may be material misstatements when goods are not delivered or services are not rendered but customers' payments are received.

Regarding the sales of wines, as most of the customers choose to store the wines in Dada's warehouse, no actual delivery of wines is required to be taken place when sales are booked. Sales of wines are easily manipulated if it does not require actual stocks to be existed and delivered.

Customers are required to prepay the storage service charges regardless of the duration of the plan. All storage service charge is recognised upfront on the date of inception by the system. Since the system does not amortise the revenue over the storage plan duration, but relies on a manual journal entry to adjust the deferred revenue, there are possible cut-off errors on revenue from storage if the monthly journal entry was incorrectly calculated.

For delivery service income, the risk of cut-off is relatively lower because the delivery service is expected to be rendered within 24 hours which is not likely to cause any cut-off issue.

Dada is a newly established entity, employees are newly recruited who may not be familiar with the business operations, the situation would increase the control risk if manual controls are placed.

However, given the effective general control of its IT system, it will mitigate the risk of material misstatements relating to completeness assertion.

Answer 4(b)(i)

Dada can implement the following application and other internal controls:

Controls over input completeness:

- Each customer's order is assigned with an individual tracking reference number under sequential orders.
- Operational staff reconciles the total customer orders to the total tracking reference number assigned and investigate the reasons for variances.
- Designated finance team staff performs review of the posting of transactions in the accounting records.

Controls over input accuracy:

- Warehouse staff checks the stock-in total and stock-out total to the system records periodically and investigate the reasons for variances.
- Warehouse team and finance team perform periodic stock take of the wines stored in Dada's warehouse and ensure the data generated from the system are accurate.

Controls over input authorisation:

- System control to limit the different levels of authority for the designated personnel.

Controls over processing:

- System control on reconciliation of processing of transactions.
- Finance team to check if any unprocessed transactions.

Answer 4(b)(ii)

Controls over valuation:

- System to calculate the billing amount based on the master data file stored in the system, such as the sales prices for different wines, the prices for storage plan, and prices for delivery charge.
- System to reconcile the billing amount to the receipts from customers' payment online.
- Accounting supervisor to review and check the calculation of deferred revenue being reclassified from revenue to liability account.

Controls over master file data:

- Maintenance a master file which contains data such as unit price, pricing formula etc.
- Designated management reviews the master file data regularly.
- Designated management reviews the reasonableness of revenue through ratio analysis or other operational data analysis.
- System control on amendment to the data kept for each tracking device.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer 5(a)

TrueFact should consider the below changes in order to improve its audit committee following the Hong Kong Listing Rules requirements:

The audit committee should consist entirely of non-executive directors. Mr Wong as the Executive Director and the Chief Executive Officer of TrueFact should not be a member of the audit committee.

There should be at least three non-executive directors on the audit committee. The majority of the audit committee members should be independent non-executive director ("INED") and the chairman of the audit committee must be an INED.

Currently the audit committee of TrueFact only consists of Mr Wong and two non-executive directors. TrueFact should consider changing the audit committee composition by removing Mr Wong and one of the non-executive directors from the audit committee and appointing at least two more independent non-executive directors to the audit committee.

At least one member of the audit committee should be an INED who has appropriate professional qualifications, or accounting or related financial management expertise.

Since all current audit committee members only have marketing and advertising expertise, TrueFact should consider appointing a new member on the audit committee with appropriate professional qualifications, or accounting or related financial management expertise.

Last but not least, the internal audit senior manager should not report to the Chief Financial Officer but to the audit committee directly.

Answer 5(b)

The main roles and responsibilities of an audit committee include the following:

- To monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting issues and judgement contained in them.
- To review the company's internal controls including financial reporting controls and risk management systems.

- To monitor and review the effectiveness of the company's internal audit function.
- To make recommendation to the board on the appointment, reappointment and removal of the external auditor, to approve the remuneration and terms of engagement of the external auditor and any questions of resignation or dismissal of the external auditor.
- To monitor and review the external auditor's independence, objectivity and effectiveness of the audit processes in accordance with applicable standards.
- To develop and implement policy on engagement of the external audit or to supply non-audit services.

Answer 6(a)

Competence

Competence relates to the nature and level of expertise of the valuer. As the valuer is a professional qualified surveyor in Hong Kong, the auditor should examine the valuer's professional certification, or licensing by, or membership of, an appropriate professional body.

In addition, the auditor should inquire the valuer's experience and reputation in the field of valuing the technical know-how. The auditor should consider whether the valuer has sufficient knowledge on fabric manufacturing industry and perform independent background check on the valuer.

Objectivity

Objectivity relates to the possible influences on the judgment of the valuer causing him to be biased. The auditor shall consider whether the valuer as the cousin of the ABC's owner is a threat to objectivity. The auditor should inquire ABC and the valuer as to their interests and relationship that may create a threat to the valuer's objectivity, such as whether the valuer has any financial interest in ABC or other business relationship, etc.

The auditor should specifically understand more of the personal relationship between the valuer and the owner of ABC, and consider if they have any other relationship that may affect the valuer's objectivity.

In addition, the auditor should discuss with the valuer if they have considered any relevant safeguards to reduce the threat to objectivity to an acceptable level.

Answer 6(b)

The relevant audit procedures should include the following:

- Obtain the valuation report performed at the acquisition date from the valuer.
- Discuss with the valuer to obtain an understanding of the work of the valuer.
- Obtain an understanding on the valuation methodology adopted by the valuer.
- Assess the appropriateness of the valuation methodology adopted by the valuer for performing the valuation.
- Discuss with management and the valuer to understand the assumptions adopted in the valuation.
- Assess the relevancy and reasonableness of the assumptions adopted in the valuation.
- Perform independent benchmarking or research on the assumptions adopted in the valuation.
- Check the mathematical accuracy of the valuation performed by the valuer.
- Review the sensitivity analysis performed by the valuer on the valuation, if any.
- Assess if there may be significant changes to the assumptions used in the valuation between the acquisition date in October 2020 and 31 December 2020 that may significantly affect the valuation of the technical know-how.
- Assess the reliability of management's forecast by comparing the actual business results for the period from the date of acquisition in October to December 2020 to the forecasted results adopted by management/ valuer in the valuation as of the acquisition date.

Answer 7

The follow up audit procedures should include the following:

- Communicate and discuss the audit findings with management and understand from management if they are aware of the revenue cut-off errors.
- Assess if the revenue cut-off errors identified was an isolated incidence and the potential financial impact of the incidence.

- Request management to perform a comprehensive assessment to quantify the potential financial impact in response of the revenue cut-off errors identified.
- Obtain and review management's quantification assessment.
- Check whether management's quantification assessment covers all 30 units of properties with lease contracts newly entered into or renewed during the year.
- Validate management's representation on the number of new lease contracts by inspecting the rental agreements entered into with the new tenants during the year.
- Check the mathematical accuracy of management's quantification assessment.
- Test the data used by management in the quantification assessment by agreeing the relevant data such as the rental period, rent free period and monthly rent to the signed rental agreements.
- Discuss with management their accounting treatment of the revenue cut-off errors identified.

Answer 8(a)

The factors that an auditor should take into account include the following:

- Whether the audit matters are communicated with those charged with governance.
- Whether the audit matters require significant auditor attention in performing the audit.
- Whether the audit matters are areas of higher assessed risks of material misstatement, or significant risks identified in accordance with HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
- Whether the audit matters require significant auditor's judgements relating to areas in the financial statements that involved significant management's judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.
- The relative significance of the audit matters of the above.
- The most significant matters in the audit of the financial statements of the current period are the key audit matters.

Answer 8(b)

The impairment of property, plant and equipment and the write-down of inventories should be considered as key audit matters. Reasons are as below:

The matters were communicated to the audit committee and discussed in the audit committee meeting.

The impairment loss of property, plant and equipment of HK\$25 million and the write-down of inventories of HK\$10 million were both financially significant compared to the company's profit before tax for the year of HK\$2 million.

Both the assessments for impairment of property, plant and equipment and the write-down of inventories involved significant management judgments and accounting estimates that required significant auditor's attention.

There were no significant changes of business, operations and controls of DDS during the year. On a relative basis, the assessments of impairment of property, plant and equipment and the write-down of inventories are more significant comparing to other audit areas.

Answer 9(a)

Given there is a recent scandal that the quality of the component auditor has been questioned, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider in particular the professional competence of the component auditor even though the component auditor is also a reputable well-known CPA firm.

The group auditor should understand from the component auditor whether the component auditor's engagement team was involved in the scandal.

The group auditor should perform procedures to assess the work quality of the component auditor, for example:

- arrange progress meetings with the component auditor;
- review the component auditor's work paper; and
- discuss with the component auditor their procedures performed and appropriateness of the audit conclusion.

If the group auditor has serious concern about the quality of work of the component auditor, the group auditor may consider carrying out additional audit procedures on the financial information of the component on their own.

Answer 9(b)

The group auditor should plan the below audit procedures:

- Work with management to understand the processes and controls in place with the third party service provider over the payroll activities performed for Motorazer.
- Evaluate and validate the operating effectiveness of the controls in place over the payroll activities performed for Motorazer by the third party service provider.
- Understand, evaluate and validate management's control and review over the work performed by the third party service provider.
- Inquire with management if an auditor's report is available to confirm the operating effectiveness of the controls in place with the third party service provider over the payroll activities performed for Motorazer.
- Obtain and review the auditor's report over the operating effectiveness of the controls over the payroll activities performed for Motorazer by the third party service provider.
- Consider substantive test approach if the controls in place with the third party service provider over the payroll activities performed for Motorazer is proven to be ineffective or a substantive test approach itself is more effective and efficient.
- Substantive test procedures include employee contract review, re-performance of the payroll calculation, agree payment to bank statements, etc.

Assessment rubric for awarding marks for core enabling competences

	2 marks	1 mark	0 mark
Demonstration of communication skill	The candidate has presented the answer in an appropriate format. The candidate has presented well-structured content to the audience specified in the question requirement.	The candidate has presented the answer in an appropriate format, but overall the content is not well-structured and logically presented to the audience specified in the question requirement.	The candidate has not presented the answer in an appropriate format. The information presented is not relevant to the audience specified in the question requirement.
Demonstration of analytical skill	The candidate has demonstrated questioning mind for issues and is able to identify relevant facts in the case background. The candidate has made appropriate judgements / conclusions based on relevant facts.	The candidate has identified some issues and some relevant facts in the case background. Not all judgements / conclusions are made based on analysis of relevant facts.	The candidate is not able to identify issues and relevant facts in the case background. The answer is merely restatement of information from the case background without any analysis.
Demonstration of problem solving skill	The candidate is able to understand the problem and determine the root causes based on the case background. The candidate is also able to identify the alternatives and recommend an appropriate solution with consideration of the circumstances.	The candidate understands the problem but has only partially determined the root causes based on the case background. The candidate has identified some alternatives without recommending which should be taken.	The candidate does not understand the problem and is not able to determine the root causes based on the case background. No alternatives or recommended solutions are found in the answer.
Demonstration of the five-step process in addressing ethical dilemmas	The candidate is able to apply the full five-step process to address the ethical dilemma based on the case background. The candidate is able to discover alternative solutions and recommend an appropriate solution with detailed explanation.	The candidate is able to partially apply the five-step process to address the ethical dilemma based on the case background. The candidate has discovered some alternative solutions without recommendation and explanation.	The candidate is not able to apply the five-step process to address the ethical dilemma based on the case background. No alternative solutions or recommendations are found in the answer.

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