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- ❖ Practising partner of a medium size firm
- ❖ Practical experience in corporate governance, risk management, auditing and tax
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- ❖ Taught over 8000 students

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Module C – Business Assurance



Module Preparation Seminar – Agenda

- Identifying and assessing the risks of material misstatement at financial statement and assertion level (HKSA 315 (Revised 2016))
- Responses to assessed risks (HKSA 330 (Clarified))
- Information Technology (Ch.20)

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HKSA 315 (Revised 2016)

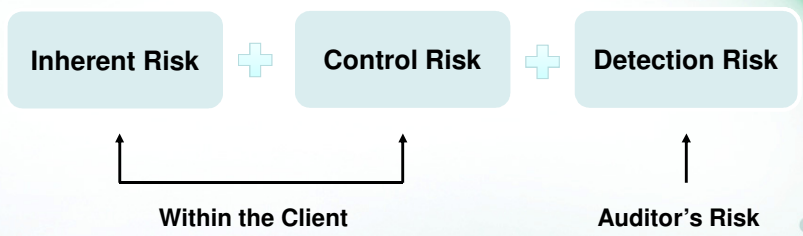
Identifying and assessing the risks of material misstatement at financial statement and assertion level



MC – HKSA 315 (Revised 2016)

Audit Risk - Definition & Components

It is “risk that auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated taken as a whole”



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Inherent Risk (“IR”)

- Refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were **no related internal controls**.
- Example:
 - Industry environmental factors – competitiveness
 - Technological obsolescence or over-dependence on single product
 - Accounts which require expert valuations

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Control Risk (“CR”)

- Refers the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, **will not be prevented or detected and corrected** on a timely basis by the accounting and **control systems**.
- If the company has good internal controls, there is a **high chance** that the control system will detect a material error.

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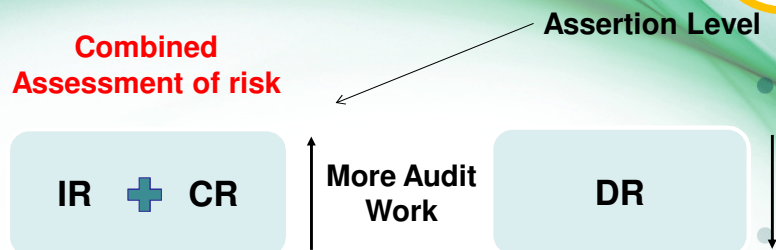
Detection Risk (“DR”)

- Refers risk that the **auditor will not detect a material misstatement** that exists in an assertion where the audit procedures fail in its effectiveness. Auditor should amend his NET (Nature, Extent and Timeliness) of the audit procedures.
- Sampling risk and non-sampling risk are components of detection risk.
- Eg Incoming auditor – ie not familiar with the audit client

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Inverse Relationship



Perform Risk Assessment
only on IR and CR

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HKSA 315 (Revised 2016) Risk Assessment



Why revised the standard? As there are changes in HKSA 610 (Revised) related to internal auditors

Risk Assessment Procedures and Related Activities

a) Inquiries of Management, the Internal Audit Function and Others within the Entity

- auditor can obtain information through inquiries with the **internal audit function**, if the entity has such a function
- Inquiries directed to **the risk management function**
- Inquiries directed to **information systems** personnel may provide information about system changes, system or control failures

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HKSA 315 (Revised 2016) Risk Assessment



b) Inquiries of the Internal Audit Function

- the internal audit function is likely to **have obtained insight into the entity's operations and business risks**, and may have findings based on its work, such as identified control deficiencies or risks
- internal audit function provides information to the auditor regarding any **actual, suspected or alleged fraud**

c) Considerations specific to public sector entities

- Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying **the risk of material non-compliance with applicable laws and regulations** and the **risk of deficiencies in internal control** over financial reporting.

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d) Audit Evidence for Elements of the Control Environment

- The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies
- The auditor may also be able to use the work of the internal audit function to modify the **n**ature or **t**iming, or reduce the **e**xtent, of audit procedures

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HKSA 315 (Revised 2016) Risk Assessment

Requirement: (Must perform)

1. Identify and Assess the risks of material misstatements **at the (Overall) financial statement level** and at the **assertion level** for classes of transactions(P/L), account balances (B/S) and disclosures.
2. Determine risks that require **special audit consideration** and consider whether the controls are implemented (**“Significant Risks”**)

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HKSA 315 (Revised 2016) Risk Assessment



3. Evaluate the design of entity's controls and determine the implementation of the entity's controls
4. If is **not possible** or impracticable to reduce the risks of material misstatements at the assertion level to an acceptably low level with audit evidence obtained by substantive testing, then auditor should evaluate the design and implementation of the client's controls i.e. in a computerized system, lack of paper trail

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Collect Audit Evidence



- Main purpose = to obtain sufficient and appropriate audit evidence to support audit opinion
- Ways to collect audit evidence
 - Risk Assessment
 - Tests of Controls
 - Substantive Testing

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Risk of material misstatement at Financial Statement Level – General

- Applying to the financial statement as a whole
- Able to reduce audit risk to an acceptably low level
- More pervasive to the financial statement at a whole
- Affect many assertions

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Risk of material misstatement at Financial Statement Level – Factors to consider

*** Always related to management***

- Risks from a weak control environment which includes management's attitudes to good internal control practice
- Management's attitude towards a good internal control
- Management's competence, integrity and experience

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Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Unusual pressures** on management (i.e. plan to go public, bonuses tied to sales or profits)
- Nature of entity's business – risky Industry, market fluctuations
- Industry factors i.e. **Special regulations and reporting changes** (i.e. Listing companies, securities companies, insurance companies, banks)

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Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Aggressive business strategies** – fast expansion, plenty of acquisition and mergers
- **Significant business risk**
 - Cannot focus on a specific risk
 - Concern about the client's going concern
 - Concern about fraud

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HKSA 330 Responses to assessed risk – FS Level

- Reduce audit risk to an **acceptability low level**, auditor should determine overall responses to assessed risks of material misstatements at the financial statement level and **documentation is required**
- Consider Control Environment

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HKSA 330 Responses to assessed risk – FS Level

****** Use general audit strategy *****

For Example:

- Assigning more staff or more training for staff
- More supervision for staff
- Emphasizing to audit staff the need to maintain professional skepticism

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HKSA 330 Responses to assessed risk – FS Level

- Collect more persuasive evidence and more procedures
- Using experts
- Incorporating more unpredictability into the audit procedures
- Change nature, extent and timeliness of substantive tests

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Risk of material misstatement at Assertion Level

- **Not able** to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures
- Refer to specific **classes of transactions, accounts balances**
- Risks arise from the particular characteristics of a class of transaction – **inherent and control risk**
- Identify controls that are likely to **prevent, detect or correct** material misstatements

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Risk of material misstatement at Assertion Level – General

- Comprises of IR and CR (**Combined Assessment of the Risk of Material Misstatements**)
- Auditor would perform **tests of controls** to support the risk assessment

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Risk of material misstatement at Assertion Level – Factors to consider

- Accounts likely to be susceptible to misstatements (i.e. required many adjustments in previous year's audit or accounts that include estimated amounts)
- **Complexity of underlying transactions** (i.e. financial instruments)
- Degree of judgement involved in determining account balances (i.e. provision for contingent liabilities and warranty expenses)
- Susceptibility of assets to loss or misappropriation

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Risk of material misstatement at Assertion Level – Responses

- **Design and perform appropriate audit procedures to address** to the assessed risks of material misstatements at the assertion level and for each material class of transactions, account balances and disclosure.
- Determine risks that require special audit considerations and consider whether the controls are implemented
- Evaluate the design of entity's controls and determine the implementation of the entity's controls Vouching etc
- **Documentation of N(Nature) E(Extent) T(Timeliness)** * of further audit procedures, linkage of those procedures with

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N – Nature of Substantive Testing

- Consider performing Substantive Testing only or both
- Tests of controls and substantive testing
- Type such as inspection, observation, inquiry etc
- Use **Substantive Approach** – Perform only substantive testing
- Use **Combined Approach** – Use both test of control and substantive testing

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E – Extent of Substantive Testing

- **Quantity** of a specific audit procedures to be performed
- Required judgment
- After consideration of materiality
- Higher Risk = increase extent
- Use sampling approach or not?

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T – Timeliness of Substantive Testing

- Perform further audit procedures **at an interim or at period end**
- Perform audit procedures before the period end – to identify significant matters at early stage of audit
- Higher risk = perform sub tests nearer to or at period end

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Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Existence** – Assets, liabilities, and equity interests do not exist at the Balance Sheet Date

Examples for increase risk:

- Multi-locations
- Assets held by third parties
- Assets that have special characteristics – require an expert to identify

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Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Completeness** – All assets, liabilities and equity interests that should have been recorded have not been recorded.

Examples for increase risk:

- Multi-locations, assets held by third party
- Wrong posting, off balance sheet items
- Understate of liabilities

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Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Accuracy, Valuation and Allocation** – Assets, liabilities, and equity interests are included in the financial statements **at inappropriate amounts** and any resulting valuation or allocation adjustments are not appropriately recorded

Examples for increase risk:

- Valuation subject to heavy estimate/ heavy market fluctuations/ expert's valuation / Heavy complex calculation is involved in the valuation i.e. manufactured goods – DM, DL, OH

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Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Rights and Obligations** – The entity does not hold or control the rights to assets, and liabilities are not the obligations of the entity

Examples to increase risk:

- Subsequent events – title has been passed
- Many different contracts with many different terms
- Title is subject to specific HKAS

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Risk of material misstatement at Assertion levels



Income Statement – Assertion Risk

- **Occurrence** – Transactions and events that have been recorded have not (1) **occurred** nor (2) pertain to the entity.

Example to increase risk:

- Sales occurred at year end
- Multiple sales – sales last for several years
- Invoice not with the client
- Consignment sales

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Risk of material misstatement at Assertion levels



Income Statement – Assertion Risk

- **Completeness** – All transactions and events that should have been recorded have not been **recorded**

Examples to increase projects:

- Consignment sales
- Cutoff dates different for many companies
- No pre-numbering invoice
- No authorization n sales invoice

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

- **Cutoff** – Transactions and events have been recorded in an **incorrect accounting period**.

Examples to increase risk:

- Transactions taken after year end
- Management's cutoff procedures not adequate

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

- **Accuracy** – Amounts and other data relating to recorded transactions and events have not been **recorded appropriately**.

Examples to increase risk:

- Complex HKAS
- Transactions terms have different interpretations
- Involve overseas accounting standards
- Require expert to interpret

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Risk of material misstatement at Assertion levels

Statement of Financial Statements & Income Statement – Assertion Risk

Classification: transactions and events have been recorded in the proper accounts

Presentation: transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework

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Significant risks

Significant risks are **complex or unusual transactions** that may indicate fraud, or other risks or are unusual in their characteristics. Routine, and non-complex transactions are less likely to give rise to significant risk than unusual transactions.

Significant risks are those that require special audit consideration.

Significant risks are often related to:

- **Non-routine transactions** are transactions which occur occasionally due to either their size or nature.
- Risks of material misstatement may be greater for matters that require the use of **accounting estimates** which involve a degree of uncertainty.

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Scenario thinking:

Which Item?	Which assertions?
PPE	
Intangible Asset	
Inventories	
Receivables	
Contingent Liabilities	
Sales	

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Exam Techniques:

1. Which item in the FS affected?
2. Which assertions?
3. If figures are given , use them ie Analytical Procedures
4. Relationship between figures
5. What facts are given in the question?
6. Answer the question risk is low/normal or high?
7. How many marks?

MC Exam Questions



Exam Questions Review Jun 2014 – Short Question 6

Risk Assessment

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HKICPA - QPMC – Jun 2014 Q6



Question

You are the auditor of Think Limited which is a furniture manufacturer with a factory in Dongguan, China. During the planning of the audit for the year ended 31 March 2014, you obtained the following financial information:

	2014 HK\$' million	2013 HK\$' million
Revenue	525	285
Costs of goods sold	330	242
Gross Profit	175	43
Property, plant and equipment	425	495
Accounts receivable	232	75
Accounts payable	155	105

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HKICPA - QPMC – Jun 2014 Q6



Required:

a) Assess and explain the risk of material misstatement relating to the occurrence assertion of revenue for the year ended 31 March 2014.

(4 marks)

b) Discuss and propose the audit procedures for the occurrence assertion of revenue.

(6 marks)

HKICPA - QPMC – Jun 2014 Q6



Answer (a)

The risk of material misstatement relating to the **occurrence assertion** of Think Limited's revenue for the year ended 31 March 2014 is **high** as:

- The revenue significantly **increased 84%** from the prior year and there was no significant capital investment in Think Limited's property, plant and equipment to **increase its production capacity**.
- The gross profit margin **increased from 15% to 33%**. For manufacturing company, revenue should change in line with the cost of goods sold.
- The accounts receivable balances **increased to 3 times** of the same in the last year and the debtor turnover period (accounts receivable / revenue x 365 days) increased from 96 days to 161 days. It indicated that the revenue may be overstated by including non-existent debtors.

HKICPA - QPMC – Jun 2014 Q6



Answer (b)

The **audit procedures** for the occurrence assertion of revenue may include:

- Perform a **financial analysis** of the fluctuation of gross profit margin.
- Ask the management for the **reasons** for the fluctuation in gross profit margin with reference to the market situation.
- Perform an **industry comparison and analysis to document** whether the change in gross profit margin is in agreement with the current market trends and situation.
- Perform a **walk through test and control test** to ensure the effectiveness of internal controls implemented for the revenue cycle.

HKICPA - QPMC – Jun 2014 Q6



Answer (b) (Cont'd)

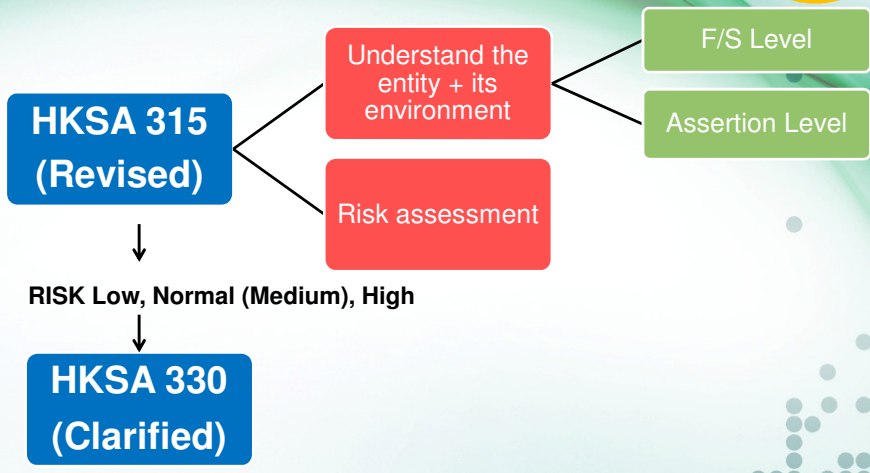
- Review whether the entity is following **HKAS 18 "Revenue"** and applies the revenue recognition policies consistently throughout the periods.
- **Discuss with the staff at the operational level** to ensure an understanding that the business operation procedure was correct and up to date and there are no key changes in the business operation procedures.
- Perform substantive procedures by **selecting samples** from the sales ledger and tracing them in goods delivery documents to ensure proper recording.
- **Direct confirmation** of customers to confirm the total sales amount for the year.



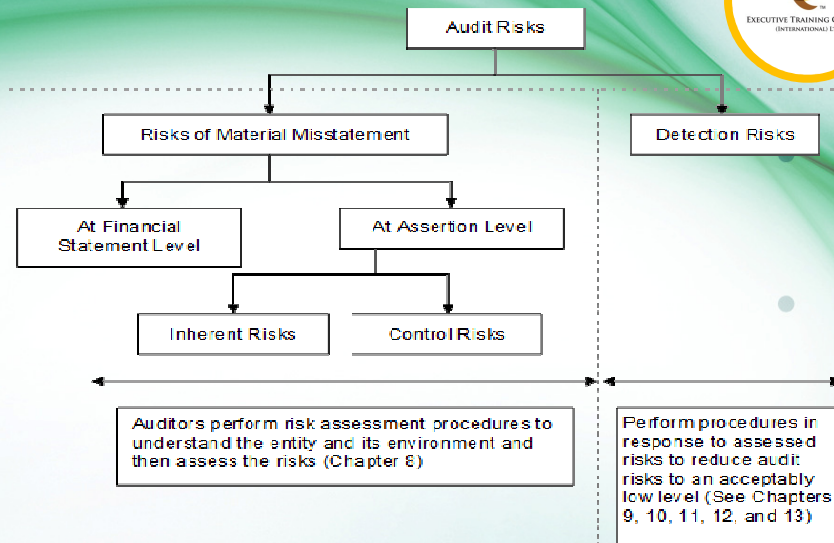
HKSA 330 (Clarified)

Responses to assessed risks

MC - HKSA 330 (Clarified)



MC - HKSA 330 (Clarified)



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MC - HKSA 330 (Clarified)



For Financial Statement Level

- Remind the engagement team to maintain professional skepticism
- Assign more experienced staff
- Budget more review and supervision
- Assign an expert if required, for example if computer fraud is suspected
- Do not rely on entity's internal control and use substantive procedures only
- Perform audit procedures in unexpected manner
- Consider resignation from engagement
- Collect more pervasive evidence
- Making general changes to the nature, timing or extent of audit procedures

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MC - HKSA 330 (Clarified)



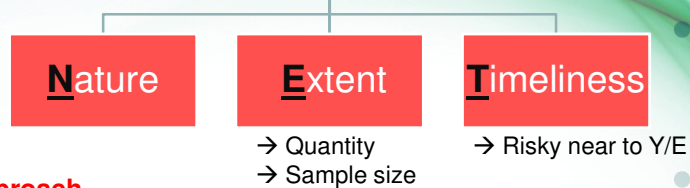
For Assertion Level

The HKSA 330 (Clarified) says that the auditor shall design and perform appropriate audit procedures whose **nature, extent and timing** are based on and are responsive to the assessed risks of material misstatement at the assertion level.

MC - HKSA 330 (Clarified)



Audit Procedures



Audit Approach

- **Combined** Approach
→ TOC & Sub Testing: IC strong
- **Substantive** Approach
→ Substantive Testing only: IC weak

MUST perform some Substantive Testing

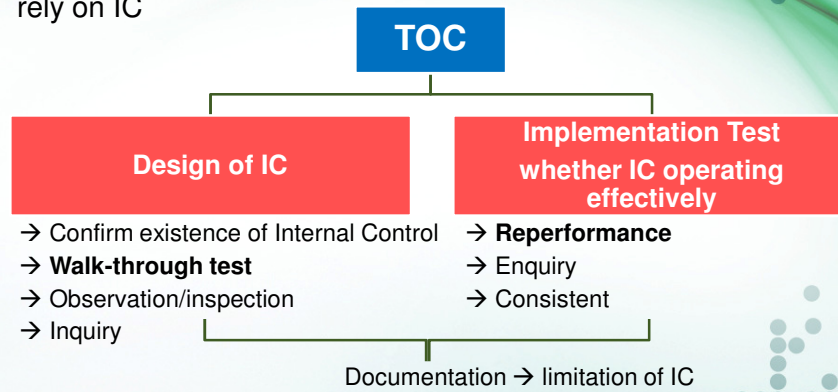
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Tests of Controls

Purpose:

- reduce Substantive Testing
- rely on IC



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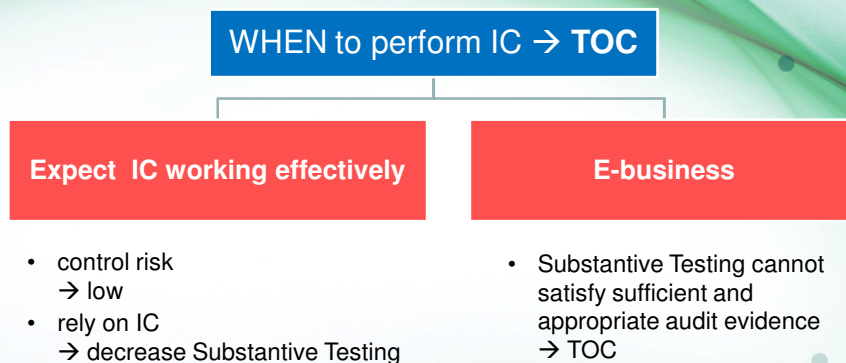
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Tests of Controls

WHEN to perform IC → TOC



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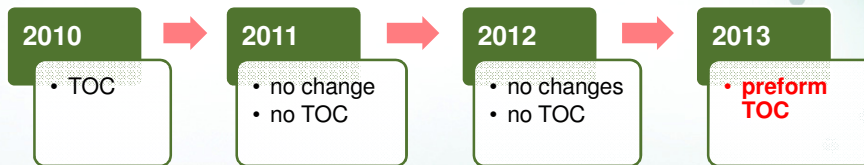
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Tests of Controls

Rely on TOC from prior year

- **Change** as from last tested
- TOC must be performed **every 3 years** even without changes



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Tests of Controls

The auditor shall also undertake tests of controls when it will not be possible to obtain sufficient appropriate audit evidence **simply from substantive procedures alone**. This might be the case if the entity conducts its business using IT systems which do not produce documentation of transactions.

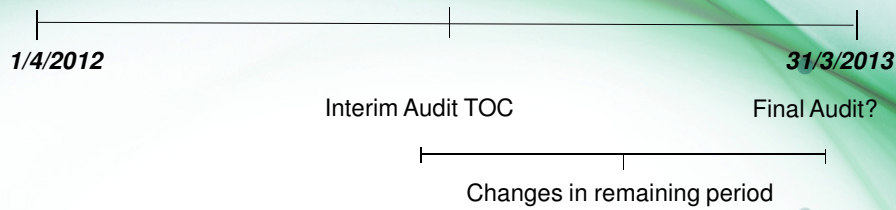
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Test of Controls



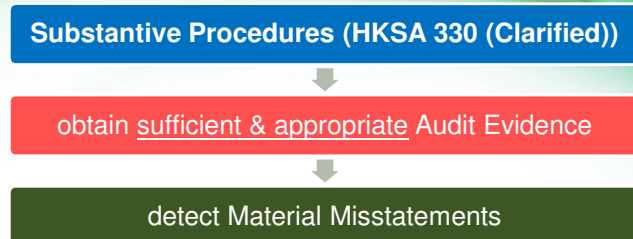
IC to mitigate **significant risks**

→ Auditor must test every year even without changes

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Substantive Testing



WHEN:

- CR high ; IC weak → Substantive Testing ↑
- reduce Detection Risk

MC - HKSA 330 (Clarified)



Substantive Testing

Substantive Testing

Substantive Analytical Procedures

- large volume of immaterial balances
- IC strong
- expectation of less immaterial errors

Tests of Details

- vouching
- confirmation
- tracing
- observation
- specifically responsive to that risk
- appropriate with regard to matters which have been identified as **significant risks**

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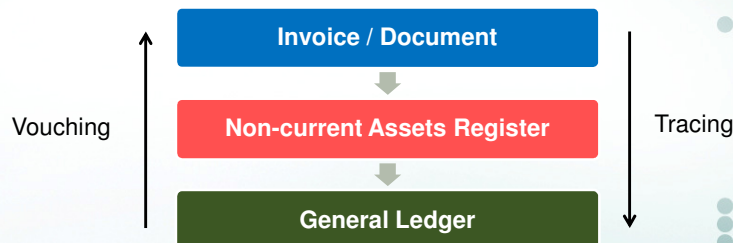
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Specific Audit Procedures

Statement of Financial Position

- Non-current Assets → Fixed Assets
- Property → HKAS 16 *PPE* ; HKAS 40 *Investment Property*
- Plant & Equipment / Computer / MV



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Specific Audit Procedures

For example : Existence

PPE exist properly recorded at Y/E

- Existence
- PPE recorded in non-current assets register actually exist at Y/E
- Physical inspection
- Confirmation
- Vouch to invoice
- Trace invoice to non-current asset register

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Audit Procedures

For example : Completeness: records complete

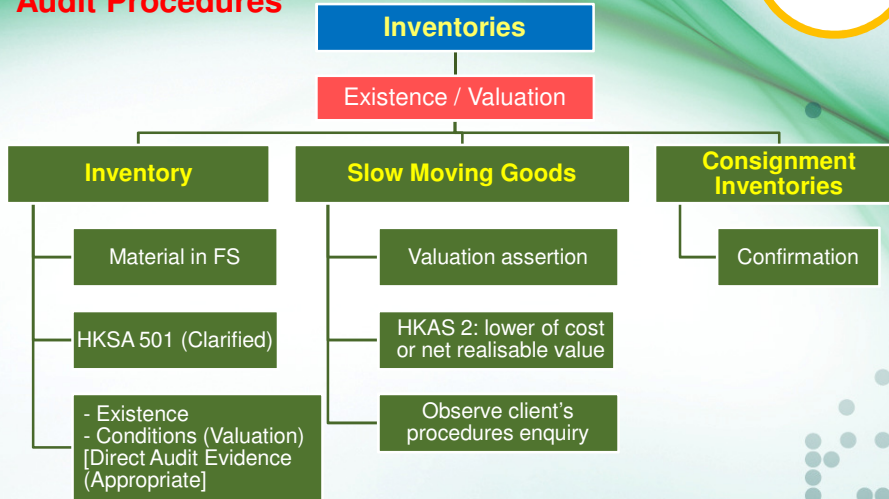
Bal b/f	xxx	→ Check opening balance
Additions	xxx	→ Check authorization
Disposals	(xxx)	→ BOD minutes, sales & purchase agreements
Bal c/f	xxx	

PPE exist property recorded at Y/E

- recalculate P&L on disposal
- check subsequent events
- check cutoff
- perform land search
- vouch to invoice

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Audit Procedures



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Audit Procedures

Accounts Receivable [Debtors]

- Directional Testing → double entry: (Dr) Trade Debtor
(Cr) Sales

HKSA 505 (Clarified) External Confirmation → Direct Communication to External Party

- "appropriate" audit evidence → reliable
- immediately after Y/E
- maintain control by auditors
- ie Independent Selection: Debtor → directly reply to auditor

overstate Revenue
→ overstate Trade Debtors

Alternative Procedures

- Subsequent Settlement
- Enquiry / Reconciliation

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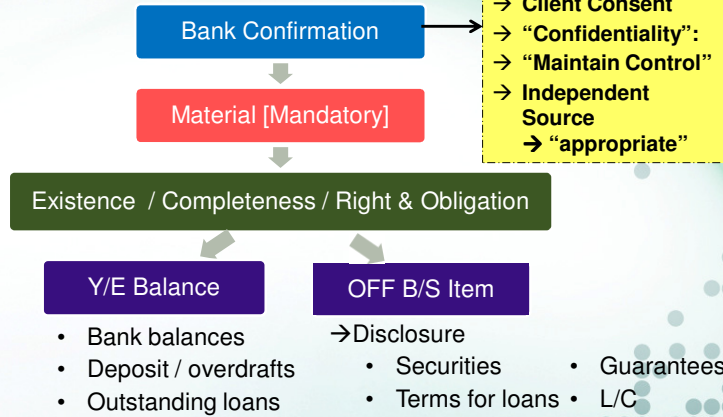
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Audit Procedures

Bank & Cash [Cash and Cash Equivalents]



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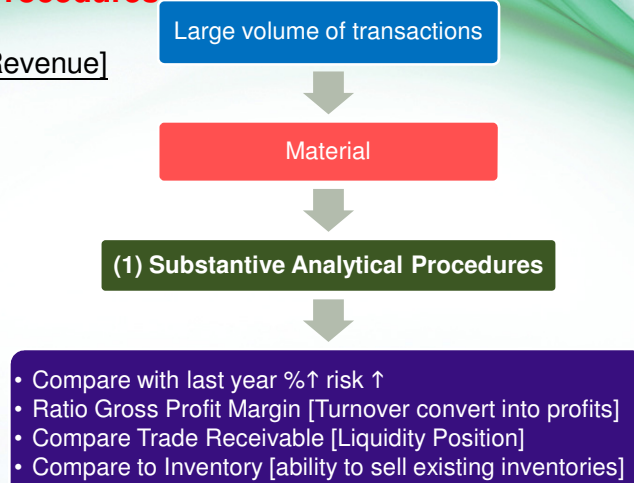
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Audit Procedures

Sales [Revenue]



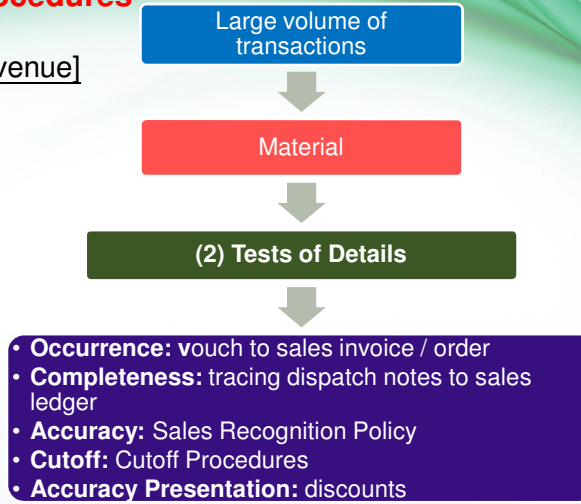
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Audit Procedures

Sales [Revenue]



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General Controls

General computer control relating to Information security

The general IT controls include controls over **data centre operations, system software acquisition and maintenance, access security, and application system development and maintenance**. They create the environment in which the application systems and application controls operate.

Examples include IT policies, standards, and guidelines pertaining to IT security and information protection, application software development and change controls, segregation of duties, service continuity planning and IT project management.

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Application Controls

Application controls are particular to an application and may have a direct impact on the processing of **individual transactions** and pertain to specific computer applications. They include controls that help to ensure the proper **authorisation, completeness, accuracy, and validity of transactions**, maintenance and other types of data input. Examples include system edit checks of the format of entered data to help prevent possible invalid input, system enforced transaction controls that prevent users from performing transactions that are not part of their normal duties, and the creation of detailed reports and transaction control totals that can be balanced by various units to the source data to ensure all transactions have been posted completely and accurately.

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Implementation of a new computer programme by the client



Risk assessment	The audit firm should assess the impact of the implementation of the new computer programme and plan the audit procedures during the risk assessment process.
Consideration of in-house capabilities	The auditor should consider: <ul style="list-style-type: none">• whether the audit team possesses the required expertise in auditing the new audit programme• the timing of the audit procedures, e.g. performing pre-implementation review or post-implementation review; and• the use of CAATs and other audit software in carrying out the journal entries testing.

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MC - Information Technology

Implementation of a new computer programme by the client



Issues related to data migration from old system into new system	<ul style="list-style-type: none">• In addition, the auditor should also consider the audit procedures to ensure the data migrated from the old system to the new system is complete and accurate.• The auditor should ensure that management's control is in place for data migration and perform relevant substantive testing, e.g. reconcile the opening balances with the closing balances.
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System conversion

Pilot system approach

In this approach, the client implements the new IT system at one representative office prior to rolling out to the remaining to other branches.

This will reduce the risk of implementation because the client could identify any problems and resolve them before implementing the IT system at the remaining branches.

Parallel operation approach

In this approach, the entity operates both the new and existing systems for a period of time until it can be certain that the new system is running successfully.

In this case, it is not practical to ask the bank customers to process their transactions at the counters through the existing computer system and then process them again using the new IT system.

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MC Exam Questions



Exam Questions Review Dec 2015 – Short Question 6

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MC Exam Questions



Question: Dec 2015 – Qu 6

Two years ago, Melon Limited acquired Lychee Limited. Melon Limited and Lychee Limited are both fruit distributors. Both companies use Enterprise Resource Planning (“ERP”) computer software for daily operations and bookkeeping. However, the system specifications and the ERP modules used are very different in the two companies. In order to enhance the operational efficiency, it was decided that Lychee Limited will switch to the ERP system of Melon Limited and scrap its own ERP system this year. You are the auditor of Lychee Limited and in the process of understanding the change of system with the management.

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MC Exam Questions



Question: Dec 2015 – Qu 6

Required:

a) Suggest the possible factors that may lead to material misstatements in the financial statements of Lychee Limited as a result of the change of system.

(3 marks)

b) In response to the possible factors identified in Question 6(a), suggest audit procedures to address the possible risks of material misstatements in the financial statements relating to the above change of system.

(7 marks)

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MC Exam Questions



Answer: Dec 2015 – Qu 6(a)

The possible factors that may lead to material misstatements of financial statements of Lychee Limited include the following:

- There may **not be appropriate and sufficient training** provided to the staff of Lychee Limited on Melon Limited's system which increases the possibility of human error in recording the transactions during the operation.
- There may be significant changes to the processes and controls over respective significant operating cycles of Lychee Limited that were redesigned to facilitate the use of Melon Limited's system. These new processes and controls **may not be effectively implemented** in Lychee Limited which increases the risks of material misstatements to the financial statements.

MC Exam Questions



Answer: Dec 2015 – Qu 6(a) Cont'd

- There could be **errors or missing data** in converting Lychee Limited's data from the old ERP system to the new ERP system.
- The system conversion involves **system development processes and data conversion processes**. It creates opportunity for management fraud if these processes are not well planned and closely monitored.

MC Exam Questions



Answer: Dec 2015 – Qu 6(b)

The audit engagement team can consider the following audit procedures in response to possible material misstatements of financial statements relating to the system conversion:

- Understand the **system development processes** and how the changes to the system of Lychee Limited affect the financial statements.
- Understand whether the management has engaged a third party consultant to assist the system switch or Lychee Limited performed the **system change in-house**.
- Assess the **competence and experience** of the management team and / or the third party consultant for system conversion.

MC Exam Questions



Answer: Dec 2015 – Qu 6(b) Cont'd

- Understand the **management's plan** for the system conversion, including the scope of changes, system design, timeframe and key milestones, training and contingency plan, if any.
- Ask the management about any **changes to the processes and controls** in respective significant business processes in response to the changes in the system.
- Perform a **walk-through test** to understand the new processes and controls implemented in response to the system changes.
- Evaluate and validate the **control effectiveness** of the newly implemented controls in the respective significant business processes to ensure the controls are operating effectively since its implementation during the year.

MC Exam Questions



Answer: Dec 2015 – Qu 6(b) Cont'd

- Understand, evaluate and validate **the IT general control** of the new system of Lychee Limited, including controls over the data centre and network operations, system software changes and maintenance; access security; application system development and maintenance.
- Understand the **management's controls** over the data conversion processes.
- Consider testing **the data conversion** either using the **control reliance approach** if the audit engagement team considers the management's data conversion controls are appropriate for the size and operation of Lychee Limited or the audit engagement team can adopt the substantive approach if it considers the controls designed by the management over data conversion are ineffective.

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MC Exam Skills



1. Identify audit issues in the case
2. Count the marks
3. Use auditing wordings
4. Writing skills
5. Cross over standards
6. Practical audit procedures
7. Time management

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