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

Hong Kong's
CPA Qualification
香港會計師專業資格

Examination Technique Seminar on

Section A (Case)

for

Module C on Business Assurance

Speaker
Mr. Harvey Lam

14 May 2013

HKCA - HKICPA MC Seminar 14 May 2013

About HKCA

HKCA Learning Media Limited ("HKCA") is established to provide professional accountancy training to university graduates and working adults who are keen to pursue an accountancy qualification in Hong Kong and Mainland China.

We offer highest standard of accountancy training through our experienced tutors who will lead our students towards examination successes in QP. Our tutors are specialists in relevant papers and give you "IDEAS to Pass".

HKCA is here "All for You to Pass".

About Lecturer – Harvey Lam (BA, MSc, CPA, ACA)

Since graduating from the UK, Harvey began his professional career with one of the Big Four firms as auditor for more than 7 years. Harvey is a member of HKICPA and ICAEW.

He holds a Bachelor's degree with First Class Honours and a Master's degree with Distinction in Accounting and Finance, and was a prize winner in both of his undergraduate and postgraduate programmes as the best performer. With his experience, Harvey aims to pass his confidence to students for passing QP exam.

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Agenda

- December 2012 Exam Paper (Section A) Review
- June 2012 Exam Paper (Section A) Review
- Mock Paper (Section A)
- Additional Questions
- Q&A session

Topics Covered in June and December 2012 Section A

Diet	Topic	Tips	Marks
December 2012	Q1: Ethics – Independence and Safeguard	"IFAIR", "6R", "Remarks"	12
	Q2: Internal Controls over Information System	IT Mindmap	12
	Q3a: RoMM at Assertion Level	Assertion Table	5
	Q3b: Internal Controls on specific processing	"SPAMSOAP"	4
	Q3c: Professional Scepticism	HKSA 200	8
	Q4: Subsequent Events	HKSA 560	9
June 2012	Q1: RoMM at Assertion Level and Audit Procedures	Assertion Table, "AEIOU CR"	18
	Q2: RoMM at Assertion Level and Audit Procedures		13
	Q3: Internal Controls over Information System	IT Mindmap	5
	Q4: Corporate Governance	"ACT", Roles of Audit Committee	14

Specific Observations
- Carbon-copying of auditing procedures will NOT work.
- Increasing emphasis on internal controls (and application of real-life situations)
- Impact of information system on audit process

Key Examiners' Comments
- Performed well in identifying relevant auditing standards
- Performed well in identifying assertions at risk
- Improvements needed in designing specific audit procedures and internal controls
- Improvements needed in applying knowledge to case context

Reminders on Exam Techniques
- Identify which specific areas you are asked
- Plan your answer before writing
- Logical and step-by-step presentation
- Structure your answer in adequate depth
- Time management (1.8 minutes per mark)
- Attempt all questions (the first mark is always easier than the final mark)

Independence
Threats to Independence ("IFAIR")
- Self-**I**nterest
- **F**amiliarity
- **A**dvocacy
- **I**ntimidation
- Self-**R**eview

After you identified the threats, the next step is to determine the safeguard. A useful approach is the "6R" approach:
- Refuse
- Rotate
- Remove
- Review
- Reveal
- Resign

Threat	Circumstance	Remark	Possible Safeguards
Self-interest	Financial interests	The following parties CANNOT own direct or indirect material financial interest in client: 1) Firm 2) Assurance team member 3) Immediate family member of assurance team member	• Dispose of the direct financial interest before joining the engagement team • Dispose of the indirect financial interest fully • Dispose of a sufficient amount of the interest so it is no longer material before joining the engagement team • Remove the member from the assurance engagement • Keep the entity's audit committee informed of the situation • Use an independent partner to review work carried out if necessary • Discuss with those charged with governance/audit committee
	Close business relationship (e.g. purchase of goods or financing)	Only if it is at arm's length	• Terminate the assurance provision • Terminate the business relationship • Remove the member from the assurance engagement
	Employment with client	Threat depends on: • Position and involvement in the audit team • Position in the client (more problematic if connected with financial reporting)	• Modify the assurance plan • Involve additional partner to review the work performed • Carry out quality control review of engagement • Cooling off
	Family and personal relationships	Include immediate family member (spouse or dependent) Threat depends on: • Position and involvement in the audit team • Position in the client (more problematic if connected with financial reporting) • Nature of relationship	• Remove the member from the assurance engagement • Discuss with those charged with governance/audit committee • Carry out quality control review of engagement
	Gifts and hospitality	Not acceptable if the value of gifts and hospitality is not clearly insignificant	• Decline the offer • Discuss with those charged with governance/audit committee
	Loans and guarantees	Only if arm's length BUT not acceptable if the client is not a financial institution	• Involve second partner or quality control partner to review the work performed • Decline the offer if not arm's length

Self-interest	Overdue fees	Generally the audit firm is expected to require payment of fees before audit report is issued.	• Include an independent review to ensure the fees charged are fair • Policies in place to ensure that unpaid fees do not build up to unfeasibly high levels • Discuss with senior management- Do not accept new engagement from the same client • Resign from assurance engagement
	Percentage or contingent fees	For assurance engagements, threats cannot be reduced to acceptable levels	• Should not enter into contingent fee arrangement for assurance engagements! If non-assurance engagements: o Disclose to audit committee o Review or determine the fee by unrelated third party o Carry out quality control review of engagement
	Lowballing	Fee should be charged based on time and experience of staff Consider whether audit quality is compromised	• Keep record to demonstrate that the firm used appropriate staff, spend sufficient time and adhered to professional standards • Demonstrate that the engagement complied with standards and quality control procedures
Self-review	Recent service (i.e. from mgt to engagement team)	2 years cooling off period if served in the role of director or officer of client	• Carry out quality control review • Discuss with those charged with governance/audit committee
	General other services	Not allowed to: 1) authorise or execute a transaction 2) report in management capacity to those charge with governance	• Segregation of duties - use different team members • Carry out quality control review • Disclose and discuss with those charged with governance/audit committee • Establish policies and procedures to prohibit from making managerial decisions on behalf of client • Resign from assurance engagement
	Preparing accounting records and F/S	Not allowed for listed or PIE For ALL clients, not allowed to: 1) determine journal entries without client approval 2) authorise or approve transactions 3) prepare source documents	• Use staff members other than assurance team members to carry out the work • Obtain client's approval for work and underlying assumptions taken

	Valuation services	Not allowed on valuation which is: 1) material to F/S 2) subject to high degree of subjectivity	• Second partner or quality partner review • Confirm that the client understands how the valuation is reached and the underlying assumptions • Ensure that the client acknowledges its responsibility for the valuation • Use separate staff for the valuation and audit
	Internal audit	Not allowed for PIE for: 1) significant part of internal control over financial reporting 2) financial accounting systems that generate information that is significant to F/S	• Ensure that the client acknowledges its responsibility for establishing, maintaining and monitoring internal controls • Obtain client's approval • Use separate staff for internal audit and external audit • Second partner or quality partner review
	Corporate finance	Not allowed to promote, deal in or underwrite client's shares	• Use separate teams of staff • Establish policies and procedures to prohibit from making managerial decisions on behalf of client
Advocacy	Percentage or contingent fees	See above	See above
	Corporate finance	See above	See above
Familiarity	Long association	Threat depends on: • Length of time • Role of individual in the audit tem	• Rotation of senior personnel • Second partner review • Internal independent quality control reviews
	Employment with client	See above	See above
	Family and personal relationships	See above	See above
Intimidation	Close business relationship	See above	See above
	Family and personal relationships	See above	See above
	Employment with client	See above	See above

<u>Designing Internal Control</u>

1) Think what might go wrong
2) Set the Objectives (i.e. what is the purpose of the internal control?)
3) Design measures to achieve (2), typically a combination of the following model ("SPAMSOAP"):

<u>S</u>egregation of Duties
<u>P</u>hysical and Access Controls
<u>A</u>uthorisation and Approval
<u>M</u>anagement Controls
<u>S</u>upervision, Monitoring and Review
<u>O</u>rganisation
<u>A</u>ccounting Controls
<u>P</u>olicies and Personnels

Key Assertions

Balance Sheet:

Assertion	Definition	Remarks
Existence	Assets, liabilities and equity exist	▪ Physical existence ▪ Recognition Criteria
Completeness	All assets, liabilities and equity that should have been recorded have been recorded	▪ Link to Existence for physical items
Rights and Obligations	Entity holds/controls the rights to assets. Liabilities are obligation of the entity	
Valuation and Allocation	Assets, liabilities and equity are recorded at appropriate amounts	▪ Cost models with depreciation and amortisation ▪ Fair Value model ▪ Impairment

Income Statement:

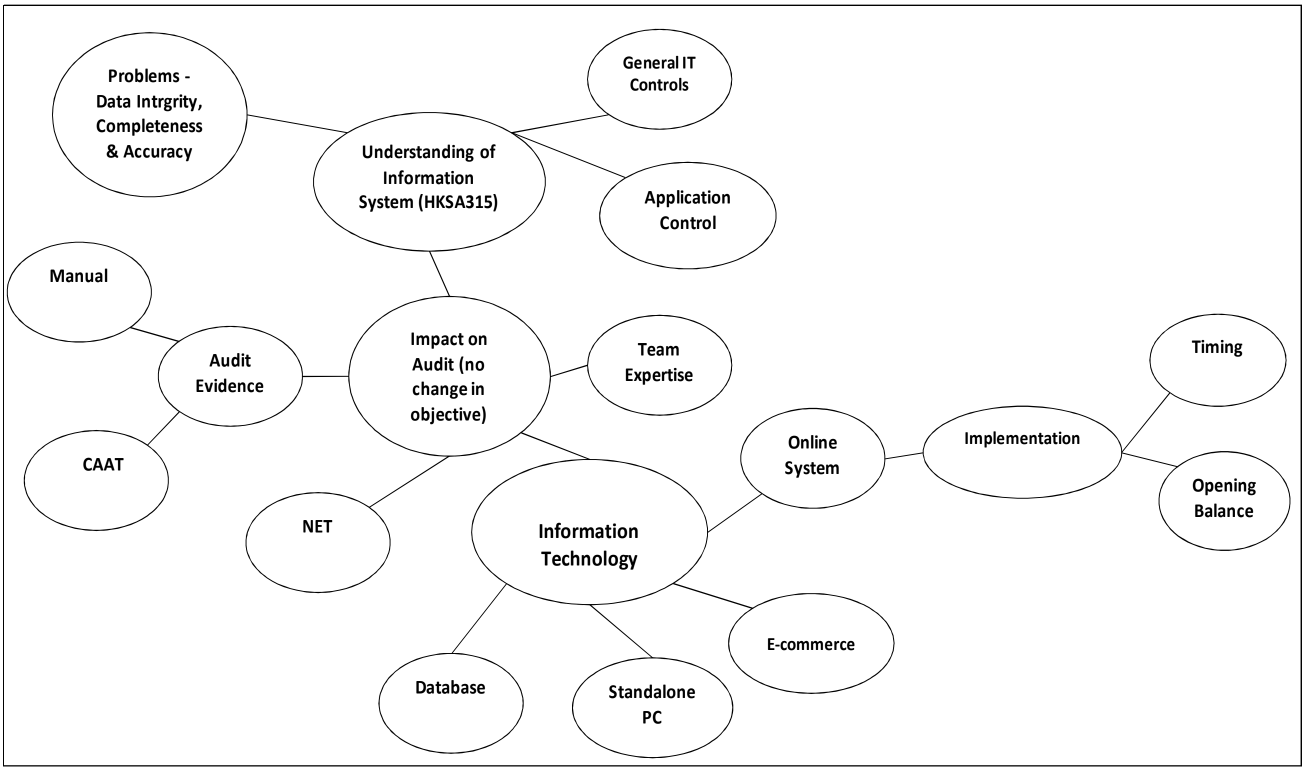
Assertion	Definition	Remarks
Occurrence	Transactions and events recorded have occurred and pertain to the entity	▪ Recognition Criteria
Completeness	All transactions and events that should have been recorded have been recorded	
Accuracy	Amounts and data relating to recorded transactions and events have been recorded appropriately	
Cut-Off	Transactions and events recorded have been recorded in the correct accounting period	
Classification	Transactions and events have been recorded in the proper F/S	▪ Recognition Criteria

Designing Specific Audit Procedures ("AEIOU CR")

Techniques	Remarks
Analytical Procedures	▪ Cannot address existence and occurrence ▪ Useful for valuation & allocation, Accuracy and Completeness
Enquiry	▪ Useful for most assertions
Inspection	▪ Useful for most assertions
Observation	▪ Useful for physical assets
Recalc**U**lation and reperformance	▪ Useful for valuation & allocation and accuracy
Confirmation	▪ Useful for most assertions (except for valuation & allocation of accounts receivables)
Reconciliation	▪ Cannot address existence and occurrence ▪ Useful for valuation & allocation, Accuracy and Completeness

Approach	Sample Procedures
Test what **M**anagement has done (E, U)	• Enquire into/Discuss with management regarding [ascertain the assertions] • Assess experience and competence of stuff performing the management's actions • Reperform management's calculation • Examine compliance of accounting policies with HKFRS
Auditor designed procedures (A, **I**, O, C, R)	• Obtain reconciliations/breakdowns showing [……] • Agree opening balance to prior year's audited F/S • Agree closing balance to F/S • Check mathematical accuracy of the [accounting record] • Vouch [supporting documents] for breakdown/movement items • Vouch or Physically Observe from list to floor • Vouch or Physically Observe from floor to list • Send confirmations to [….] confirming [….] • Review minutes and correspondence • Review agreements • Analytical Procedures (Compare A to B…) • Search for unrecorded liabilities • Obtain LoR to confirm [state specific matters]
Post balance sheet indication	• Check for any subsequent settlements

Information Technology Mindmap



Mock Exams – Case Study

Elite Group Investment Limited ("EGI") is an investment holding company incorporated in Hong Kong. Its primary business is to invest in private equity investments through the use of different types of complex business ventures. The investment strategy of EGI is to target potential unlisted companies in Mainland China and exit upon initial public offering of its investments.

Mr. Gong is the founder of EGI and is currently the Chairman and Chief Executive Officer. As advised by its tax advisor, EGI invests in the private equity investments through different layers of companies (including subsidiaries, associates and jointly-controlled entities) from different locations. EGI has offices in 8 cities in Mainland China so that the local project teams can source new investment targets more effectively.

Mr. Gong understands the importance of commitment by the senior management and the project teams. As a result, EGI's policy is to base the bonus package on the profit or loss of EGI as stated in the audited financial statements.

You are a manager at ABC & Co. ("ABC"), EGI's auditor since 2008. You are the manager-in-charge of the audit of EGI's financial statements for the year ended 31 December 2012.

Below is an extract of the consolidated financial data of EGI:

	As at 31 December 2012 (Unaudited) HK$ million	As at 31 December 2011 (Audited) HK$ million
Goodwill	14,560	10,198
Financial assets at fair value through profit or loss	44,654	40,988
Cash	12,690	14,523
Total assets	84,230	78,231
Bank loans	17,080	15,150
Profit before tax	7,850	9,004

Currently, EGI determines the fair value internally with the use of valuation models. The investment portfolio of EGI contains all unlisted private equity investments. These investments are classified as financial assets at fair value through profit or loss (Note: Assume that EGI has not early adopted HKFRS 9). Financial assets at fair value through profit or loss are initially recognised at fair value. Subsequent to initial recognition, all financial assets at fair value through profit or loss are measured at fair value. Gains and losses arising from changes in the fair value of financial assets at fair value through profit or loss are recognised in the income statement in the period in which they arise. Financial assets are derecognised when the rights to receive cash flows from the investments have expired or EGI has transferred substantially all risks and rewards of ownership.

On 1 August 2012, EGI adopted a new computerised portfolio management system to record and maintain the investment data. The system is mainly accessible and used by the Accounting Department, Project Team across all offices of EGI. The new system can also serve as document library where all documents related to the investments can be accessed across networks to other computers.

Question 1 (10 marks – approximately 18 minutes)

Mr. Gong is aware that there are some newly issued accounting standards that may affect EGI's consolidation accounting. Mr. Gong invited ABC to give a full-day presentation to EGI's senior management regarding the application of the new accounting standards and provide recommendations on how EGI can adopt the new accounting requirements. After the presentation, Mr. Gong has given fruit baskets to each presenter in the audit team to express his gratitude.

Required:

Explain the independence issues, and discuss any safeguards or actions that ABC may implement.

(10 marks)

Question 2 (7 marks – approximately 13 minutes)

Explain fraud risk factor and identify three main fraud risk factors from the audit of EGI's financial statements for the year ended 31 December 2012.

(7 marks)

Question 3 (18 marks – approximately 33 minutes)

Assume that ABC & Co. has accepted the nomination as EGI's auditor. With respect to the audit of EGI's financial statements for the year ended 31 December 2012:

Required:

(a) Assess the risk of material misstatement of financial assets at fair value through profit or loss at the assertion level in respect of:

(i) valuation and allocation.

(4 marks)

(ii) classification

(2 marks)

(b) Design further audit procedures that your team would perform to address the risk you assessed in part (a)(i).

(12 marks)

Question 4 (9 marks – approximately 16 minutes)

Discuss the degree of impact that the hotel management computerised system might have on the objectives, scope and approach of auditing.

(9 marks)

Question 5 (6 marks – approximately 11 minutes)

Identify the internal controls which should be in place relating to acquisition of unlisted private equity investments in the case of EGI.

(6 marks)

End of Questions

Suggested Answers

Answer 1

The Code of Ethics for Professional Accountants provides specific guidance on independence requirements for an assurance engagement.

ABC should identify the threats to independence and evaluate the significance of these threats and apply safeguards to reduce the threats to an acceptable level.

Receiving gift from an audit client may create self-interest threat. Self-interest threat occurs as a result of the financial or other interests of auditor or of an immediate or close family member.

ABC should not receive gifts from EGI unless the value of the gift is clearly insignificant. In this case, the value of fruit basket is unlikely to be significant. In assessing the significance, ABC can refer to retail price of similar class of fruit basket.

The safeguards ABC should apply to eliminate or reduce the self-interest threat to an acceptable level may include:

- Decline the gift if the value of the fruit basket is not insignificant (e.g. luxury fruits)
- Discuss with those charged with governance
- Keep the audit committee informed of the situation

On the other hand, providing specific accounting application advice may create self-review threat. Self-review threat occurs when a previous judgement needs to be reviewed by the auditor responsible for that judgement.

Generally, providing advice on general application of accounting standards may not be unacceptable. However, ABC should not provide advice on accounting treatment over specific transaction involving significant judgement that leads the auditor to take up management capacity.

The safeguards ABC should apply to eliminate or reduce the self-review threat to an acceptable level may include:

- Segregation of duties by using different team members for audit work and the presentation.
- Establish policies and procedures to prohibit from making managerial decisions on behalf of client
- Carry out internal independent quality control review
- Incorporate second partner review by the work performed by team members taking part in the presentation
- Disclose and discuss with those charge with governance

Answer 2

Fraud risk factor refers conditions or circumstances that may increase the risks of fraud. The fraud risk factors from the perspective of EGI's auditor are as follows:

Incentive to meet profit targets
The bonus of senior management is linked to the profits or loss. As a result, there is an increased risk that the financial statements may be manipulated to achieve a desirable outcome to the senior management.

In particular, changes in fair value of unlisted investments would be recognised in the consolidated income statement, which is subject to high degree of subjectivity and potential manipulation.

Multi-location business
The organisational structure of EGI is complex in that the group holds its investments through different layers of group companies at different locations. EGI also has offices in 8 cities in Mainland China.
Running a business in multiple locations increases the risks of having inconsistent systems, controls and other procedures.

Dominance of power
Mr. Gong is both the Chairman and Chief Executive Officer. With dominance of power, there is an increased risk of management override.

Answer 3(a)

Financial assets at fair value through profit or loss ("investments") is a material balance in the balance sheet as it constituted 53% of total assets as at 31 December 2012.

The following factors indicate a HIGH risk of material misstatement in the valuation and allocation assertion of investments:

- The investments are unlisted and are measured at fair value. This means that the fair value cannot be obtained from active and quoted markets.
- The fair value is calculated by valuation models which involve assumptions and thus increases subjectivity.
- The use of valuation models (e.g. discounted cash flow) may also involve complex calculation. There is a higher risk of inaccurate calculation.

The following factors indicate a HIGH risk of material misstatement in the classification assertion of investments:

- EGI invests in the private equity investments through the use of different business ventures. Since the holding structure may be complex where control, significant influence or joint-control may exist (which would result in totally different accounting treatment from fair value).

Answer 3(b)

Valuation and allocation means the assertion that the carrying amount (i.e. fair value) of financial assets at fair value through profit or loss of EGI at the balance sheet date is measured accurately in accordance with the relevant accounting standards.

The carrying amount of investments is considered to be fair value estimate under HKSA 540 (Clarified) "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures". In the absence of precise means of measurement, ABC's primarily focus is the reasonableness of the fair value estimate.
Audit procedures that ABC would perform may include:

- Review EGI's internal valuation guideline.
- Assess the expertise and experience of those persons within EGI responsible for determining the fair value.
- Understand and evaluate the EGI's approval process of determined fair value.
- Examine the accounting policies for investments. In particular, ABC should determine whether the fair value as at the balance sheet date comply with EGI's accounting policies and HKAS 39.
- Assess the appropriateness of valuation models used by EGI. In particular, ABC should assess the consistency of valuation models used by EGI and understand the reason for any change.
- Assess the appropriateness of significant assumptions utilised by EGI.
- Test the reliability (accuracy), reasonableness, relevance and completeness of data used by EGI. For example, the financial data of underlying investments should be checked to their audited financial statements where available.
- Re-perform the calculations of fair value in EGI's valuation model.
- Develop an independent expectation on the range of fair value. Investigate any significant variance with those determined by EGI. In this regards, ABC may consider using the work of an auditor's expert in accordance with HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*.
- Agree the balance of investments as at 31 December 2011 to last year's audited financial statements.
- Obtain a reconciliation between the carrying amount of the investments between 1 January 2012 and 31 December 2012, showing items such as additions, disposals and net change in fair value.
- Review subsequent events and determine whether there are any indications that the assumptions and data used by EGI may be invalid.
- Compare the selling price of any investments sold after year-end with the stated fair value.

Answer 4

The objective and scope of auditing are generally not affected by EGI's portfolio management computerised system.

ABC should obtain an understanding of the information system, both manual and information technology ("IT") systems, including the related business processes, relevant to financial reporting. ABC should also obtain an understanding of how EGI has responded to risks arising from the computerised system and/or IT in general.

From the ABC's perspective, controls over IT systems are effective when they can preserve the integrity, accuracy and completeness of the data. Therefore, ABC should understand, evaluate and validate the general IT controls and application controls regarding the portfolio management computerised system.

Depending on the risk assessment and results of evaluation of control, ABC should determine the nature, timing and extent of the audit procedures. In particular, ABC should determine the timing of testing (whether pre-migration or post-migration).

In necessary, ABC should perform testing to reconcile the data from 30 June 2012 to 1 July 2012 to ensure that the data migrated to the new system is complete.

ABC can use either manual audit procedures, computer-assisted audit techniques ("CAATs"), or a combination of both to obtain sufficient appropriate audit evidence.

ABC should also assess whether the team members have the competency or resources to understand the computerised system or to use CAATs. Alternatively, ABC should consider whether an IT expert is necessary.

Answer 5

ABC & Co. should understand and evaluate EGI's systems and internal control procedures relating to the acquisition of unlisted private equity investments, such as:

- Policy is in place that requires a thoroughly due diligence should be performed on the acquisition targets.
- Acquisition request submitted by the local project teams should be approved by appropriate level of management (e.g. investment committee empowered by the Board) with supporting investment proposals detailing investment background, reasons for making the acquisitions and projected returns.
- Cash disbursements are made only after approval by investment committee
- The local project teams who are responsible for the acquisition should be separated from the valuation team who determines the fair value measurements.
- The computation of investment costs should be reviewed by senior management (presumably the investment committee) especially relating to the capitalisation of any transaction costs.
- The share certificates or subscription documents should be keep custody at the bank. In case they are physically kept by the EGI, these documents should be kept in secured safe.

End of Answer

Additional Questions – Case Study

XYZ Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange. XYZ Limited and its subsidiaries ("XYZ") are principally engaged in the manufacture and distribution of electronic appliances. All XYZ's production facilities are located in Mainland China. Due to the economic recession, XYZ has been facing financial difficulties in the past 2 years.

In an effort to revive business performance, XYZ has appointed Mr. Choi as the new Chief Financial Officer in March 2012. Mr. Choi has a strong reputation in reviving businesses through innovative ideas and strategies.

Below is an extract of the financial data of XYZ:

	As at 31 December 2012 (Unaudited) HK$ million	**As at 31 December 2011 (Audited) HK$ million**
Property, plant and equipment	542	450
Other non-current assets	44	60
Inventories	490	452
Trade and other receivables	693	680
Bank balance and cash	570	585
Other current assets	98	101
Total Assets	**2,437**	**2,328**
Equity	2,063	2,042
Long-term bank loans	15	11
Taxation payable	80	65
Provision for litigation	23	-
Accruals and other payables	256	210
Total Equity and Liabilities	**2,437**	**2,328**

	2012 (Unaudited) HK$ million	**2011 (Audited) HK$ million**
Revenue	3,522	3,301
Operating profit	405	388
Profit after tax	344	315

In April 2012, XYZ's previous auditor (DEF & Co.) retired and declined to stand for re-appointment after reporting on the financial statements for the year ended 31 December 2011 due to the death of their engagement partner Mr. Chung.

In June 2012, Mr. Choi met Mr. Hung (an audit partner at ABC & Co. ("ABC")) in a seminar organised by the HKICPA. Mr. Choi invited ABC to be the new auditor where Mr. Hung is to be the engagement partner. Currently, ABC has 10 directors and 220 staff members. You are the audit manager at ABC, Mr. Hung is to assign you as the manager-in-charge for the prospective audit of XYZ's financial statements for the year ending 31 December 2012. In October 2012, there was a lawsuit against XYZ at the High Court in respect of a violation of some intellectual property rights. As of 31 December 2012, the case has not been concluded but XYZ expects that it will be ordered to pay compensation.

Question 1 **(10 marks – approximately 18 minutes)**

(a) State the relevant framework / standards and discuss three particular issues that ABC has to address, with possible ways to respond, before the acceptance of audit nomination specific to the case of XYZ. **(5 marks)**

(b) Explain the ethical considerations of ABC regarding the change in auditors specific to the case of XYZ. **(5 marks)**

Question 2 **(6 marks – approximately 11 minutes)**

You have been assigned to prepare for the audit planning meeting for the final audit of XYZ's year-end financial statements.

Required:
State SIX matters that should be discussed in the audit planning meeting as part of the planning process for the audit of XYZ's financial statements for the year ended 31 December 2012. (6 marks)

Question 3 **(8 marks – approximately 14 minutes)**

One week before your team starts final audit fieldwork, you received a phone call from Mr. Choi. In the call, Mr. Choi requested that your team needed not send bank confirmations because XYZ can confirm the cash balance in the letter of representation. Mr. Choi believed that this can improve your audit efficiency.

Required:
Evaluate whether you will accept Mr. Choi's request in this circumstance, and determine your response. (8 marks)

Question 4 **(8 marks – approximately 14 minutes)**

Explain the audit procedures you would perform to examine the valuation and allocation assertion of XYZ's taxation payable as at 31 December 2012. **(8 marks)**

Question 5 **(10 marks – approximately 18 minutes)**

In relation to the lawsuit, XYZ has made a provision of HK$23,000,000 in the balance sheet as at 31 December 2012.

Required:
(a) Explain ABC's responsibilities regarding the lawsuit. (5 marks)

(b) Briefly discuss the audit approaches in auditing the adequacy of this HK$23,000,000 provision. (5 marks)

Question 6 **(8 marks – approximately 14 minutes)**

Assume that the audit of XYZ has been completed. Recently you have been approached by Mr. Choi regarding other assurance services your firm can provide. In particular, Mr. Choi would like your firm to issue an assurance report to the shareholders regarding the effectiveness of XYZ's internal control over manufacturing process.

Required:
Explain to Mr. Choi the nature of such engagement to issue assurance report by ABC as professional accountant in public practice. (8 marks)

End of Questions

SECTION A – CASE QUESTIONS (Total 50 marks)

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

CASE

Super Energy Limited ("Super Energy") is a global oil company listed in Hong Kong. It has operations in over 50 countries and is one of the largest energy companies in the world. It produces around the equivalent of 2 million barrels of oil per day and has over 10,000 petrol service stations worldwide.

Super Energy's headquarters are in Hong Kong. It is vertically integrated from exploration and production, refining, distribution and marketing to petrol station retailing. Its largest oil production plant is in America.

Super Energy's track record of corporate social responsibility has been mixed. The company has been involved in a number of major environmental and safety incidents and received criticism for its political influence. However, it is also the first major oil company to publicly acknowledge the need to take steps against climate change and take actions to reduce emissions. Super Energy currently invests over HK$10 billion per year in the development of renewable energy sources and environmental protection.

In June 2011, because of a gas release, Super Energy's oil rig working on the Bargara exploration well in the Gulf of Sankala exploded. The fire burned for 48 hours before the rig sank and the oil leaked into the Gulf of Sankala for 85 days before the well was closed and sealed. Ten people died in the accident and others were injured. The accident also caused significant damage to the environment and the livelihoods of those in the communities nearby. The accident was widely reported by the media. Super Energy was requested by the US government to investigate and explain the causes of the accident to the public.

The company has committed to take responsibility for the clean-up and compensate victims of the accident. As of 31 December 2011, the company reported that they have spent HK$20 billion on the response activities.

ABC & Co. is the auditor of Super Energy. ABC & Co. and Super Energy's board of directors meet with the Audit Committee quarterly. ABC & Co. also holds regular meetings with the Internal Audit and reviews the Internal Audit investigation reports.

There were two Internal Audit investigation reports issued in December 2011 which caused particular concern to ABC & Co. In these reports by the Internal Audit, they found a significant access control deficiency over the Flex Accounts which are the general ledger used by Super Energy worldwide, and some exploration and production facilities were potentially overstated due to certain significant controls over fixed asset registration and valuation were not properly exercised by the operation team.

Here is an extract of the financial data of Super Energy:

	Year ended **31 December 2011** (Unaudited) HK$ billion	Year ended **31 December 2010** (Audited) HK$ billion
Revenue	250	220
Profit / loss before tax	(50)	30
Total assets	3,790	3,856
Total liabilities	2,823	2,998

Question 1 **(18 marks – approximately 32 minutes)**

(a) Assuming you are ABC & Co., after reading the Internal Audit report about the potential overstatement of certain exploration and production facilities, evaluate and explain the financial statement assertions that concern you most relating to fixed assets.

(3 marks)

(b) In response to your risk assessment explained in Question 1(a), what audit procedures would you consider in addressing the risk of material misstatements you identified?

(15 marks)

Question 2 **(13 marks – approximately 23 minutes)**

(a) Assuming you are ABC & Co., in response to the accident in the Gulf of Sankala, identify three risks of material misstatements of Super Energy's financial statement as at 31 December 2011.

(3 marks)

(b) In response to the risk of material misstatements identified in Question 2(a), suggest and discuss the audit procedures that you would perform in order to address the assessed risk of material misstatements.

(10 marks)

Question 3 (5 marks – approximately 10 minutes)

Assuming you are ABC & Co., in a recent dialogue with the Internal Audit, you understand that the Internal Audit has issued an unsatisfactory report on the access control of the Flex Accounts which are the general ledger used by Super Energy worldwide. For risk assessment purposes, what are the additional procedures you would suggest to perform?

(5 marks)

Question 4 (14 marks – approximately 25 minutes)

According to the Code on Corporate Governance Practices in Hong Kong and in response to the accident in the Gulf of Sankala, discuss how the following stakeholders could discharge or perform better their own functional duties and related corporate governance responsibilities towards financial reporting and internal controls:

(a)	**The board of directors**	**(6 marks)**
(b)	**Audit Committee**	**(4 marks)**
(c)	**ABC & Co.**	**(4 marks)**

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End of Section A

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

Existence and completeness due to certain significant controls over fixed asset registration were not properly implemented by the operation team;

Valuations due to certain significant control over fixed asset valuation were not properly implemented by the operation team.

Answer 1(b)

In response to the assessed risks of the fixed assets described in 1(a), ABC & Co. should consider whether the audit procedures are affected in terms of scope (e.g. additional procedures required) and extent (e.g. more sample sizes) in response to the risk identified.

Some audit procedures are suggested below:

Existence & Completeness

- Understand the scope of the Internal Audit investigation report, e.g. location, business processes and controls.
- Understand from the Internal Audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to fixed assets.
- Confirm that Super Energy physically inspects all items in the fixed asset register at year end.
- Inspect high value items from the fixed asset register at year end. Confirm the items inspected exist and are in good condition and have correct serial numbers.
- Confirm that Super Energy reconciles opening and closing assets by serial numbers as well as amounts.
- Obtain the fixed asset register with gross book value, accumulated depreciation and net book value, and reconcile with the opening position.
- Compare the fixed asset balance in the general ledger with the fixed assets register and obtain explanations for any differences.
- For a sample of fixed assets which physically exist, confirm that they are recorded in the fixed asset register.

Valuation

- Understand the scope of the Internal Audit investigation report, e.g. location of the exploration and production facilities that may have been potentially overstated or understated.
- Understand from Internal Audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to fixed assets.
- Verify the valuation of the exploration and production facilities in the valuation report.
- Consider the source of valuation and review the valuation report, e.g. experience of valuer, scope of work, methods and assumptions used, and valuation bases are in line with accounting standards.

Answer 2(a)

In response to the accident, assessing the risk of material misstatements relating to Super Energy's financial statements as a whole, ABC & Co. should consider the following:

- The occurrence and completeness of the expenses incurred and paid relating to the accident.
- The adequacy of the provision for claim and litigation provided against the parties affected by the accident.
- The adequacy of the disclosure made in the financial statements in response to the accident e.g. provision and contingency made.
- The potential asset impairment loss after the accident.

Answer 2(b)

ABC & Co. should consider the below audit procedures.

In response to the risk of material misstatement relating to the expenses incurred and paid:

- Understand and evaluate the controls in place for initiating and recording the expenses incurred and paid.
- Identify and validate the key controls relating to the expenses incurred and paid.
- Review the voucher register and expense ledger for large or unusual items.
- Check expenses recorded in the expense ledger or cash to supporting documents such as approved requisition forms to ensure the expenses are valid and are recorded in the correct expenses ledger.
- Test the arithmetical accuracy (i.e. by recalculating the amounts) on suppliers' invoices, voucher register and expense ledger.
- Perform procedures to search for unrecorded liabilities.

In response to the risk of material misstatement relating to the provision for claim and litigation:

- Make appropriate inquiries of management and others within Super Energy including in-house legal counsel.
- Review minutes of meetings of those charged with governance and correspondence with the entity's lawyers.
- Examine legal expenses accounts.
- Meet with Super Energy's external lawyers to seek their advice and request an opinion letter if necessary.
- Request management, or those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
- Obtain details of all provisions for claim and litigation which have been included in the financial statements.
- Obtain a detailed analysis of all provisions for claim and litigation showing opening balances, movements and closing balances.
- Determine for each material provisions for claim and litigation whether Super Energy has a present obligation as a result of past events by reviewing the correspondence relating to the item and holding discussions with management.
- Compare the amount provided with the post year end payments and with any amount paid in the past for similar items.

In response to the adequacy of the disclosure made in the financial statement:

- Consider the adequacy of disclosure of provision for claim and litigation and contingent liabilities in the financial statements in accordance with HKAS *37 Provisions, Contingent Liabilities and Contingent Assets*.

In response to the potential asset impairment loss:

- Discuss with management the estimate of asset loss in the accident and understand their basis of the assessment.
- Verify the valuation of the asset in the valuation report.

Answer 3

ABC & Co. should consider the additional procedures below for risk assessment purposes:

- Review the Internal Audit Report in detail and discuss the Internal Audit findings with management and reassess the risk of material misstatements relating to the data integrity and reliability to the financial statements as a whole.

- Understand from management the remedial action plan and implementation time, e.g. use of CAAT to analyse and identify the inappropriate access, setting up a plan on rectifying the access control and segregation of duties with a detailed timeline.

- Identify whether there are compensating controls (e.g. monthly review of the exception log summarizing the control access exceptions, understand and investigate the control access exceptions etc.).

- Consider performing testing of the compensating controls by understanding, evaluating and validating the key management compensating controls.

Answer 4(a)

The board of directors of Super Energy have direct corporate governance responsibility for the accident and should:

- Perform and present a balanced, clear and comprehensive assessment of the impact of the accident on Super Energy's current year performance, balance sheet position and future prospects to both the shareholders and investors.

- Ensure maintenance of proper records for providing reliable financial, managerial and operating information for decision-making, evaluation of activities or publications relating to the accident.

- Ensure adequate control of the risks inherent in the rig operations, investigate the causes of the accident, act on the lessons learnt and improve the operation safety manual if necessary.

- Understand the impacts and implications of the accident and take appropriate actions to clean up the environment and provide appropriate compensation to those affected.

- Ensure Super Energy's compliance with applicable legislation and regulations in terms of protecting employees' safety, protecting the natural environment and compensating those affected in the accident.

- Maintain an ongoing dialogue with shareholders and in particular, use the annual general meeting or other general meetings, to communicate with shareholders the development of the accident and the company's responsive action, and encourage shareholders' participation.

Answer 4(b)

The Audit Committee has the responsibility of liaising with ABC & Co., supervising internal audits and reviewing the annual financial statements and internal controls.

In response to the accident, the Audit Committee should:

- Discuss with the board of directors the setting up of an independent committee to investigate the causes of the accident.

- Set up and supervise an independent team to understand the root cause of the accident.

- Supervise the Internal Audit to review the operational procedures, identify control deficiencies and any improvement on operation procedures as required.

- Discuss with the board of directors and / or external advisors the procedures setting up for claims from those affected.

- Discuss with legal, finance and accounting departments / units and the Internal Audit the adequacy of provision and contingency made against the accident and the sufficiency of disclosures made in the quarterly and annual reports.

Answer 4(c)

ABC & Co. does not have direct corporate governance responsibility for the accident, but they are required to provide a check on the information aspects of corporate governance.

In response to the accident:

- ABC & Co. is required to give an opinion on whether the financial statements give a true and fair view, audit the validity of the expenses incurred, and assess the adequacy of provision and contingency made in response to the accident.

- ABC & Co. need to have an understanding of the internal controls on expenses incurred, provision and contingency made in response to the accident, and should report any material weaknesses in internal control to the board and audit committee.

- ABC & Co. should communicate with the board or audit committee about significant risks that require disclosure in the financial statements, any uncertainties about the going concern assumption, any disagreements they have with management about the financial statements, and so on.

- ABC & Co. may be asked to check whether Super Energy follows the provisions in the Corporate Governance Code for the effectiveness of the system of internal control reviewed and reported on. This should cover all significant controls, including financial, operational and compliance controls and risk management systems.

* * * END OF SECTION A * * *

Hong Kong Institute of Certified Public Accountants
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Qualification Programme Examination Panelists' Report

Module C – Business Assurance
(June 2012 Session)

(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)

(I) Section A – Case Questions

General Comments

Section A was based on a practical case in which candidates were asked to address common business assurance and auditing issues. Though the case was set in the context of an oil & gas company, the questions focused on general audit issues such as fixed assets, adequacy of provision, expenses cut-off, etc. The questions were not industry-specific. The questions were designed to engage candidates in a discussion of more practical issues.

Candidates should note that marks are awarded mostly on how well relevant auditing standards are applied. This means marks will only be given when candidates are able to demonstrate that they understand the issue and apply the auditing standards appropriately.

Candidates are reminded to read the questions carefully in order to understand the exact requirements, instead of jumping into the answers too quickly and providing irrelevant answers. The problem of not fully understanding the questions was highlighted by the unsatisfactory answers to Question 2 and Question 3.

Some candidates copied too much from the Learning Pack. The objective of this examination required candidates to apply more common sense and business thinking skills. Candidates are reminded to not just directly copy from the learning materials, but to apply the knowledge to the real-life practical cases.

Specific Comments

<u>Question 1(a) – 3 Marks</u>

This question was straightforward. Candidates were asked to evaluate and explain the financial statement assertions relating to fixed assets that would concern them most in response to the facts and circumstances specified in the case.

Candidates performed well in this question. Most of the candidates were able to identify at least two financial statement assertions in addressing the risk specified in the case. However, some candidates were not able to explain well why those financial statement assertions were at risk.

Question 1(b) – 15 Marks

This question required the candidates to discuss the proposed audit procedures in addressing the risks of material misstatements identified in Question 1(a).

Candidates performed unsatisfactorily in this question. Candidates were unable to demonstrate that they fully understood the facts stated in the Internal Audit Report which were important for determining the specific audit procedures. Some candidates only suggested general audit procedures, such as understanding the depreciation policy adopted by management, recalculating the depreciation, performing an analytical review, etc., which could not address the specific risk pertaining to the case.

Question 2(a) – 3 Marks

This question required the candidates to identify three risks of material misstatements of the financial statements in response to the accident specified in the case.

Some candidates followed the wrong direction in tackling this question. They analyzed the risks from the boarder perspectives such as business risk, operational risk, going concern, non-compliance of laws and regulations, etc. However, the question required candidates to discuss the specific risks in response to the accident that may affect the financial statements. Some candidates were able to identify the facts of the accident but were unable to translate the facts into the issues that may affect the financial statements.

Question 2(b) – 10 Marks

This question required the candidates to discuss the proposed audit procedures in response to the risk of material misstatements identified in Question 2(a).

Candidates did not perform well in this question. Some candidates could not fully understand the question and the impact of the accident on the financial statements. Therefore, the audit procedures suggested by the candidates were too general and were not able to address the specific risk identified in Question 2(a). Some candidates focused on the audit procedures in response to the increased engagement risk e.g. increase in professional scepticism, etc.

Question 3 – 5 Marks

This question required the candidates to suggest additional procedures for risk assessment purposes in respect of the unsatisfactory Internal Audit findings on system access.

Quite a lot of candidates misunderstood the question and provided irrelevant solutions such as assessing the competence of the Internal Audit, copying from the Learning Pack the general audit procedures for IT and system audit, jumping to the conclusion that there could be fraud, etc. Some candidates did not understand the role and function of an Internal Audit. Very few candidates suggested that there could be compensating controls and related testing approach. Some candidates did not attempt the question.

Question 4(a) – 6 Marks

This question required the candidates to discuss the Board of Directors' duties in response to the accident specified in the case within the Code of Corporate Governance Practice in Hong Kong. The question was direct and easy to understand but required the candidates to apply a thorough understanding of the Code of Corporate Governance and common sense.

The overall performance on this question was not satisfactory due to candidates not fully understanding the roles of the Board of Directors within the Code of Corporate Governance Practice. Some candidates copied directly from the Learning Pack and were not able to provide relevant responses.

Question 4(b) – 4 Marks

This question required candidates to discuss the Audit Committee' duties in response to the accident specified in the case within the Code of Corporate Governance Practice in Hong Kong. The question again required the candidates to demonstrate their understanding of the roles of the Audit Committee and apply their knowledge to a practical case.

Some candidates could not distinguish between the responsibility of the Board of Directors and the Audit Committee. Quite a lot of the candidates could only state the basic responsibility of Audit Committee but were not able to relate their knowledge to the case.

Question 4(c) – 4 Marks

This question required the candidates to discuss the auditor's duties in response to the accident specified in the case within the Code of Corporate Governance Practice in Hong Kong.

The question was straightforward. Candidates performed well in this question. In general, candidates were able to address this question properly by referencing the Learning Pack.

(II) Section B – Essay/Short Questions

General Comments

Candidates generally performed well in questions which required explanations of auditing skills and knowledge. However, when questions became more practical based on some "real-life" issues that candidates should be familiar with, the results were disappointing possibly due to inadequate examination preparation and/or inadequate work experience.

SECTION A – CASE QUESTIONS (Total 50 marks)

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

CASE

Cheese and Cream Cake Limited ("CCC") is a limited liability company incorporated in Hong Kong. CCC is a chain of upmarket cake shops with five shops in Central, Admiralty, Causeway Bay, Tsim Sha Tsui and Tai Kok Tsui respectively. The shops in Admiralty and Tai Kok Tsui are located within upmarket shopping malls, whilst the rest are on main street at prime locations.

Mr. Tom Tam ("the Father") and his wife ("the Mother") founded CCC about fifteen years ago and introduced some special ingredients into tiramisus and American cheese cakes which have become very popular amongst local customers. The Father had 80 percent of CCC's equity, whilst the Mother held the remaining equity. The couple's two daughters (known as "the 1st Daughter" and "the 2nd Daughter" respectively) helped the Father to operate CCC until 2009.

The Father passed away in 2009, and the 1st Daughter and the 2nd Daughter have each inherited 40 percent of CCC's equity from him. The 1st Daughter and the 2nd Daughter have jointly managed CCC since then.

CCC is regularly featured in the media and has received various best quality and favourite cakes awards. Local customers as well as tourists from mainland China and overseas are attracted by its speciality tiramisus and American cheesecakes.

ABC & Co has been the auditor of CCC since 2007. Mr. Au at ABC & Co. ("ABC") is the engagement partner in charge of CCC's audit. Between 2007 and 2010, ABC's audit opinions on CCC's financial statements were all unqualified. CCC's management accounts for the year ended 31 December 2011 show a net profit of HK$19 million.

In 2010, CCC started packaging its specialty tiramisus and American cheesecakes in sealed boxes for sale in department stores in order to take advantage of the booming tourism and retail market in Hong Kong. Gift vouchers were also introduced in 2010 and have proven to be a very successful initiative when many customers bought the gift vouchers as Christmas presents for their families and friends.

There have been heated arguments between the 1st Daughter and the 2nd Daughter over the direction and operation of CCC's business since the Mother passed away in early 2011. The Mother left her entire stake in CCC's equity to the 1st Daughter who has become the majority shareholder. The 1st Daughter has put her son on the Board of CCC. The 2nd Daughter has accused the 1st Daughter of abusing her powers in the running of CCC's business.

In mid-2011, a discrepancy in the stock of gift vouchers with a total face value of HK$1.1 million was discovered. The stock of gift vouchers in hand could not be reconciled with the quantity issued and sold to customers. Comparing the print-runs and stacks of gift vouchers with the stock held in hand indicated that gift vouchers with a face value of HK$2.5 million were issued between January 2011 and June 2011. However, the sales records only showed that gift vouchers totalling HK$1.4 million were sold during the same period.

In mid-2011, CCC's management requested a proposal from a computer consulting firm in respect of the design, supply and installation of an integrated computer system. Under the proposed system, CCC seeks to link together its accounting and operating functions and to feed the sales and inventories records of the five shops into the headquarters accounting system giving real-time information for the management to make timely decisions, such as changing the product-mix and facilitating the procurement arrangements.

In late-2011, the 2nd Daughter, through her lawyers, warned that she would apply for the winding-up of CCC and argued that she could no longer tolerate the 1st Daughter's abuses of power. CCC's prosperous business appears unaffected by the dispute between the 1st Daughter and the 2nd Daughter.

The 1st Daughter has offered to buy the 2nd Daughter's shares as CCC's business is a going-concern and it would not make any sense to wind it up. Before the winding-up petition is filed, the 1st Daughter and the 2nd Daughter have resolved their row in a mediation and have agreed to jointly appoint a single expert in assessing a fair value of CCC's equity which could possibly form the basis for the 1st Daughter to buy the 2nd Daughter's equity.

In December 2011, the 1st Daughter expressed her intention to appoint ABC as the single expert. However, the 2nd Daughter nominated another CPA firm to carry out the valuation.

In January 2012, a group of tourists from mainland China was reported to have suffered from severe food poisoning after eating CCC's tiramisus and were hospitalized for a few days. A formal complaint was filed with CCC's management in February 2012, and a lawsuit is likely to follow if CCC fails to come up with a proposal acceptable to the victims.

Question 1 **(12 marks – approximately 22 minutes)**

ABC & Co. ("ABC") is currently considering whether or not to act as the single expert in the valuation.

Required:

(a) What independence issues should ABC address? (8 marks)

(b) What possible safeguards should ABC put in place? (4 marks)

Question 2 **(12 marks – approximately 22 minutes)**

Identify and explain the specific controls which should be in place to ensure the proper functioning of CCC's proposed integrated computer system.

(12 marks)

Question 3 **(17 marks – approximately 31 minutes)**

ABC is currently planning for the audit of CCC's financial statements for the year ended 31 December 2011.

Required:

(a) Other than fraud risks, identify and explain the risk of material misstatements at the assertion level for particular account balance(s) in response to the discrepancy in gift vouchers.

(5 marks)

(b) Identify the internal controls which should be in place relating to the issue, redemption, safekeeping and recording of gift vouchers.

(4 marks)

(c) Discuss how ABC should exercise professional scepticism in response to the discrepancy in gift vouchers.

(8 marks)

Question 4 **(9 marks – approximately 15 minutes)**

ABC has substantially completed the audit of CCC's financial statements for the year ended 31 December 2011. The discrepancy in gift vouchers has been resolved, and ABC is generally satisfied that there are no material misstatements. ABC has just been notified by CCC's management about the food poisoning scandal.

Required:

Discuss the audit procedures that ABC should carry out in respect of the food poisoning scandal before concluding its audit opinion on CCC's financial statements for the year ended 31 December 2011. Comment on the disclosure requirement.

(9 marks)

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End of Section A

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

As ABC & Co is the auditor of CCC, consideration of whether or not to act as the single expert should be made with reference to the possible impacts on ethical issues relating to the audit engagement.

The single expert's valuation will indicate a fair value of CCC's equity which could possibly form the basis for the 1st Daughter to buy the 2nd Daughter's equity. As the valuation will affect a transaction between the two shareholders rather than CCC itself, the financial statements may not be materially affected.

Under the Code of Ethics for Professional Accountants, ABC & Co should assess the levels of self-review threat, self-interest threat, familiarity threat, advocacy threat and intimidation threat. ABC & Co should be able to accept the engagement if such threats can be maintained at an acceptably low level.

Self-review threat may be created as the valuation exercise may rely on audited financial statements. However, the valuation exercise will take into account many other factors beyond the audited financial statements.

If the single expert's valuation is to be adopted in CCC's financial statements (which is not likely in this case) which are subsequently subject to ABC & Co's audit, a self-review threat arises.

Self-interest threat and familiarity threat may be created if Mr. Au or his team has a close relationship with CCC's shareholders, directors or senior management.

An advocacy threat may be created if the fair value from the valuation is adopted in litigation when the proposed transaction between the 1st Daughter and the 2nd Daughter turns sour.

The 2nd Daughter has nominated another CPA firm to be the single expert. An intimidation threat may be created if the 2nd Daughter insists on her choice. Even if the 2nd Daughter agrees to appoint ABC & Co, she may not fully co-operate during the valuation exercise, particularly as the 1st Daughter and the 2nd Daughter are likely to be multiple responsible parties providing information for the valuation.

Answer 1(b)

As possible safeguards, ABC & Co should:

- involve an engagement partner on the valuation other than Mr. Au;
- involve a second partner review to ensure any contentious issues are well addressed;
- use separate teams for the valuation and the audit;
- confirm with the 1st Daughter and the 2nd Daughter regarding how the inputs, assumptions and calculations are reached in the valuation; and
- ensure that the 1st Daughter and the 2nd Daughter both acknowledge their responsibilities towards the supply of accurate and unbiased information for the valuation.

Answer 2

The specific controls which should be in place to ensure the proper functioning of CCC's proposed integrated computer system are as follows:

System design and supply

The design of the proposed integrated computer system should be secure, reliable, efficient, agile and cost-effective. Therefore, user involvement and management input are important during the system design and the selection of hardware supplies.

Also, consideration should be made regarding the system lifecycle and the possibility for future upgrades.

Training and implementation

Proper training about the system should be provided to front-line staff (for operation) as well as to management staff (for review and control) before implementation.

Implementation may be done in phases and/or in parallel with the existing system for an initial trial period.

Location of terminal devices

Terminal devices will be located throughout the five shops in Central, Admiralty, Causeway Bay, Tsim Sha Tsui and Tai Kok Tsui. Two of the shops are in shopping malls, whilst the rest are on main street at prime locations. As layouts and fittings are different, consistent and adequate control procedures, system infrastructures and technical support should be in place covering all the terminal devices regardless of their locations.

Access controls

Each of the terminal devices should be physically secured. Access controls should be exercised through a combination of user's identities, passwords and security keys. Users' identities should be unique to individual cashiers or operators. Passwords should be confidential subject to periodic prompted changes.

An automatic log-off function should be installed in case the screen is left idle for, say, 2 minutes.

Confidential data should be encrypted for transit. A firewall should be installed against hacking and intrusion.

Back-up files and contingency plans should be kept to avoid disruptions and to ensure data integrity.

Transaction trails

Transactions are recorded as they occur under the proposed real-time integrated system. It is possible that some visible transaction trails will be lost or will not be produced.

Some manual supporting records should be kept for such purposes. Alternatively, input data should be logged to provide the trails through the issue of printouts from the terminal on a daily basis.

Reporting and review

Audit logs, exception reports and other security monitoring reports should be prepared.

These reports should be reviewed by CCC's management for endorsement and/or appropriate actions.

Answer 3(a)

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* requires ABC & Co to gather, review and analyse the information through observation, inquiry and discussion to create a picture of CCC as a whole in order to understand the particular risks it faces.

Gift vouchers which are issued and sold to customers represent an obligation for CCC to provide the holders of those vouchers with goods and services equating to the face value of those vouchers. Therefore, it should form a liability in CCC's financial statements.

Comparing the print-runs and stacks of gift vouchers with the stock held in hand indicated that gift vouchers with a face value of HK$2.5 million were issued between January 2011 and June 2011. However, the sales records only showed that gift vouchers totalling HK$1.4 million were sold during the same period. Therefore, the completeness of CCC's liability and cash at bank is questionable. In particular, CCC's liability could have been understated by HK$1.1 million and the corresponding misstatement is likely to be an understatement of cash at bank of HK$1.1 million.

The discrepancy amounted to HK$1.1 million which is more than 5 percent of CCC's net profit (HK$19 million) according to its 2011 management accounts. It is therefore likely to be material.

<u>Answer 3(b)</u>

ABC & Co. should understand and evaluate CCC's systems and internal control procedures relating to the issue, redemption, safekeeping and recording of the gift vouchers, such as:

- sequential pre-numbering controls and monitors of gift vouchers;
- validation and endorsement over the issue, cancellation and redemption of gift vouchers;
- physical safekeeping of gift vouchers;
- proper recording of the movements and balances of gift vouchers;
- reconciliation of gift vouchers; and
- review and approval of the reconciliation and exception reports.

<u>Answer 3(c)</u>

HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* requires ABC & Co to:

- obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level; and
- plan and perform the audit with professional scepticism.

Professional scepticism does not mean that ABC & Co should mistrust all information and representations provided by CCC and to take this approach would create a very difficult working relationship. However, a belief in the honesty and integrity of CCC's management does not relieve ABC & Co of the need to maintain professional scepticism or allow ABC & Co to be satisfied with less than persuasive audit evidence, i.e. an awareness of the nature and limitation of audit evidence is important.

By exercising professional scepticism, ABC & Co should approach the audit with a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

Therefore, ABC & Co should recognise the characteristics of gift vouchers which, in the context of auditing, may refer to its portability, convertibility and vulnerability to misappropriation.

ABC & Co should be cautious regarding any suspicious and unusual circumstances which increase the risks of material misstatements and/or indicate the evidence of fraud.

Also, ABC & Co should be aware when audit evidence contradicts other audit evidence obtained. For example, reviewing the reference numbers of the used gift vouchers (i.e. those redeemed by customers) should help to ascertain the causes of the discrepancies. If CCC can identify any particular customer who bought a large volume of gift vouchers (e.g. a bank using the gift vouchers as free gifts for its own customers), ABC & Co may consider sending a confirmation to that customer.

ABC & Co should avoid using unrealistic assumptions in designing audit procedures or evaluating audit evidence, e.g. sending negative confirmations to a large number of customers of CCC is not likely to produce any persuasive audit evidence.

ABC & Co should consider the reasonableness of CCC's management responses to the discrepancy, i.e. whether or not and to what extent an investigation has been conducted; the findings of the investigation; the actions to contain and correct the discrepancy; and the measures to prevent the same problem from happening again.

Answer 4

ABC & Co should consider if the food poisoning scandal (and forthcoming claim) would affect its assessment of the risk of material misstatements in respect of CCC's financial statements.

The scandal is an event which took place between the date of the financial statements and the date of the auditor's report. HKSA 560 (Clarified) *Subsequent Events* requires ABC & Co to obtain sufficient appropriate audit evidence about whether this event is properly reflected in CCC's financial statements in accordance with the applicable financial reporting framework.

In view of the nature and scale of the event (which is likely to be a non-adjusting event under HKAS 10 *Events After the Reporting Period*), a disclosure should be made in CCC's financial statements. In particular, the disclosure should cover:

- the nature and details of the food poisoning event; and
- the nature, details and expected amount of the claim to be submitted by the victims.

Before concluding the audit opinion on CCC's financial statements for the year ended 31 December 2011, CCC should:

- discuss with CCC's management the nature and details of the scandal;
- find out the assessment of the scandal by CCC's management;
- ask CCC's management if there are any significant subsequent events to their knowledge that should be brought to ABC & Co's attention;
- review CCC's management procedures for identifying subsequent events to ensure that the management is aware of the risks; and
- review CCC's internal documents up to the date of the auditor's report, such as:
  - meeting agendas, minutes and written resolutions of the board of directors and the management; and
  - correspondence with victims (claimants), lawyers, hospitals and expert doctors.

* * * END OF SECTION A * * *

Hong Kong Institute of
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Qualification Programme Examination Panelists' Report

Module C – Business Assurance
(December 2012 Session)

(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)

(I) Section A – Case Questions

General Comments

Section A was based on a practical case of a cake company with operations in Hong Kong. The questions were designed to address the business issues faced by the cake company, its owners and the auditor.

Candidates were required to have a good knowledge of the relevant auditing standards to be used in the case. Marks were given when candidates could demonstrate their understanding of the issues involved and apply their knowledge of auditing techniques and standards appropriately.

Candidates must remember that they have to read the questions carefully to understand the exact question requirements and it is never a simple requirement of copying answers straight from the Learning Pack.

Specific Comments

Question 1(a) – 8 Marks

This question required candidates to identify the independence issues on accepting other assurance services by the auditor.

Most candidates were able to apply the Code of Ethics for Professional Accountants and identified at least two out of the five threats. However, only a few candidates were able to link the case facts to the threats identified.

Question 1(b) – 4 Marks

This question required candidates to identify the possible safeguards for those threats identified in Question 1(a).

Candidates performed well in this question. Most candidates were able to identify some safeguards. The best candidates were able to highlight that this is the transaction between the two equity owners but not the cake company subject to any auditing requirement.

Question 2 – 12 Marks

This question required candidates to identify and explain the specific controls that should be adopted by the cake company with regard to the proposed integrated computer system.

The overall performance on this question was not satisfactory because candidates did not show a good understanding of the exact question requirements.

Most candidates wrongly answered from an auditor's point of view on how to audit the controls and spent time explaining the definitions of general and application controls. In particular, candidates are reminded to answer in their own words instead of copying straight from the Learning Pack.

Question 3(a) – 5 Marks

This question required candidates to identify and explain the risk of material misstatements at the assertion level for particular account balances in response to the discrepancy in gift vouchers.

The question was straightforward. However, most candidates did not analyse the accounting treatment of the gift vouchers properly in order to conclude that cash and liability were the relevant account balances.

Question 3(b) – 4 Marks

This question required candidates to identify the internal controls on the issue, redemption, safekeeping and recording of gift vouchers.

Candidates performed well in this question. Most candidates made use of the background information provided in the question to suggest the relevant controls.

Question 3(c) – 8 Marks

This question required candidates to discuss how the auditor should exercise professional scepticism regarding the discrepancy in gift vouchers and the relevant substantive procedures.

Most candidates' discussion on professional scepticism was too generic and only a few candidates were able to mention the substantive procedures.

Question 4 – 9 Marks

This question required candidates to discuss the audit procedures on subsequent events and comment on the disclosure requirements.

This was a straightforward question. Most candidates were able to identify the food poisoning scandal as a subsequent event and suggested the appropriate audit procedures to be carried out by the auditor. However, many candidates did not comment on the disclosure requirement of the subsequent event as required. Quite a number of candidates spent a lot of time covering the going concern issue and the auditor’s report which were not a question requirement.

(II) Section B – Essay/Short Questions

General Comments

Candidates generally performed well in questions which required explanations of audit principles and requirements. When questions required more analytical skill and became more practical based on “real-life” situations, the candidates' performance was generally disappointing. This might possibly be due to limited work experience or inadequate examination preparation.

Candidates were generally not confident to conclude their judgment on risk assessment. Most candidates responded with an uncertain assessment as to the risk identified. Candidates are encouraged to apply their business sense, even common sense, in dealing with the “real-life” issues in the examination and to be more confident in explaining their judgment and rationale.

Some candidates spent too much time on providing excessive descriptive materials from auditing standards and/or the Learning Pack, some of which were irrelevant or not required by the questions. Candidates were reminded that marks were mostly awarded on how well the relevant audit standards were applied to the case or questions.

Candidates are encouraged to make a reasonable attempt at all questions. Some answers by candidate were too short or in bullet points, possibly due to poor time management or inadequate presentation planning. Lastly, illegible handwriting and poor English inevitably affected the assessment.

Specific Comments

Question 5(a) – 5 Marks

This question required candidates to assess and explain their assessment in relation to the risk of material misstatement over inventory valuation.

Some candidates did not read the question carefully and gave irrelevant answers explaining the inventory risk in terms of existence, accuracy, etc. Some candidates were not confident enough to exercise judgement and concluded that the risk assessment was “high”. Some candidates concluded that the risk assessment was “high” but were unable to explain their judgement based on the facts mentioned in the case.