

Student Notes

Module C (Jun 2012)

Session	Methodologies	Chapters covered	Students Notes
Workshop 1			
1. Introduction	<ul style="list-style-type: none"> • Presentation • Group discussion 		Please refer to Workshop 1 Student Notes
2. Corporate governance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 1 & 2	
3. Overview of an audit	<ul style="list-style-type: none"> • Card game 		
4. Audit acceptance / continuance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 4 & 7	
5. Audit planning	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 8, 10, 11 & 12	
6. Project management in audit planning stage	<ul style="list-style-type: none"> • Group discussion 	Ch. 8	
7. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		
Workshop 2			
8. Reboot	<ul style="list-style-type: none"> • Presentation • Group discussion 		
9. Audit execution	<ul style="list-style-type: none"> • Individual work • Progress meeting and reporting • Group discussion 	Ch. 9, 10, 12, 13 & 15	Pg. 1 – 34
10. Project management in audit execution stage	<ul style="list-style-type: none"> • Presentation • Group discussion 		
11. Audit completion	<ul style="list-style-type: none"> • Group sharing • Group discussion 	Ch. 9, 15, 16 & 17	Pg. 35 – 47
12. Group audit	<ul style="list-style-type: none"> • Group discussion 	Ch. 18	Pg. 48 – 53
13. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		

Audit execution

Instruction to audit senior-in-charge in handling the progress meeting

You are the audit senior-in-charge and are going to lead a progress meeting with your audit team members. Each team member is responsible for the audit of a different area.

During the audit, a number of audit issues have been identified.

You have to distribute the respective audit area (in the attached handout sections) to each member at the beginning of the progress meeting. Consider the best way to allocate the work. The senior-in-charge should have information on all the issues.

In the coming progress meeting, each team member is going to report to you on an audit issue and make suggestions to resolve the issue. You will lead a discussion to agree on the required work.

Tips in handling the progress meeting:

- Set a clear objective(s) for the meeting and control the meeting so as to achieve the objective(s),
- Ensure all people attending the meeting also understand the objectives of the meeting clearly and prepare for it,
- Be familiar with the audit areas so that you can advise on the audit issues to the team members,
- Control the running of the meeting in respect of timing and content,
- Maintain a good discussion atmosphere (especially for quiet or aggressive members)

Golden Panda Jewellery Co Limited

Audit area: Tangible non-current assets

(i) Acquisition of retail premises in mainland China

As part of Golden Panda's expansion strategy, the company has acquired a number of retail premises in mainland China during the year ended 31 March 2012. John Tse, the finance director, has provided you with a schedule of the premises acquired and the associated costs to be included in the financial statements for the year ended 31 March 2012.

Premises	Premises cost (a)	Refurbishment costs (b)	Legal & professional expenses (c)	Staff time (d)	Total
	HK\$000	HK\$000	HK\$000	HK\$000	HK\$000
Oriental Mall, Beijing	14,057	3,900	1,564	1,987	21,508
Pearl River Tower, Guangzhou	13,998	3,512	1,315	1,713	20,538
The Landmark, Shanghai	10,989	5,741	974	1,287	18,991
Time Square, Chengdu	8,143	2,008	3,236	3,125	16,512
Total	47,187	15,161	7,089	8,112	77,549

Notes:

- (a) **Premises costs** consist of the actual price agreed and paid for the premises.
- (b) **Refurbishment costs** consist of all costs associated with bringing the premises to a condition appropriate for trading; this includes small building works, updating of interiors and branding. Fixtures and fittings, such as display cabinets, are capitalised separately under that category.
- (c) **Legal and professional expenses** consist of those costs incurred such as time spent by lawyers and accountants in negotiating and signing contracts, resolving disputes etc. In the case of Time Square, Chengdu, additional costs were incurred due to the original negotiation to acquire the property failing, as a result of a competitive bid being accepted, but negotiations were re-opened by the property vendor when that competitive transaction failed to complete.
- (d) **Staff time** consists of internal staff costs such as those of directors, legal and property staff spent on the transaction and supervising the refurbishment work.

(ii) Change in accounting policy

Jane Wang has passed you a copy of an email from Auric Kim, Golden Panda's CEO, regarding the company's accounting policy in respect of land and buildings.

FW: Golden Panda – accounting policy change

To: Audit senior

From: Jane Wang

Received: 09 April 2012

Attached: GPProperty.xls

I have just received this email from Auric Kim at Golden Panda – as a matter of urgency please can you identify any issues and consider the impact on the audit work that will be required in order to address the proposed action by Auric in his email.

Thanks

Jane

Golden Panda – accounting policy change

To: Jane Wang

From: Auric Kim

Received: 09 April 2012

Attached: GPProperty.xls

Dear Jane

I have been advised by an acquaintance that it would be helpful to Golden Panda's proposed listing to revalue the premises currently carried in our financial statements as these will have appreciated in value since acquisition. We wish to pursue this for the current year end in respect of the retail properties and in order to achieve this I understand that we need to obtain an expert valuation of the properties in question. We have done this (fortunately Cammi's brother-in-law works in the property industry so his company were able to do this quickly for us) and I attach a summary of the results.

I appreciate the audit work will commence shortly and therefore wanted you to see this as soon as possible so that you could consider the impact on the audit.

Kind regards

Auric Kim

Student Notes

Module C (Jun 2012) Workshop 2 – Handout 9.1 Audit Execution

Attachment: GPProperty.xls

Premises	Current cost in SOFP	Acc'd dep'n at 31 March 2011	Value in SOFP at 31 March 2011	Valuation by expert valuer at 7 April 2012	Increase in value
	HK\$000	HK\$000	HK\$000	HK\$000	HK\$000
IFC, Central	5,492	1,216	4,276	18,654	14,378
Canton Road, Tsim Sha Tsui	6,321	1,987	4,334	12,985	8,651
Festival Mall, Kowloon Tong	4,665	1,876	2,789	13,987	11,198
Total retail premises	16,478	5,079	11,399	45,626	34,227
Shenzhen production unit	3,143	2,897	246	not valued	n/a

SOFP – Statement of Financial Position

Golden Panda Jewellery Co Limited

Audit area: Trade receivables

(i) Trade receivable circularisation

As part of the planned audit procedures a sample of trade receivable balances, for wholesale sales, were selected for circularisation. A positive confirmation was carried out such that wholesale customers were asked to respond to the circularisation stating whether they agreed with the amount (per the sales ledger) or to state in what respect they disagreed with the amount stated. In total trade receivables amounting to HK\$32,083,000 were circularised of which HK\$21,795,000 were agreed as being correct in the response from the customer. The following issues arose from the remaining responses:

Wholesale customer	Balance per sales ledger at 31 March 2012 HK\$000	Amount due per response from customer HK\$000	Difference HK\$000	Notes
Bao Tin Company	4,876	-	-	No response received
Tin On Ltd	3,271	1,457	1,814	Response stated invoice for £1,814 is in dispute due to sub-standard products
RNS Trading	1,765	817	948	Invoice GP3910-1, for HK\$948,000, had not been received by RNS Trading on 31 March 2012
Jewellery Express	300	-	-	No response received
Beijing (Gold) Traders	76	0	76	Response stated invoice GP3987-2 had been paid on 13 March 2012

After further investigation the following additional information was:

Tin On Ltd:

A letter was found from this wholesale customer stating that a shipment of jewellery received on 18 March 2012 was of sub-standard quality and the customer is refusing to pay the invoice for these goods. Cammi Kim told the audit team that this customer is in breach of its contractual agreement with Golden Panda and that there were no quality issues with the jewellery in question.

RNS Trading:

On discussion with the sales ledger supervisor, you discovered that invoice GP3910-1 was posted to RNS Trading on 2 April 2012 but recorded in the sales ledger on 31 March 2012. The sales ledger supervisor told you that the goods were due to be shipped on 31 March 2012, per the contract, but the courier had arrived earlier than usual that day and so the shipment had not been boxed. Therefore the goods were shipped the next working day, 2 April.

Beijing (Gold) Traders:

You raised this issue with the sales ledger supervisor who discovered that the amount had been paid by Beijing (Gold) Traders but had been credited to the account of Beijing Jewellery Merchants Ltd in error.

(ii) Year-end allowance against receivables

You obtained a schedule setting out the calculation for the allowance against receivables as at 31 March 2012. You noticed that in spite of the trade receivables gross balance being higher than in the prior year that there was a reduction in the overall provision. You therefore asked to see the same calculation for the provision in the prior year in order to compare them.

The table below sets out the comparison:

	Allowance calculation year ended 31 March 2012 HK\$000	Allowance calculation year ended 31 March 2011 HK\$000
Allowances against specific accounts:		
Sam Tse Limited ¹	2,189	2,189
Mong Kok Jewellery Company ²	-	1,061
Other specific allowances	1,020	956
General allowance	4,812	6,310
Allowance at year end	8,021	10,516

Note 1: The balance due from Sam Tse Limited continues to be outstanding from the prior year. You discover that the sales ledger team commenced legal proceedings in October 2011 and these have been slow to progress.

Note 2: The balance due from Mong Kok Jewellery Company continues to be outstanding at 31 March 2012 however, the head of the accounts team has told you that the company has committed to paying the outstanding balance in full and therefore the allowance against this account has been written back.

Golden Panda Jewellery Co Limited

Audit area: Cash

(i) Bank reconciliation

As part of the planned audit procedures, the audit junior has audited the bank reconciliation for Golden Panda's main bank account. All uncleared lodgements, cheques and items on the bank statement not in the cash book were agreed to the cash book and post year-end bank statements. He has now passed the work on to you to review.

			HK\$'000	HK\$'000
Balance per bank statement at 31 March 2012*				40,456
Add: uncleared lodgements				
<i>Cash book date</i>		<i>Date cleared</i>		
31/03/12		04/04/12	675	
24/03/12		04/04/12	4,044	
29/03/12		06/04/12	218	
27/03/12		05/04/12	19,756	
31/03/12		10/04/12	<u>2,777</u>	
				27,470
Less: uncleared cheques				
<i>Cash book date</i>	<i>Cheque number</i>	<i>Date cleared</i>		
30/03/12	5736	02/04/12	2,055	
31/03/12	5744	18/04/12	778	
31/03/12	5745	19/04/12	3,052	
31/03/12	5746	23/04/12	233	
31/03/12	5747	22/04/12	9,915	
31/03/12	5748	19/04/12	10,452	
				(26,485)
Items on bank statement not in cash book				
<i>Bank statement date</i>				
31/03/12			(1)	
31/03/12			<u>2,000</u>	
				(1,999)
Balance per cash book at 31 March 2012				<u>39,442</u>
* agreed to bank statement				

Golden Panda explanations for items on bank statement but not on cash book:

- HK\$1k relates to unexpected banking charges. These were entered on the cash book on 2/4/2012
- HK\$2m relates to an amount credited to Golden Panda in error by the bank. The item can be seen to be deducted from the bank statement on 1/4/2012

(ii) Bank confirmation letter

When preparing for the final audit, you sent bank confirmation requests to all banks where Golden Panda holds an account. Request letters were sent in advance of the audit to give the banks enough time to respond before year-end audit procedures commenced.

Whilst reconciling the responses to the bank statements, you noted that a response was missing from a deposit account with George Town Bank based in the Cayman Islands. You tried calling and emailing the bank several times but have been unable to get a response.

On the way home from work you noticed the following article in the newspaper.

Hong Kong Times

Cayman Islands cyclone clean-up begins

George Town, 12 May 2012

The rescue operation is coming to an end after the devastating tropical cyclone that hit the Cayman Islands last week.

The death toll currently stands at 5,261 but is expected to rise as hundreds of residents are still missing. A three year old girl was rescued yesterday but hopes of finding any more survivors are fading fast.

The long clean-up operation is now beginning. It is estimated that the massive storm surge produced by the cyclone destroyed 50% of property on the islands. Around 25,000 people are thought to be homeless and many local businesses have been completely destroyed.

On March 31st 2012 the general ledger was showing the account balance at HK\$10m.

Golden Panda Jewellery Co Limited

Audit area: Inventory

(i) Inventory count and valuation

Whilst an inventory count at retail premises was not undertaken, due to reliance on the stock control system in each store, a full inventory count was required at each of the production units operated by Golden Panda.

Inventory at each unit consists of raw materials and finished goods. There is no work-in-progress as any work in production at the end of each day is completed before the production unit closes for security reasons.

As in previous years, Golden Panda hired a firm of external specialist auditors; Fung Wei & Co, to assist Golden Panda staff in the inventory count at each production unit and value the inventory on hand. Fung Wei & Co has made their report available to Yin Yang & Co for the purposes of the external audit.

As part of the firm's audit planning the competence, capabilities and objectivity of Fung Wei & Co were found to be appropriate and the scope and objectives of their work, as set out in their plan was considered to also be appropriate. No staff from Yin Yang & Co attended any of the inventory counts.

You have recently received Fung Wei & Co's report on the year-end inventory count and valuation which includes the following sections:

- Results of test counts – the outcome of Fung Wei & Co staff test counts on inventory counted by Golden Panda staff
- Issues arising – a summary of any issues identified by Fung Wei & Co staff during the year end count
- Valuation – basis and methods applied to valuing the inventory
- Appendix containing detailed table of inventory quantities, valuation and totals to be included in the financial statements

Jane Wang, the audit partner, has now asked you to perform any additional work necessary in order to ensure Yin Yang & Co is satisfied with the amount recorded for year-end inventory at production units. The following is an extract from the 'issues arising' section of Fung Wei & Co's report:

Issues arising

The following issues arose during the course of our work. Issues were discussed with management and the outcome of such discussions, where appropriate are also recorded.

Issue 1

At the time of the inventory count at the Qingdao production unit, there was a quantity of inventory that had recently been completed for two wholesale customers but which had not been dispatched. The inventory was due to leave the production unit on 31 March however the courier arrived before the inventory had been packaged and therefore the courier was

asked to return on 2 April in order that the goods could be dispatched. The total value of this inventory was HK\$897,000 with a sales value of HK\$1,130,220. As the inventory was still on the premises at the time of the count it is included in the total figures provided.

Issue 2

(ii) Valuation of finished goods

As part of your firm's audit procedures in respect of the value of finished goods inventory held in the retail stores at the year-end, the audit team has been reviewing the value attributed by Golden Panda to items of inventory that have been purchased from external suppliers. These include finished items of gold jewellery and watches.

As part of the audit work on the valuation of watches a member of the audit team has brought the following article to your attention. You have ascertained that Golden Panda has had HK\$11 million of inventory in its stores at the year-end which had been purchased from TixTox, one of its major suppliers and the manufacturer referred to in the article from the online magazine: Focus on Consumer.

Time up for TixTox

13 April 2012

TixTox watches have been synonymous with quality and style for generations along with this prestigious manufacturer's 'no problem' attitude when it comes to dealing with customer complaints or issues and replacing or mending items under warranty.

It is ironic therefore that today's shock announcement by TixTox's owner-managers that the watch giant is to be wound up is the result of a much publicised wrangle over the treatment of its warranties in its financial statements and an argument with its creditors and auditors.

The demise of the company is also going to leave consumers short-changed as current warranties on TixTox watches will no longer be honoured. This means that if you buy a TixTox watch from a retailer now you are not covered in the event that the watch goes wrong and needs repair.

In spite of loving this manufacturer and all they have stood for, it would be too much of a gamble to invest in a watch of this value without cover. Our consumer advice therefore is to consider one of the other high-end brands still in production!

Golden Panda Jewellery Co Limited

Audit area: Contingent liabilities and provisions

(i) **Breach of contract**

During your firm's review of the board minutes of Golden Panda an issue was identified regarding a legal claim being made by a wholesale customer, Ming Jewellers, in respect of a breach of contract for bespoke production of gold jewellery items. The board minutes note that the directors do not believe that the customer has any grounds for the claim as they believe that Golden Panda has fulfilled the terms of the contract and therefore no amounts in respect of the issue have been included in the year-end financial statements.

On making enquiries with management regarding the issue you were provided with the following letter from Ming Jewellers' legal advisors which sets out the basis of the legal action against Golden Panda:



Frederick Lee Commercial Law Office
Suite 37B
Central Towers
135 Main Road
Central

19 January 2011

Cammi Kim
Managing Director
Golden Panda Jewellery Company
28/F Golden Tycoon Centre
555 Nathan Road
Mongkok

Dear Ms Kim

Notice of legal action in respect of breach of contract between Golden Panda Jewellery Company, Hong Kong and Ming Jewellers, Hong Kong

I am writing to you on behalf of our client, Ming Jewellers, who have instructed this firm to proceed with legal action resulting from the breach of contract, dated 15 August 2011, by Golden Panda Jewellery Company (Golden Panda) for the production and supply of a bespoke range of gold jewellery.

In the contractual agreement between Golden Panda and Ming Jewellers, Golden Panda committed to produce and supply 1,000 units of jewellery comprising necklaces and bracelets to a bespoke design, known as the Lustre Collection, which was created through collaboration between the two companies, specifically for Ming Jewellers. The contract was for exclusive design and supply (see section 5.8 of the contract).

After receipt and payment of the shipment had taken place in November 2011, Ming Jewellers identified a jewellery collection, the Lustric Collection, for sale in the retail market by a competitor company which bore significant similarities in both design, quality and target market to those of the Lustre Collection. The Lustric Collection was also designed and produced by Golden Panda.

My clients believe that the supply of this product to a competitor company is in breach of the contractual agreement between Golden Panda and Ming Jewellers. However, after a number of attempts to resolve the issue with Golden Panda management through informal channels, without success, my client has instructed us to pursue formal legal action.

Ming Jewellers will be seeking recovery of the full amount paid for the 1,000 units of jewellery as well as compensation for costs incurred in the design and marketing projects associated with the collection and loss of revenue as a result of being unable to launch the collection to the public.

Yours sincerely,

JLee

Jane Lee

Senior Legal Executive

(ii) Warranty provision (retail sales)

During discussions with the Head of Accounts at Golden Panda you noted the following information regarding the warranties offered by Golden Panda to its retail customers when they purchase an item of jewellery from Golden Panda:

Golden Panda warranties

- 1) A standard 5 year warranty is given on all purchases to retail customers free of charge
- 2) Each warranty allows for Golden Panda to either repair or replace an item, at no cost to the customer, which is found to be defective and is returned to the original store during the 5 year warranty period
- 3) Historically the claims under warranties have been low due to the high quality of products and a warranty provision of 0.2% of sales is made each year
- 4) In April 2011 Golden Panda introduced a lifetime warranty on items with a sales price in excess of HK\$64,000

Golden Panda Jewellery Co Limited

Supplementary Task

Audit area: Trade payables

(i) Supplier statement reconciliations

As part of the planned audit procedures a sample of supplier statements were selected for reconciliation to the balances, for those suppliers, on the trade payables ledger. The balance in the draft financial statements at 31 March 2012 is HK\$111,573,000. A member of the audit team undertook the audit procedure and you are now required to review the results of this audit procedure:

Supplier	Trade payable per purchase ledger at 31 March 2012 HK\$000	Balance due per supplier statement at 31 March 2012 HK\$000	Difference HK\$000	Amounts paid not shown on statement HK\$000	Invoices on ledger entered after statement date HK\$000	Unreconciled difference HK\$000
Wing Sing	4,490	6,635	2,145	(70)*	50^	2,125
Tai Fong	3,895	3,945	50	(40)	-	10
Yun Fat	3,450	3,660	210	(60)	-	150
Hong Sing	1,655	1,695	40	-	40^	-
Others	635	695	60	(65)*	5^	-

* Agreed to payment on bank statement ^ Agreed to supplier invoices

Discussion points

Audit execution

Audit area – Tangible non-current assets

(i) Acquisition of retail premises in mainland China

What is the issue?

- A number of premises have been acquired in mainland China and will need to be presented in the financial statements
- The total costs proposed to be capitalised by management is HK\$77,549,000 which is 8.8% of total assets and therefore material to the financial statements
- The directors of Golden Panda have included a number of costs in the overall acquisition costs, some of which may not be permitted to be included under Hong Kong accounting standards, e.g. internal staff costs
- Refurbishment costs may be inappropriately capitalised and in the case of The Landmark, Shanghai, these appear to be disproportionately large compared to the cost of the property and those costs incurred on other properties
- Legal and professional expenses relating to the Time Square, Chengdu property are high compared to other properties acquired due to the inclusion of expenses relating to a failed negotiation. It is likely that such costs should be recognised in profit or loss during the year

What is the implication for the audit evidence and the financial statements?

- Appropriate amounts will need to be capitalised as tangible non-current assets in the financial statements
- However, expenditure not meeting capitalisation criteria set out by accounting standards must be recognised in profit or loss
- There is a risk of management bias, particularly given the proposed listing of Golden Panda, that items that should be charged to profit or loss are capitalised
- Appropriate depreciation policies will also need to be applied to the premises acquired. As these are estimates they may also be subject to management bias
- Audit evidence must be obtained for each aspect of the premises' costs that are being capitalised as well as the appropriateness of management's estimate of the premises' useful life

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- The original final agreement for the purchase of the premises should be inspected for each property and the amount paid agreed to bank statements
- A breakdown of the refurbishment costs should be obtained for each property and reviewed for appropriateness in terms of whether the items included are capital in nature
- For a sample of refurbishment costs, these should be traced to appropriate documentation such as invoices from suppliers or agreements with contractors
- Legal and professional expenses should be traced to invoices and the nature of each item reviewed as to whether it is appropriate to include it in the cost of the asset
- Discussions should be held with management to better understand the basis for capitalising all of the legal and professional expenses associated with the acquisition of Time Square, Chengdu
- The basis for including staff time should be discussed with management including what documentation is available to support the staff time, how the cost of such time has been calculated and whether the staff were employed specifically for this purpose or whether they were already employed by Golden Panda

(ii) Change in accounting policy

What is the issue?

- The directors of Golden Panda wish to change the accounting policy in respect of property valuation from one of historical cost to one of revaluation method
- The current proposed revaluation (ignoring depreciation) is HK\$34,227,000 which is 3.9% of total assets and therefore material to the financial statements
- The valuation of property is subjective and has been carried out by a firm of expert valuers who appear to be related to the directors. This may increase the risk of bias and an inappropriate valuation

What is the implication for the audit evidence and the financial statements?

- The motivation of management for the revaluation is to improve the view presented by the financial statements in light of the proposed listing of Golden Panda – therefore there appears to be an element of management bias in this decision
- The valuation will need to be reflected in the financial statements and will impact on both the statement of financial position and the statement of comprehensive income, through increased depreciation charges
- The reliability of the expert valuer's report must be considered
- The accounting for revaluation of assets is complicated and errors may occur in recording the revaluation in the accounting records

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Further discussions should be held with management to understand the basis for the change in accounting policy including reasons for not including the production unit in the revaluation exercise
- An original copy of the report by the expert valuer should be obtained and the valuations proposed by management agreed to the report
- Procedures to ascertain the reliability of the expert valuer's report should be undertaken including their degree of independence, their qualifications, the appropriateness of the conclusions reached
- Prices of similar properties in the area should be reviewed and compared to the valuations proposed for reasonableness
- The accounting treatment should be reviewed in the financial statements and amounts recalculated to ensure no errors have arisen
- Depreciation charges based on the new revalued amount should be calculated and compared to the charges included in the financial statements
- The notes to the financial statements should be reviewed for appropriate disclosures regarding the change in accounting policy

References

The above is based on the following auditing standards:

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* states that materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Auditors need to use professional judgment in determining materiality and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

The concept of materiality is applied by the auditor in:

- (a) planning and performing the audit
- (b) evaluating the effect of identified misstatements on the audit
- (c) evaluating the effect of uncorrected misstatements on the financial statements i.e. the nature of the uncorrected misstatements
- (d) forming the opinion in the auditor's report

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks* requires that the auditor shall evaluate the audit evidence obtained and consider whether the assessment of risk of material misstatement at the assertion level remains appropriate.

The auditor must conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptable low level.

Further audit evidence must be obtained if the auditor has not obtained sufficient appropriate audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor must modify the auditor's report.

Any unexpectedly high misstatements found in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated. The auditor should consider whether the sample results provide a reasonable basis for conclusions about the population and should further consider the likelihood of actual misstatement in the population.

The auditor should consider the results of other audit procedures in order to assess the risk of misstatements in the population. The auditor may further request management to investigate the identified misstatements and consider whether management shall make any necessary adjustments. In addition, the auditor shall reconsider the nature, extent and timeliness of further audit procedures.

Learning Pack

Chapter 13: Specific audit procedures – section 1: Tangible non-current assets

HKSA 500 (Clarified) *Audit Evidence* applies when information prepared by the work of management's expert, is to be used as evidence. In such cases, the auditor shall:

- (a) evaluate the competence, capabilities and objectivity of that management's expert
- (b) obtain an understanding of the work of that management's expert
- (c) evaluate the appropriateness of that management's expert's work as audit evidence related to the assertion

Learning Pack

Chapter 14: Using the work of experts – section 1.6: Management's expert

Audit area – Trade receivables

(i) Trade receivables circularisation

What is the issue?

- Two responses, representing 16.1% of the sample tested, have not responded
- One response has highlighted that there is a dispute over the invoice and this raises questions as to whether this amount will be paid by the customer
- The amount is not included in the calculation for the allowance against receivables and therefore trade receivables may be overstated in the financial statements
- Two responses appear to indicate errors in accounting for receivables – relating to a cut-off error in respect of the date on which goods were despatched and a recording error in relation to cash being received from a customer
- This may impact on the extent to which it is considered appropriate to rely on any internal controls in respect of this balance

What is the implication for the audit evidence and the financial statements?

- In all cases further investigation is required in order to establish whether the issues identified are isolated instances or whether they are indicative of further potential errors in the population as a whole
- In the case of the responses which have not been received, further audit work will be required to either attempt to illicit a response from the customer or to corroborate the balances using alternative audit procedures
- In the case of the cut-off error this may be indicative of other cut-off errors, for example were other shipments due to go out on 31 March but failed to do so because of the early arrival of the courier?
- This would potentially impact on other areas of the financial statements, other than trade receivables as these items should be excluded from sales and recorded as part of inventory at the year end

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Follow up the circularisations where no response was obtained (Bao Tin and Jewellery Express) by writing a further letter where a response cannot be obtained; alternative procedures must be undertaken which may include: review of cash received from the customer post year-end, inspection of signed delivery notes and contracts with customer
- Further procedures to understand the dispute with Tin On Ltd should be undertaken, these will include discussions with management (including reasons for not including the amount in the year end allowance), inspection of other correspondence with the customer and Golden Panda's legal advisors, inspection of the contract terms with Tin On and review of any events after the year end which may indicate whether the amount is recoverable

- In respect of the cut-off issue arising with the invoice to RNS trading, further procedures to establish whether other cut-off errors might have occurred should be undertaken. The issue should be discussed with the production unit and the sales ledger supervisor to ascertain whether other shipments were delayed
- Cut-off procedures may need to be extended and should include reviewing a sample of invoices posted before the year end and comparing those to shipment documentation and delivery notes in order to establish the actual date of despatch
- The reasons for the misallocation of funds between customer accounts should be ascertained to identify whether this is a one off incident or whether a systematic lapse in controls may have lead to further errors
- Where there is a risk of other errors this will raise concerns regarding the adequacy of the year end allowance against receivables as there may be accounts that are not being chased (as they appear to have been paid) but which are outstanding at year end

(ii) **Year-end allowance against receivables**

What is the issue?

- The general allowance against receivables has been reduced compared to the prior year (from 6% of gross receivables to 3%) and the reason for this is unclear
- There is a balance which is more than a year old due from Sam Tse Limited. While this amount is still included in the allowance for receivables it is questionable whether this amount should actually now be written off completely given the slow progress of the legal proceedings
- In spite of the age of the debt due from Mong Kok Jewellery Company the allowance has been written back although the balance is still outstanding at year end

What is the implication for the audit evidence and the financial statements?

- Each of the issues points to a potential understatement of the allowance for receivables, or an overstatement of trade receivables in the financial statements
- Given the proposed listing it may be that management are being less prudent in an attempt to present a better view of the company in the financial statements
- Further audit evidence is required in order to understand the change in accounting estimate (i.e. reducing the general allowance from 6% to 3%) as well as ascertaining the likely recoverability of the amounts due from Sam Tse Limited and Mong Kok Jewellery Company

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Discuss with management the reasons for the reduction in the general allowance
- Compare the level of trade receivables balances written off during the year with the allowance recorded at 31 March 2011
- Ascertain whether the allowance created in the prior year was sufficient to cover those amounts that were written off – i.e. establish how good management are at estimating the level of general allowance required. There may be evidence from prior years that the allowance was too large
- Ascertain what progress has been made in the legal proceedings against Sam Tse Limited
- Inspect correspondence with Golden Panda's legal advisors to ascertain whether the legal proceedings are likely to be successful
- Review any events after the reporting period that provide evidence as to the outcome of the legal proceedings
- Review correspondence with Mong Kok Jewellery Company for evidence that it has committed to pay the amounts outstanding
- Inspect cash receipts after the year end for evidence that the amount has now been paid

References

The above is based on the following auditing standards:

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* states that materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Auditors need to use professional judgment in determining materiality and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

The concept of materiality is applied by the auditor in:

- (a) planning and performing the audit
- (b) evaluating the effect of identified misstatements on the audit
- (c) evaluating the effect of uncorrected misstatements on the financial statements i.e. the nature of the uncorrected misstatements
- (d) forming the opinion in the auditor's report

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks* requires that the auditor shall evaluate the audit evidence obtained and consider whether the assessment of risk of material misstatement at the assertion level remains appropriate.

The auditor must conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptable low level.

Further audit evidence must be obtained if the auditor has not obtained sufficient appropriate audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor must modify the auditor's report.

Any unexpectedly high misstatements found in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated. The auditor should consider whether the sample results provide a reasonable basis for conclusions about the population and should further consider the likelihood of actual misstatement in the population.

The auditor should consider the results of other audit procedures in order to assess the risk of misstatements in the population. The auditor may further request management to investigate the identified misstatements and consider whether management shall make any necessary adjustments. In addition, the auditor shall reconsider the nature, extent and timeliness of further audit procedures.

HKSA 505 (Clarified) *External Confirmations* requires that for an external confirmation, in the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with HKSA 705 (Clarified).

HKSA 530 (Clarified) *Audit Sampling* based on the sampling results, requires the auditor to:

- (a) investigate the nature and cause of any deviation or misstatements identified; and
- (b) evaluate their possible effect on the purpose of the audit procedure and on other areas of audit

HKSA 540 (Clarified) Auditing Accounting Estimates, including Fair Value 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 accounting estimates are reasonable and related disclosures are adequate.

The auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- (a) The requirements of the applicable financial reporting framework
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- (c) How the management makes the accounting estimates
- (d) Method of measurement
- (e) Relevant controls
- (f) Assumptions underlying the accounting estimate
- (g) Changes in methods for making accounting estimates
- (h) Reviewing prior period accounting estimates

Learning Pack

Chapter 9: Audit evidence, procedures, audit methodologies and audit sampling

Chapter 12: Substantive procedures, including analytical procedures

Chapter 13: Specific audit procedures – section 4: Receivables

Chapter 15: Accounting estimates, opening balances and comparatives

Audit area – Cash

(i) Bank reconciliation

What is the issue?

- The uncleared lodgements have not been banked until approximately a week after the cash was received
- This could indicate a cut-off issue where amounts received by Golden Panda after the period end are reported in the current period
- Additionally, the uncleared cheques (with the exception of cheque 5736) have not been cleared for over two weeks
- This may mean that even though cheques have been entered into the cash book before the period end, they were not sent until after the period end indicating further cut-off issues
- These issues imply there might be some element of 'window dressing' to enhance the appearance of liquidity in Golden Panda
- The items appearing in the bank statement that are not in the cash book have satisfactory explanations and do not require further work

What is the implication for the audit evidence and the financial statements?

- Including payments that were not actually received by Golden Panda until after the period end, increases bank and reduces receivables in the statement of financial position
- Delaying the sending of cheques means the bank balance appears higher than it should and liabilities appear lower than they should
- Overall the effect is to increase assets and decrease liabilities, making liquidity ratios, for example the acid test, more favourable
- Yin Yang & Co must also consider whether the window dressing is indicative of fraudulent financial reporting at Golden Panda. Alternatively, a teeming and lading fraud could have occurred, where an embezzlement of receipts is covered up by an apparent delay in banking subsequent receipts

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Yin Yang & Co should carry out further audit procedures around bank cut-off to collect sufficient reliable audit evidence
- Samples can be extended for all audit procedures already carried out on the bank figures
- Where lodgements have not been cleared by the bank until the new period, Yin Yang & Co should examine the paying-in slip to ensure that the amounts were actually paid into the bank on or before the period-end date
- Yin Yang & Co can also inspect the cash book and bank statements before and after the year-end for exceptional entries or transfers which have a material effect on the balance shown to be in-hand
- Explanations should be sought to corroborate any unusual items in the bank statement or cash book
- If fraudulent activity is suspected after additional procedures have been carried out, Yin Yang and Co must communicate this to the appropriate level of management or, if it is suspected that management is involved, to those charged with governance

(ii) **Bank confirmation letter**

What is the issue?

- Yin Yang & Co has not received a bank confirmation letter reply for an overseas deposit account based in the Cayman Islands
- Golden Panda claims there is HK\$10m in the account, a figure which is material to the financial statements (1.1% of total assets, 0.9% of revenue and 9.3% of PBT)
- Given the extent of damage from the cyclone, it appears unlikely that Yin Yang & Co will receive a response from the bank

What is the implication for the audit evidence and the financial statements?

- The bank confirmation letter is an important source of evidence for Yin Yang & Co as it is from an independent source and covers the assertions of completeness, existence, rights and obligations and valuation
- There is a very small chance that George Town Bank's disaster recovery system will be able to send a confirmation response before the auditor's report is signed, but the chance of this is unknown at the audit execution stage
- The non-response raises the possibility that the cash and bank balance on the statement of financial position contains a misstatement that will not be discovered by Yin Yang & Co
- If Yin Yang & Co cannot obtain sufficient appropriate audit evidence then the opinion in the auditor's report may have to be modified

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Yin Yang & Co will need to carry out alternative audit procedures to provide sufficient and appropriate audit evidence about the assertions of completeness, existence, rights and obligations and valuation for the bank figures
- Procedures could include the following:
 - Trace cheques shown as outstanding from the bank reconciliation to the cash book prior to the period end and to the after period end bank statements (if any have been received) and obtain explanations for any large or unusual items not cleared at the time of the audit
 - Compare cash book and bank statements in detail for the last month of the year, and match items outstanding at the reconciliation date to bank statements
 - Obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement and vice versa by discussion with finance staff
 - Verify contra items appearing in the cash books or bank statements with original entry
 - Verify balances per the cash book according to the bank reconciliation by inspecting cash book, bank statements and general ledger
 - Inspect the cash book and bank statements before and after the year-end (if received) for exceptional entries or transfers which have a material effect on the balance shown to be in-hand
 - Identify whether any accounts are secured on the assets of the company by discussion with management
 - Determine whether the bank accounts are subject to any restrictions by inquiries with management

References

The above is based on the following auditing standards:

HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that if the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of written representations by management, recognising that an instance of fraud is unlikely to be an isolated occurrence.

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- (a) management;
- (b) employees who have significant roles in internal control; or
- (c) others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

HKSA 505 (Clarified) *External Confirmations* requires that for an external confirmation, in the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with HKSA 705 (Clarified).

Learning Pack

Chapter 10: Fraud and irregularities

Chapter 13: Specific audit procedures – section 5: Bank and Cash

Audit area – Inventory

(i) Inventory count

What is the issue?

- Yin Yang & Co have decided as part of their planning to rely on the work of other expert auditors for the audit of inventory held at production units at the year end
- Whilst the competence and independence of expert auditors has already been considered, Yin Yang & Co must also evaluate the adequacy of the audit work performed for the purposes of reaching a conclusion on the audit of the financial statements
- Inventory at the Qingdao production unit that was about to be dispatched to customers was not collected by the courier and therefore remained in inventory at the year end

What is the implication for the audit evidence and the financial statements?

- The final valuation figure, as calculated by Feng Wei & Co, will be included in the financial statements of Golden Panda and is likely to be highly material
- If the work of Feng Wei & Co is found to be inadequate then Yin Yang & Co will either need to agree additional procedures with Feng Wei & Co or perform additional procedures itself
- The inventory that failed to be despatched to customers from the Qingdao production unit was correctly included in inventory however, given it was about to be despatched, the customers may have been invoiced and the amount included in sales – risk of a potential cut-off issue

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- The report should be reviewed along with any supporting working papers in order to evaluate the adequacy of the work carried out by Feng Wei & Co
- This would include:
 - reviewing the results of tests counts in order to obtain comfort over the accuracy of the count
 - understanding and corroborating the basis for the valuation of certain items including agreeing a sample of costs to invoices and timesheets etc
 - reperforming any calculations relevant to the valuation of inventory
 - reperforming a sample of quantity x valuation calculations and agreeing to amounts included in the financial statements
- The audit team should also discuss any significant issues with management and Feng Wei & Co, including those highlighted in the report, and consider the impact on the reliability of the procedures undertaken and the amounts included in the financial statements
- In respect of the inventory ready for despatch at the Qingdao unit a review should be carried out with respect to the period in which the amounts were invoiced to customers and when they were included in the financial statements

(ii) Valuation of finished goods

What is the issue?

- A major supplier of watches, TixTox, has announced that its business will cease and that warranties held for the watches that it produced will no longer be honoured
- Golden Panda held HK\$11 million of TixTox watches in its retail stores on 31 March 2012
- This represents 10.2% of profit before tax and is therefore material to the financial statements
- The advice in the article is that consumers should no longer purchase TixTox watches

What is the implication for the audit evidence and the financial statements?

- The net realisable value of the TixTox watches may now be below cost due to the announcement made by TixTox
- The announcement occurred after the year-end however, the circumstances leading to the event were conditions which were present on 31 March 2012 and therefore this is an adjusting subsequent event
- The inventory of TixTox watches should be written down in the financial statements to their net realisable value
- Audit evidence will need to be obtained in order to ascertain what an appropriate net realisable value may be

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- The impact of the announcement should be discussed with management at Golden Panda to ascertain what the likely impact is to be on the net realisable value of the inventory held
- Any alternative provisions that management are able to make, such as offering an alternative warranty, should be considered
- Post year-end sales of the TixTox watches should be examined to ascertain what sales price is achieved after the announcement
- A further review of press and articles should be undertaken to ascertain other commentary on the issue
- A review of any correspondence with TixTox or Golden Panda's legal advisors should be undertaken to ascertain if any further information is available regarding the net realisable value of the inventory or decisions regarding the warranties
- If the inventory is written down to a net realisable value then this should be traced through to the financial statements for accuracy

References

The above is based on the following auditing standards:

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* states that materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Auditors need to use professional judgment in determining materiality and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

The concept of materiality is applied by the auditor in:

- (a) planning and performing the audit
- (b) evaluating the effect of identified misstatements on the audit
- (c) evaluating the effect of uncorrected misstatements on the financial statements i.e. the nature of the uncorrected misstatements
- (d) forming the opinion in the auditor's report

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks* requires that the auditor shall evaluate the audit evidence obtained and consider whether the assessment of risk of material misstatement at the assertion level remains appropriate.

The auditor must conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptable low level.

Further audit evidence must be obtained if the auditor has not obtained sufficient appropriate audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor must modify the auditor's report.

Any unexpectedly high misstatements found in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated. The auditor should consider whether the sample results provide a reasonable basis for conclusions about the population and should further consider the likelihood of actual misstatement in the population.

The auditor should consider the results of other audit procedures in order to assess the risk of misstatements in the population. The auditor may further request management to investigate the identified misstatements and consider whether management shall make any necessary adjustments. In addition, the auditor shall reconsider the nature, extent and timeliness of further audit procedures.

HKSA 530 (Clarified) *Audit Sampling* based on the sampling results, requires the auditor to:

- (a) investigate the nature and cause of any deviation or misstatements identified; and
- (b) evaluate their possible effect on the purpose of the audit procedure and on other areas of audit

HKSA 540 (Clarified) *Auditing Accounting Estimates, including Fair Value 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 accounting estimates are reasonable and related disclosures are adequate.

The auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- (a) The requirements of the applicable financial reporting framework
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- (c) How the management makes the accounting estimates
- (d) Method of measurement
- (e) Relevant controls
- (f) Assumptions underlying the accounting estimate
- (g) Changes in methods for making accounting estimates
- (h) Reviewing prior period accounting estimates

HKSA 620 (Clarified) *Using the Work of an Auditor's Expert* requires that the auditor shall evaluate the adequacy of the auditor's expert's work based on:

- the relevance and reasonableness of auditor's expert's findings or conclusions
- the relevance and reasonableness of significant assumptions and methods used by the auditor's expert
- the relevance, completeness and accuracy of the source data used by the auditor's expert

Learning Pack

Chapter 9: Audit evidence, procedures, audit methodologies and audit sampling

Chapter 12: Substantive procedures, including analytical procedures

Chapter 13: Specific audit procedures – section 3: Inventory

Chapter 14: Using the work of others

Chapter 15: Accounting estimates, opening balances and comparatives

Audit area – Contingent liabilities and provisions

(i) **Breach of contract**

What is the issue?

- A wholesale customer, Ming Jewellers, has commenced legal proceedings against Golden Panda for breach of contract
- The directors do not believe a breach of contract has occurred and have therefore not included any amounts in year-end financial statements
- If the legal proceedings find in favour of Ming Jewellers, Golden Panda could become liable for significant costs associated with the amounts received in respect of the sale as well as additional compensation to be paid to Ming Jewellers
- If the legal proceedings were successful and compensation was highly material this could impact on the appropriateness of the going concern presumption

What is the implication for the audit evidence and the financial statements?

- If it is probable that Ming Jewellers will be successful in their claim against Golden Panda then the estimated liability should be included in the financial statements at year end
- If it is possible that Ming Jewellers will be successful in their claim against Golden Panda then the issue should be adequately disclosed in the financial statements at the year end
- If there are any doubts as to Golden Panda's ability to continue in business as a result of the legal proceeding the doubts over the going concern presumption should be disclosed in the financial statements at the year end
- Additional audit procedures need to be undertaken in order to ascertain the likelihood of success of the legal proceedings against Golden Panda and the extent of the likely liabilities that would arise in that event

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Discuss with management the reasons why they believe that the legal proceedings will not be successful and that no breach of contract has occurred
- Inspect correspondence with Golden Panda's legal advisors to ascertain their view on the likely outcome of the legal proceedings
- Review the contract between Ming Jewellers and Golden Panda to ascertain which specific clauses may have been breached and seek an expert opinion if considered necessary
- Ascertain whether any similar proceedings have been brought against Golden Panda (or other jewellery manufacturers) in the past and review the outcome of those cases
- Review events after the end of the reporting period for any indications as to whether or not the legal proceedings are likely to be successful

(ii) **Warranty provision (retail sales)**

What is the issue?

- Golden Panda offers a warranty with all items of jewellery sold which will result in some future costs being incurred (for repair or replacement) in respect of items sold during the year
- The level of such future costs has to be estimated and may be subject to management bias
- During the current year, Golden Panda has introduced a lifetime warranty for items with a sales value in excess of HK\$64,000
- This is a new warranty and therefore there is no historical data to indicate what level of costs Golden Panda might incur in the future under this warranty, thus making it more difficult to estimate

What is the implication for the audit evidence and the financial statements?

- A warranty provision is required in the financial statements to reflect the costs (repair or replacement) to Golden Panda of meeting any warranty claims in the future in respect of jewellery items sold during the year
- This will need to include both the standard five year warranty and the new lifetime warranty
- Evidence regarding the level of claims under the five year warranty, relative to sales in the year, should be relatively easy to obtain as there will be historical evidence to support the likely level of claims
- There will be little or no evidence to support the likely level of claims under the lifetime warranty recently introduced and therefore there is a greater risk of this not being fairly reflected in the financial statements

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Ascertain from management the basis for the calculation of the warranty provision and specifically the basis for the provision re the new lifetime warranty
- Compare the basis for the provision re the five year warranty with prior years and enquire as to the reasons for any differences
- Compare the level of claims in prior years, under the five year warranty, with the amounts actually provided in the financial statements to ascertain the degree of accuracy of management's estimate
- Research other similar companies to ascertain the accounting policies and estimates applied in their financial statements compared with those proposed by Golden Panda
- Obtain a schedule from management of the calculation of the provision and reperform the calculation agreeing the relevant figures, e.g. sales for the year, back to accounting records

References

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* states that materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Auditors need to use professional judgment in determining materiality and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

HKSA 540 (Clarified) *Auditing Accounting Estimates, including Fair Value 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 accounting estimates are reasonable and related disclosures are adequate.

The auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- (a) The requirements of the applicable financial reporting framework
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
- (c) How the management makes the accounting estimates
- (d) Method of measurement
- (e) Relevant controls
- (f) Assumptions underlying the accounting estimate
- (g) Changes in methods for making accounting estimates
- (h) Reviewing prior period accounting estimates

Learning Pack

Chapter 8: Planning, materiality and risk assessment

Chapter 13: Specific audit procedures – section 8: Impairment losses and contingencies

Golden Panda Jewellery Co Limited

Draft financial statements

You have been provided with a copy of the draft financial statements for Golden Panda for the year ending 31 March 2012.

Required

Use the draft financial statements to help you with the work required during the audit execution stage, and, when your facilitator instructs you to do so, carry out analytical procedures at the review stage.

Key questions/approach for analytical procedures at the review stage

- Does the evidence that has been obtained throughout the audit execution phase support the view shown in the financial statements?
- Do the financial statements comply with accounting regulations and presentation requirements?
- Are the accounting policies appropriate, particularly in light of the audit evidence obtained and your understanding of the business?
- Is there anything in the financial statements that audit procedures have not adequately considered? Any new transactions, balances or factors that you are aware of?
- Is the presentation/view given in the financial statements overly biased?
- Are the financial statements consistent with your knowledge of the business?

DRAFT Extract from statement of comprehensive income for the year ended 31 March 2012

	Note	2012 HK\$000	2011 HK\$000
Revenue	2	1,121,825	842,568
Cost of sales		<u>(784,659)</u>	<u>(608,782)</u>
Gross profit		337,166	233,786
Distribution and selling expenses		(99,675)	(140,115)
Administrative expenses		<u>(123,890)</u>	<u>(50,865)</u>
Operating profit		113,601	42,806
Finance costs	3	<u>(5,875)</u>	<u>(3,275)</u>
Profit before taxation		107,726	39,531
Taxation	4	<u>(15,390)</u>	<u>(7,115)</u>
Profit for the year		<u>92,336</u>	<u>32,416</u>

DRAFT Statement of financial position as at 31 March 2012

	Note	2012 HK\$000	2011 HK\$000
ASSETS			
Non-current assets			
Property, plant and equipment	5	189,789	68,201
Current assets			
Inventories		481,972	435,396
Trade receivables	6	152,395	94,644
Cash and bank balances		<u>56,278</u>	<u>19,480</u>
		690,645	549,520
Total Assets		<u>880,434</u>	<u>617,721</u>
EQUITY AND LIABILITIES			
Equity			
Share capital	7	25,000	25,000
Share premium		75,000	75,000
Reserves		<u>473,080</u>	<u>346,517</u>
		573,080	446,517
Non-current Liabilities			
Long term borrowings	8	143,696	50,000
Current liabilities			
Trade payables, deposits received and accruals	9	133,135	96,723
Taxation payable		15,390	3,178
Bank loan		<u>15,133</u>	<u>21,303</u>
		163,658	121,204
Total equity and liabilities		<u>880,434</u>	<u>617,721</u>

Statement of changes in equity for the year ended 31 March 2012

	Share capital HK\$000	Share premium HK\$000	Retained earnings HK\$000	Revaluation reserve HK\$000	Total HK\$000
Balance as at 1 April 2011	25,000	75,000	346,517		446,517
Profit for the year			92,336		92,336
Revaluations in the year				<u>34,227</u>	<u>34,227</u>
Balance as at 31 March 2012	<u>25,000</u>	<u>75,000</u>	<u>438,853</u>	<u>34,227</u>	<u>573,080</u>

Student Notes

Module C (Jun 2012) Workshop 2 – Handout 11.1 Audit Completion

Cash flow statement extract as at 31 March 2012

	2012	2011
	HK\$000	HK\$000
Profit before taxation	107,726	39,531
Adjustments for:		
Depreciation	20,517	18,195
Interest expense	5,875	3,275
(Increase) in inventory	(46,576)	(81,423)
(Increase) in receivables	(57,751)	(33,087)
Increase in trade payables, deposits received and accruals	<u>36,412</u>	<u>56,901</u>
	<u>(41,523)</u>	<u>(36,139)</u>
Cash generated from operations	66,203	3,392
Interest paid	(5,875)	(3,275)
Income taxes paid	<u>(3,178)</u>	<u>(6,135)</u>
Net cash from operating activities	57,150	(6,018)
Cash flows from investing activities		
Purchase of property, plant & equipment	(109,365)	(57,609)
Income from sale of property, plant & equipment	<u>1,487</u>	<u>12,199</u>
Net cash used in investing activities	(107,878)	(45,410)
Cash flows from financing activities		
Proceeds from long term borrowings	108,829	35,143
Repayment of borrowings	<u>(21,303)</u>	<u>-</u>
Net cash received from financing activities	<u>87,526</u>	<u>35,143</u>
Net increase/ (decrease) decrease in cash	<u>36,798</u>	<u>(16,285)</u>

Notes to the financial statements for the year ending 31 March 2012

1 ACCOUNTING POLICIES

1.1 Basis of preparation

The financial statements have been prepared under the historical cost convention modified to include the revaluation of certain non-current assets and in accordance with applicable accounting standards.

1.2 Revenue

Revenue comprises revenue recognised by the Group in respect of the sale of gold jewellery and watches. Revenue is reported less value added tax and after discounts and returns. An estimate is made of returns from customers after the reporting date which relate to sales made during the reporting period.

1.3 Non-current tangible assets and depreciation

Non-current tangible assets are stated at cost less depreciation. Depreciation is provided at rates calculated to write off the cost of non-current assets, less their estimated residual value, over their expected useful lives on the following bases:

Buildings	– 3% straight line
Leasehold improvements	– 15% or over the remaining term of the lease, whichever is shorter
Plant and machinery	– 12% straight line
Motor vehicles	– 20% straight line
Fixtures, fittings and office equipment	– 20% straight line

Depreciation costs are recognised as part of cost of sales, with the exception of depreciation on motor vehicles which is included as part of distribution costs.

1.4 Inventories

Inventories are valued at the lower of cost and net realisable value. Cost is determined on an average cost basis. Net realisable value is determined by reference to management estimates based on prevailing market conditions.

1.5 Foreign currencies

Transactions in foreign currencies are translated into Hong Kong Dollars at the rate ruling on the date of the transaction.

2 REVENUE

Revenue is attributable to the principal activity of the Group. An analysis of revenue is given below:

	2012 HK\$000	2011 HK\$000
China (including Hong Kong)	1,069,099	783,588
Rest of the world	<u>52,726</u>	<u>58,980</u>
	<u>1,121,825</u>	<u>842,568</u>

3 FINANCE COSTS

	2012 HK\$000	2011 HK\$000
On bank loans and overdrafts	<u>(5,875)</u>	<u>(3,275)</u>

4 TAXATION

	2012 HK\$000	2011 HK\$000
Corporation tax	<u>(15,390)</u>	<u>(7,115)</u>

5 PROPERTY, PLANT AND EQUIPMENT

	Buildings HK\$000	Leasehold improvements HK\$000	Plant, machinery, fixtures, fittings and equipment HK\$000	Total HK\$000
Cost/revaluation				
At 1 April 2011	19,621	61,950	46,720	128,291
Additions	77,549	21,659	10,157	109,365
Write off/Disposals	-	(9,147)	(4,544)	(13,691)
Revaluations	<u>29,148</u>	<u>-</u>	<u>-</u>	<u>29,148</u>
At 31 March 2012	<u>126,318</u>	<u>74,462</u>	<u>52,333</u>	<u>253,113</u>

Student Notes

Module C (Jun 2012) Workshop 2 – Handout 11.1 Audit Completion

	Buildings	Leasehold improvements	Plant, machinery, fixtures, fittings and equipment	Total
	HK\$000	HK\$000	HK\$000	HK\$000
Depreciation				
At 1 April 2011	7,976	17,567	34,547	60,090
Charge for the year	2,198	9,554	8,765	20,517
Write Off/Disposals	-	(8,330)	(3,874)	(12,204)
Revaluations	(5,079)	-	-	5,079
At 31 March 2012	<u>5,095</u>	<u>18,791</u>	<u>39,438</u>	<u>63,324</u>
Net book value				
At 31 March 2012	<u>121,223</u>	<u>55,671</u>	<u>12,895</u>	<u>189,789</u>
At 1 April 2011	<u>11,645</u>	<u>44,383</u>	<u>12,173</u>	<u>68,201</u>
6 TRADE RECEIVABLES				
			2012	2011
			HK\$000	HK\$000
Gross trade receivables			160,416	105,160
Allowance for receivables			<u>(8,021)</u>	<u>(10,516)</u>
Trade receivables			<u>152,395</u>	<u>94,644</u>
7 SHARE CAPITAL				
			2012	2011
			HK\$000	HK\$000
Share capital called up, allotted and fully paid			<u>25,000</u>	<u>25,000</u>
8 LONG TERM BORROWINGS				
			2012	2011
			HK\$000	HK\$000
Bank loan			68,000	50,000
Mortgage on properties			<u>75,696</u>	<u>-</u>
			<u>143,696</u>	<u>50,000</u>
9 TRADE PAYABLES, DEPOSITS RECEIVED AND ACCRUALS				
			2012	2011
			HK\$000	HK\$000
Trade payables			111,573	82,214
Deposits received			19,178	12,541
Accruals			<u>2,384</u>	<u>1,968</u>
			<u>133,135</u>	<u>96,723</u>

Discussion points

Analytical procedures at the completion stage

Observation	Commentary and potential issues
Distribution and selling expenses have fallen by 29% since 2011 whereas sales have increased by 33% in the same period	This could indicate an understatement of distribution and selling expenses.
Administrative expenses have increased by 144% since 2011 which seems not to be in line with increased sales of 33% over the same period	Administrative costs could be overstated. When taking these two issues together there could be a misclassification of costs across the categories.
The gross profit margin has increased slightly from 27.7% to 30% but the operating profit margin has increased from 5% to 10%	When looking at costs in aggregate (distribution, selling and admin) the increase is 17% on the prior year which indicates an understatement of costs overall when considering the 33% increase in sales.
Taxation has increased by HK\$8m or 116% from 2011 to 2012, but profit before tax has increased by 173% in the same period	In 2011, an effective rate of tax of 18% was applied but in 2012 a rate of 14% appears to have been applied. This suggests a potential understatement of tax.
Inventory has increased by HK\$47m from 2011 to 2012 but inventory days have fallen from 261 days in 2011 to 224 days in 2012	This indicates that inventory is being held for less time and so there is a possibility that inventory is understated and profit overstated. In any case, the inventory days ratio seems high and it may be worth comparing this to the industry average.
Gross trade receivables have increased by 53% from 2011 to 2012. However the allowance for receivables has fallen by 24%	The receivables allowance estimate may be too low. The fall in allowance is especially unusual as receivables days have increased from 45 days to 52 days suggesting the company is taking longer to collect any outstanding debts. Issues identified at the audit execution stage do not appear to have been satisfactorily resolved.
Together the long term borrowings and the bank loan have increased by 223% since 2011. However, the finance charges have only increased by 79%	Finance charges may have been understated.
There is a new mortgage on properties of HK\$75.7m	This suggests the company is looking for finance and may raise questions over going concern.

Audit completion

(i) **Payments for advisory services on acquisition of jewellery retailer**

On 12 May 2012 you read the following article in a newspaper:

Golden Panda payment probes widens

Hong Kong Times, 12 May 2012

The investigation announced by the Hong Kong authorities on 19 March over payments made by Golden Panda Jewellery Co as part of the acquisition of a jewellery retailer in June 2010 took another turn today.

In a shock announcement today both John Tse, Golden Panda's finance director and William Chang – the recently appointed independent non-executive director set to chair the audit committee – quit their posts. Neither was available for comment.

George Yun-Wing, the former financial controller, who claimed he was forced to resign from his position as financial controller when he questioned a large payment to an unknown advisory firm in the Cayman Islands, has already agreed to meet with Hong Kong investigators. It is expected that Mr Tse and Mr Chang have been requested to do the same resulting in their decisions to step down. Mr Yun-Wing continues to deny that he was asked to leave due to personal issues.

Golden Panda have remained silent about the purpose of the payments and speculation has grown over whether the payments were legitimate or were in fact made in order to secure Golden Panda a competitive advantage by guaranteeing it the acquisition when there were other interested investors for the jewellery retailer ultimately acquired by Golden Panda.

The scandal is likely to have a seriously damaging effect on the proposed listing of Golden Panda that is being prepared for later this year and evidence suggests that the negative publicity is also having a knock-on effect on the current performance of the wholesale and retail business as customers are reluctant to be associated with a company who has previously been renowned for its quality and ethical standards.

Amidst the speculation the organizers of Miss Hong Kong also announced that they are currently considering whether it is appropriate for Golden Panda to continue as the competition's lead sponsor.

Required

Identify the issues for Golden Panda's financial statements for the year ended 31 March 2012 and any additional audit steps that should be taken.

(ii) **Dispute with wholesale customer – breach of contract**

On 13 May Cammi Kim passes you a copy of the following letter from LSP Legal Advisors, the legal firm appointed by Golden Panda in respect of the legal proceedings being taken against Golden Panda by Ming Jewellers

LSP Legal Advisors
Floor 29 Mongkok Building
251 Mongkok Road
Mongkok



Cammi Kim
Managing Director
Golden Panda Jewellery Company
28/F Golden Tycoon Centre
555 Nathan Road
Mongkok

12 May 2012

Dear Ms Kim

Legal proceedings against Golden Panda Jewellery Company by Ming Jewellers

Thank you for our recent meeting regarding the above legal proceedings. As discussed, LSP Legal Advisors will represent Golden Panda in respect of this case. Since our meeting we have taken the opportunity to review the circumstances of the case including reviewing the contractual agreement between Golden Panda and Ming Jewellers as well as the various correspondences between Golden Panda and Frederick Lee Commercial Law Office who represents Ming Jewellers.

I set out our preliminary findings in the attached document and would welcome the opportunity to discuss these with you further as well as the next steps required in preparation for defending the claim.

Please contact my office to arrange an appointment.

Yours sincerely,

David Chan

David Chan

Partner



Golden Panda Jewellery Company

Preliminary research findings in legal proceedings brought by Ming Jewellers

Summary

1. The contract between Golden Panda and Ming Jewellers provides for an exclusive design to be created and produced by Golden Panda and specifically provides against the sharing or production of that design with any other parties.
2. There are some similarities between the design produced for Ming Jewellers, the Lustre Collection and the Lustric Collection which was designed and produced for another Golden Panda client. However, the designs are not identical and an expert opinion will need to be sought to establish whether the designs are of such a similar nature as to constitute a breach of contract.
3. Should a breach of contract be found to have occurred the amounts payable to Ming Jewellers by Golden Panda will be limited to, per the contract:
 - the contract value of the items produced, time and travel costs in respect of design meetings to create and approve the design,
 - costs incurred by Ming Jewellers in bringing the product to market (e.g. advertising costs) and
 - legal costs incurred by Ming Jewellers in the course of the legal proceedings.
4. The contract does not provide for the payment of compensation for loss of revenue.
5. The contract value agreed with Ming Jewellers was HK\$11,240,765.
6. When reviewing other similar cases a significant proportion (c. 70% of those we reviewed) have been successful and resulted in the supplier paying amounts to the customer under the contract.
7. In the successful cases reviewed additional costs, including legal costs, typically paid to the customer range from 20-45% of the contract price.

LSP Legal Advisors
Floor 29 Mongkok Building
251 Mongkok Road
Mongkok

Required

Identify the issues for Golden Panda's financial statements for the year ended 31 March 2012 and any additional audit steps that should be taken.

Discussion points

Audit completion

(i) **Payments for advisory services on acquisition of jewellery retailer**

What is the issue?

- Developments in the issue over possible improper payments by Golden Panda raise further concerns over management integrity
- The resignation of both the finance director and chair of the audit committee also seems to suggest that there are issues which have not yet been fully disclosed
- The speculation around the issue also raises questions over whether Golden Panda is likely to be successful in its proposed listing
- If the listing is not successful or has to be abandoned then this may give rise to concerns over the going concern presumption, particularly in light of the fact that the venture capital investors are seeking an exit route
- The impact on the level of trading may compound this issue further
- If the sponsorship deal with the Miss Hong Kong contest is withdrawn then this may impact the financial statements

What is the implication for the audit evidence and the financial statements?

- The audit team will need to consider carefully any areas where audit evidence has relied on representations from management and alternative sources of evidence, e.g. third party evidence should be sought
- This will be particularly important when auditing areas where there is a high degree of judgment or subjectivity
- If there are doubts as to the company's ability to continue as a going concern then this would need to be disclosed in a note to the financial statements
- Any amounts included in respect of the Miss Hong Kong contest may need to be removed from the financial statements

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Review any correspondence between the Hong Kong investigators and Golden Panda to ascertain the timescales of the investigation
- Review management's plans for listing in particular the share price that is planned and consider the likely impact on the achievable price given the current issues. Consider what price is likely to be acceptable to the venture capitalist
- Review any correspondence with (and where possible discuss with) the venture capitalist to understand what their likely plans are with respect to establishing an exit route in the event that the listing fails
- Review the level of sales post year end with the same periods for the prior year in order to quantify the effect of any downturn in trading resulting from the current speculation

- Review any correspondence with the organisers of Miss Hong Kong to ascertain whether the sponsorship deal is likely to be withdrawn
- Where the deal is withdrawn consider the impact on the financial statements, e.g. whether any payments made will be recoverable

(ii) **Dispute with wholesale customer – breach of contract**

What is the issue?

- Further investigation by the legal advisors to Golden Panda indicate that there is a significant likelihood that Ming Jewellery may be successful in its legal proceedings for breach of contract
- The amount potentially payable under the contract is:

	HK\$000
Sales value of contract	11,241
Additional costs relating to marketing and legal expenses (say 33%)	<u>3,710</u>
Total	<u>14,951</u>

- This represents 1.3% of revenue 13.8% of profit before tax and 1.7% of total assets and is therefore considered material in the context of the draft financial statements

What is the implication for the audit evidence and the financial statements?

- If further investigation, particularly the expert opinion referred to in the letter from Golden Panda's legal advisors, suggests that the similarity between the two jewellery collections is sufficient to constitute a breach in the contract with Ming Jewellery, a provision should be recorded in the financial statements
- If there is still uncertainty then it would appear that, as a minimum, a contingent liability should be disclosed in the notes to the financial statements

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from Golden Panda?

- Review any further correspondence or investigations in respect of the case
- Discuss with management its plans for including a provision or contingent liability in the financial statements or whether a settlement is likely to be made
- Ascertain whether an outcome to the legal proceedings is likely before the financial statements are approved

References

HKSA 560 (Clarified) *Subsequent Events* provides guidance to auditors in this area. The objectives of the auditor are described below:

- To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are appropriately reflected in the financial statements in accordance with the applicable financial reporting framework
- To respond appropriately to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report

Learning Pack

Chapter 16: Overall audit review and finalisation

Audit reporting

Lamma Limited

Lamma Limited (Lamma) is a chemicals company in Hong Kong. The company specialises in the production of raw chemicals which are sold to pharmaceutical companies for the manufacture of drugs and medications.

You are the external auditor of Lamma for the year ended 31 March 2012.

Peng Chau Limited (Peng Chau) is the most important customer of Lamma, accounting for 59% of revenues in the year ended 31 March 2011. In May 2011, Peng Chau's highest selling product, a drug for arthritis sufferers, was found to be carcinogenic. The drug was immediately withdrawn from the market and legal action is pending against Peng Chau. Negative reporting in the press has resulted in a loss in confidence in Peng Chau and sales of all their other products have also fallen by 50% since the prior year.

A preliminary investigation has shown that the chemicals supplied by Lamma were not to blame for the carcinogenic element of the arthritis drug. However, the effect of the situation on the cash flow of Lamma has been severe as a result of decreased orders from Peng Chau. Revenues at Lamma have fallen by 45% since the prior year and the company made a net loss of HK\$800k.

Lamma has struggled to find other pharmaceutical companies who are willing to buy their products.

The statement of financial position is showing net current liabilities of HK\$500k. Additional audit procedures have shown that there is significant doubt in Lamma's ability to continue as a going concern.

The directors of Lamma have included a statement highlighting the significant doubt over Lamma's ability to continue as a going concern. You have reviewed the statement and are satisfied it meets the relevant reporting requirements.

Required

Discuss the impact on your auditor's report and determine the appropriate audit opinion in this situation.

Lantau Limited

Lantau Limited (Lantau) is a media company with approximately 300 employees. The company purchases a variety of media for clients' advertising campaigns including television, internet, and radio. The company has expanded rapidly since its establishment five years ago.

You are the newly appointed external auditor of Lantau and you are currently working on the audit for the period ended 31 March 2012. Throughout your audit you have encountered difficulties discussing any accounting issues as none of the directors hold a professional accountancy qualification. There are two qualified accountants in the finance department who have been of some assistance.

The auditor's opinion for the prior period was qualified. The predecessor auditors stated in their auditor's report that non-current assets were overstated by HK\$225k due to the capitalisation of training costs related to training staff at Lantau how to use a new computer system.

The directors of Lantau feel that the HK\$225k training fees should be capitalised as they are directly attributable to the cost of the new computer system and are unwilling to amend the financial statements.

Total assets of Lantau at 31 March 2012 are HK\$10.2m and the profit before tax for the period ended 31 March 2012 is HK\$1.9m. Computer equipment is depreciated at 33.33% on a straight line basis.

Required

Discuss the impact on your auditor's report and determine the appropriate audit opinion in this situation.

Discussion points

Audit reporting

Lamma Limited

Impact on auditor's report

- Lamma Limited (Lamma) has lost a key customer, made a net loss in the year and is currently exhibiting a net current liability position
- These conditions collectively cast significant doubt about the going concern assumption which cannot be mitigated by increased revenues from other pharmaceutical firms
- The assessment of going concern has been supported through the performance of additional audit procedures by the auditors
- The auditors believe the doubts about going concern have been adequately disclosed
- There is no disagreement as to the basis of preparation or disclosures
- The nature of the uncertainty means it must be brought to the attention of shareholders
- The auditors shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report
- The Emphasis of Matter paragraph must highlight the conditions which cast significant doubt over Lamma's ability to continue as a going concern and draw attention to the related disclosure note in the financial statements
- The Emphasis of Matter paragraph would also state that the auditor's opinion is not modified in respect of this matter

Reference

The above is based on the following auditing standards:

HKSA 570 (Clarified) *Going Concern*

HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*

HKSA 706 (Clarified) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

As per HKSA 706 (Clarified), if the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) include it immediately after the Opinion paragraph in the auditor's report;
- (b) use the heading – Emphasis of Matter, or other appropriate heading;
- (c) include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- (d) indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Lantau Limited

Impact on auditor's report

- The HK\$225k training costs should not have been capitalised as per IAS 16 *Property, Plant and Equipment*
- The closing balance of non-current assets was misstated by HK\$225k and correctly resulted in a qualification in the predecessor auditor's report for the prior period
- Therefore, the opening balance of non-current assets contains a misstatement that affects the current period's financial statements
- The current period depreciation charge is also overstated by HK\$75k (HK\$225k x 33.33%)
- The training costs of HK\$225k represent 2.2% of total assets and 11.8% of profit before tax and are material
- The excess depreciation is not material being 0.7% of total assets and 3.9% of profit before tax. However, this is material when taken in aggregate with the HK\$225k training costs and needs to be adjusted
- As the misstatements can be isolated to non-current assets and the depreciation charge, they are not pervasive to the financial statements
- The auditor's report would be qualified on the basis that this is material but not pervasive and that the corresponding figures (i.e. prior year comparatives) are materially misstated
- As the report has been qualified, the auditors must use the heading "Qualified Opinion" for the opinion paragraph
- The auditors shall also include a paragraph providing a description of the matter giving rise to the qualification and a quantification of the financial effects
- This shall be inserted immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion"

Reference

The above is based on the following auditing standards:

HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances*

HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*

HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report*

As per HKSA 510 (Clarified), if the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with HKSA 705 and HKSA 710.

HKSA 705 (Clarified) includes the following table to illustrate how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Golden Panda Jewellery Co

Acquisition of Po Fook Jewellery Co

In June 2010, Golden Panda acquired Po Fook Jewellery Co, a luxury jewellery retailer based in Singapore. Po Fook specialised in selling high quality gold jewellery which it purchased from other manufacturers, including commissions from Golden Panda. Po Fook did not own any manufacturing facilities.

At the time of the acquisition, Po Fook had fifteen retail stores. Thirteen of these stores were located in Singapore and the other two were based in upmarket shopping malls in Malaysia and Thailand. By December 2010, all Po Fook retail stores had been rebranded as Golden Panda outlets.

Golden Panda acquired Po Fook via the purchase of shares in a holding company Po Fook Singapore Ltd. The holding company had three 100% owned subsidiaries in Malaysia, Thailand and Singapore and the legal structure has not altered since the acquisition. The Singaporean holding company and each of the subsidiaries has an accounting year end of April 30th.

Monthly consolidation journals are prepared and inputted by the finance manager at Golden Panda. These are reviewed by the financial controller.

Note: that pre-workshop materials and financial statements do not include the acquisition of Po Fook Jewellery Co.

Required

Discuss the additional risks as a result of the acquisition and determine the appropriate actions to be taken by Yin Yang & Co.

Note: Student notes to this handout withheld.