



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



Module Preparation Seminar (Part II)
for
Module C on Business Assurance

Speaker
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Section 1 - Basics of Audit Responses

Reference: HKSA 330 (Clarified) *The Auditor’s Responses to Assessed Risks*

Concept Check:

- What is the relationship between risks of material misstatement and audit response?
- Can you differentiate the following terms?
 - Audit Response
 - Audit Approach
 - Audit Procedures

Responses to RoMM at the Assertion Level

HKSA 330 (Clarified) requires that the auditor shall design and perform further audit procedures whose **n**ature, **t**iming and **e**xtent (“NET”) are based on and are responsive to the assessed risks of material misstatement at the assertion level.

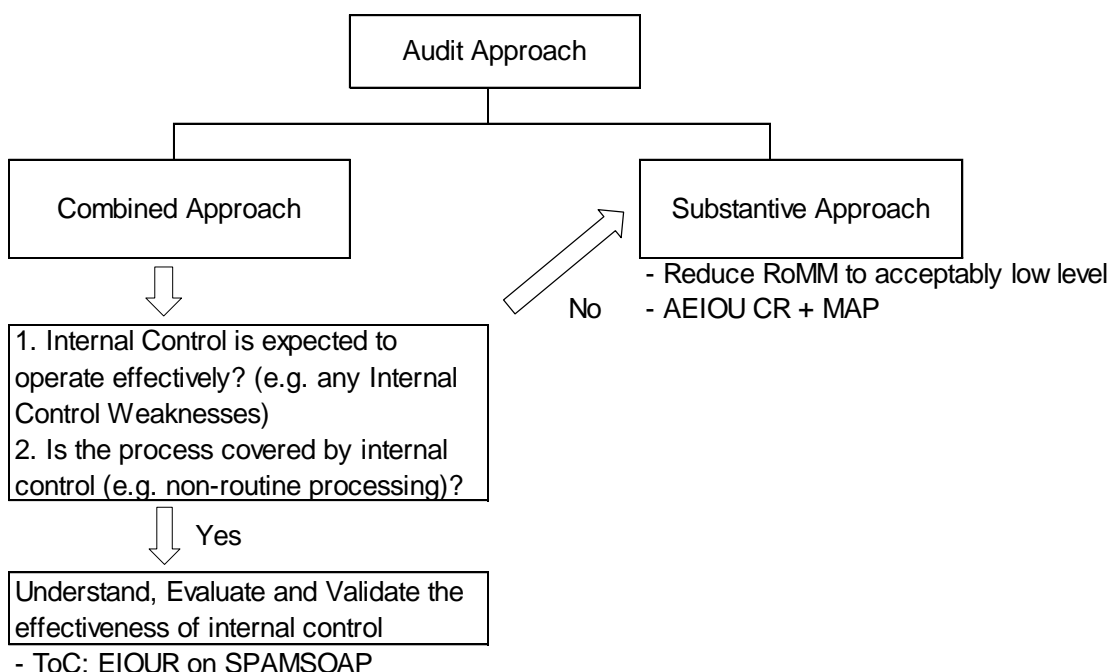
Nature	It refers to the audit approach and what type of audit testings would be performed.
Timing	It refers to whether to perform audit procedures at interim stage or at period end. Typically, if the RoMM is higher, audit procedures should be performed nearer or at period end or at unpredictable times.
Extent	It refers to the quantity of audit evidence. Typically, the higher the RoMM the greater extent is required. One way to increase extent is by increasing sample size.

Audit Approach

Approach	Remark
Substantive Approach	Only substantive procedures would be performed. Nevertheless, the auditor may perform one or in combination of test of details and substantive analytical procedures.
Combined Approach	Perform both tests of controls and substantive procedures.

In essence, the key determination factor is: are we going to perform tests of controls? The determination of audit approach can be illustrated by the following flowchart:

Determine Audit Approach



Types of Audit Testings

Before going further, we first look at how auditors can obtain audit evidence (mnemonic “AEIOU CR”):

Techniques	Remarks
<u>A</u> nalytical Procedures	<ul style="list-style-type: none"> Cannot address existence and occurrence Useful for valuation and allocation, accuracy and completeness
<u>E</u> nquiry	<ul style="list-style-type: none"> Useful for most assertions
<u>I</u> nspection	<ul style="list-style-type: none"> Useful for most assertions
<u>O</u> bservation	<ul style="list-style-type: none"> Useful for physical assets
Recalc <u>U</u> lation and reperformance	<ul style="list-style-type: none"> Useful for valuation and allocation and accuracy
<u>C</u> onfirmation	<ul style="list-style-type: none"> Useful for most assertions (except for valuation and allocation of accounts receivables)
<u>R</u> econciliation	<ul style="list-style-type: none"> Cannot address existence and occurrence Useful for valuation & allocation, accuracy and completeness

The above techniques can be applied when performing audit testings.

Type	Remark
Tests of Controls (“ToC”) Typically this involved “EIOUR”.	Perform if: <ul style="list-style-type: none"> The auditor expects the internal controls are operating effectively and intends to rely on internal controls; or Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level (e.g. relate to the inaccurate or incomplete recording of routine and significant items by highly automated processing) If ToC is performed at interim: <ul style="list-style-type: none"> Obtain audit evidence about any significant changes subsequent to interim (by inquiry, observation and/or confirmation) Determine the additional audit evidence for the remaining period If using prior year’s ToC results: <ul style="list-style-type: none"> Obtain audit evidence about any significant changes subsequent to prior year (by inquiry, observation and/or confirmation) If there have been changes, ToC should be performed again this year If there have been no changes, ToC should still be performed at least once in every third audit. Also, some ToC should still be performed each year. Prior year’s ToC result should not be used if the controls relate to significant risks.
Substantive Procedures This covers all AEIOU CR.	This must be performed for: <ul style="list-style-type: none"> each material class of transactions, account balances and disclosures to reduce RoMM to acceptably low level significant risks Substantive procedures can be: <ul style="list-style-type: none"> tests of details or substantive analytical procedures

Designing Specific Audit Procedures (“AEIOU CR”)

It is virtually not possible to list out all audit procedures to address each item by assertions. In fact, the audit procedures to address the same assertion of the same item would vary according to the specific circumstances.

Nevertheless, the below “MAP” approach would prove to be useful which makes use of “AEIOU CR” model.

Approach	Sample Substantive Procedures
Test what Management has done (E, U)	<ul style="list-style-type: none"> • Enquire into/Discuss with management regarding [ascertain the assertions] • Assess experience, competence, objectivity of staff/expert performing the [management’s actions] • Examine compliance of accounting policies with HKFRS • Reperform/recalculate management’s calculation
<u>A</u> uditor designed procedures (A, I, O, C, R)	<p>Basic procedures:</p> <ul style="list-style-type: none"> • Obtain reconciliations/breakdowns showing [.....] • Agree opening balance to prior year’s audited F/S • Agree closing balance to F/S • Check mathematical accuracy of the [accounting record] <p>Main procedures:</p> <ul style="list-style-type: none"> • Vouch [supporting documents] for breakdown/movement items • Vouch or Physically Observe from list to floor • Vouch or Physically Observe from floor to list • Send confirmations to [...] confirming [...] • Test reconciling items by vouching [.....] and obtain explanations.... • Review minutes and correspondence for.... • Review agreements for..... • Analytical Procedures (Compare A to B...) • Search for unrecorded liabilities <p>Procedures involving Accounting Estimates or Fair Value:</p> <ul style="list-style-type: none"> • Assess reasonableness of models and assumptions used by management • Develop an independent estimates and compare with management’s calculations (may also use auditor’s expert) • Review subsequent events to assess reasonableness • Obtain LoR to confirm [state specific matters]
<u>P</u> ost balance sheet indication	<ul style="list-style-type: none"> • Check for any subsequent settlements

Practice Question 1 – QP MC May 07 (extract)

Engineering Materials Manufacturing Company Limited is a company listed on the Hong Kong Stock Exchange.

Engineering Materials Manufacturing Company and its subsidiaries (“EMM”), are principally engaged in the manufacture and trading of engineering materials, including steel, iron, aluminium, cement, timber and asphalt. EMM’s customers are mainly construction and engineering companies in Mainland China, Hong Kong and other Asian countries. As at 31 December 2006, over 90% of EMM’s assets were located in Mainland China.

In view of the booming economy in Mainland China, EMM embarked on an expansion plan two years ago to double the group’s turnover within five years. EMM plan to implement this strategy through acquisition of other manufacturers as well as setting up new plant in strategic locations in the Mainland. In the last two years, an increasing trend in turnover and receivables has been noted.

On 21 December 2006, EMM succeeded in issuing debentures of US\$130,000,000 at an interest rate of 9.5% per annum. The debentures are listed on an overseas exchange. The proceeds received were used partly to repay bank loans when they were due, while the remaining cash was kept in banks in Mainland China.

EMM’s previous auditor, XYZ & Co, was re-appointed in April 2006 after it reported on EMM’s financial statements for the year ended 31 December 2005. However, XYZ & Co resigned in November 2006.

XYZ & Co had proposed a fee which doubled the fee it charged EMM in the last year but EMM did not accept the increment. According to EMM, they wanted to change auditors periodically to ensure independence. According to XYZ & Co, the firm is prepared to rotate the engagement partner in accordance with quality control standards.

The directors of EMM approached ABC & Co in January 2007 and proposed to appoint them as the auditor of EMM’s financial statements for the year ended 31 December 2006.

(i) EMM’s consolidated balance sheet at 31 December 2006 is as follows:

(HK\$’000)	2006	2005
Property, plant and equipment	515,661	476,838
Lease premium on land	176,140	45,208
Intangible assets	8,862	4,773
Goodwill	14,086	14,086
Prepayments and deposits	168,442	84,144
Deferred tax assets	15,309	14,391
Non-current Assets	898,500	639,440
Current portion of lease premium on land	3,819	1,067
Inventories	80,931	87,143
Trade receivables	936,370	817,126
Cash and cash equivalents	1,220,018	1,064,385
Current Assets	2,241,138	1,969,721
Total Assets	3,139,638	2,609,161

(HK\$'000)	2006	2005
Share capital	423,835	423,835
Share premium and reserves	910,425	805,075
Minority interests in assets and liabilities	132,731	76,314
Equity	1,466,991	1,305,224
Long-term borrowings	98,833	463,266
Long-term notes	940,636	-
Deferred tax liabilities	1,555	2,298
Non-current Liabilities	1,041,024	465,564
Trade and other payables	115,473	151,593
Short-term borrowings	455,509	496,910
Current portion of long-term borrowings	43,333	168,513
Current tax liabilities	17,308	21,357
Current Liabilities	631,623	838,373
Total Liabilities	1,672,647	1,303,937
Total Equity and Liabilities	3,139,638	2,609,161

(ii) An analysis of the trade receivables is as follows:

(HK\$'000)	2006	2005
Within 60 days	533,253	585,004
Between 61 days to 180 days	395,030	206,082
Over 180 days	8,087	26,040
	936,370	817,126
Industry Data:		
Turnover/Receivables	4.67 times	4.56 times
Receivables Turnover (days)	78	80

EMM normally grants 60 days credit to its customers.

(iii) EMM's consolidated income statement for the year ended 31 December 2006 is as follows:

(HK\$'000)	2006	2005
Turnover	3,044,505	2,832,638
Cost of sales	(2,722,517)	(2,487,302)
Gross profit	321,988	345,336
Other revenue	9,111	11,098
Other operating gains (net of losses)	2,898	10,423
Distribution and selling expenses	(11,605)	(5,837)
Administrative expenses	(79,849)	(80,222)
Other operating expenses	(2,724)	(12,695)
Profit from operations	239,819	268,103
Finance costs	(73,970)	(31,484)
Profit before taxation	165,849	236,619
Income tax expense	(27,273)	(41,300)
	138,576	195,319
Attributable to shareholders of EMM	116,979	174,760
Minority interests in profit or loss	21,597	20,559
	138,576	195,319

You are ABC & Co's audit manager.

Practice Question 1**Question 3 (15 marks - approximately 27 minutes)**

You assessed the risk of material misstatement of the existence of EMM's cash and cash equivalents as medium, with an expectation that EMM's internal controls operated effectively during the period.

(a) Determine the audit approach you would adopt to examine the existence of EMM's cash and cash equivalents.

(3 marks)

(b) List two control activities and two monitoring of controls relevant to the existence of EMM's cash and bank balances that you would expect to have been implemented.

(4 marks)

(c) For each of the control activities and monitoring of controls you mentioned in (b), suggest an appropriate test of control.

(4 marks)

(d) Determine any substantive procedures you would perform to examine the existence of EMM's cash and cash equivalents.

(4 marks)

Practice Question 1 – Answer**Answer 3(a)**

Given that the risk of material misstatement of the existence of EMM's cash and cash equivalents is assessed as medium with an expectation that EMM's internal controls operated effectively during the period, it is reasonable for the team to adopt a combined approach in examining the existence of EMM's cash and cash equivalents.

Under the combined approach, the team should (1) perform tests of control to obtain appropriate sufficient evidence that the internal controls relevant to the existence of EMM's cash and cash equivalents had been operated effectively during the period, and (2) perform substantial procedures to obtain further evidence that the risk of material misstatement is reduced to an acceptably low level.

Answer 3(b)

Control activities that are relevant to the existence of EMM's cash and bank balances include:

Control activities

- (i) Periodic and timely reconciliation of the balances as shown in the bank statements against the records of cash and cash equivalents by a competent and independent staff (or other forms of performance review that related different sets of data to one another);
- (ii) Automated or manual checking of the arithmetical accuracy of records (or other forms of application controls in the processing of information about cash transactions);
- (iii) Physical access to cash and computer terminals and/or programmes that process cash transactions are restricted to authorised persons (or other forms of physical control); and
- (iv) Different persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and the custody of cash (or other forms of segregation of duties).

Monitoring of controls

- (i) Management review of bank reconciliations to ensure that the reconciliations have been performed in a regular and timely manner; and
- (ii) Internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or extent of segregation of duties in processing cash transactions (or other relevant monitoring of controls).

Practice Question 1 – Answer
Answer 3(c)

Tests of controls on the control activities that are relevant to the existence of EMM's cash and bank balances include:

Tests of controls on control activities

Any two of the following:

- (i) Asking the relevant member of staff how he/she prepares the bank reconciliations to determine whether bank reconciliations are prepared properly.
- (ii) Inspection of the documentation of the reconciliations during the year of the balances as shown in the bank statements against the records of cash and bank balances to obtain evidence that the reconciliations have been performed regularly and in a timely manner by a competent member of staff;
- (iii) Obtaining evidence that the controls have operated effectively during the year, and re-performing the automated or manual checking of the arithmetical accuracy of records to identify any deficits of the controls;
- (iv) Observation of whether the physical access to cash and computer terminals and/or programmes that process cash transactions are actually restricted to authorised persons; and
- (v) Observation and/or inspection of documentation of which persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and custody of cash and cash equivalents.

Tests of controls on monitoring of controls

Any two of the following:

- (i) Asking the management how he/she reviews the bank reconciliations to determine whether the reviews have been conducted properly.
- (ii) Inspection of the documentation of management's review of bank reconciliations during the year; and
- (iii) Observation and/or inspection of documentation of the internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or the extent of segregation of duties in processing cash transactions, and determination of whether the internal auditors'/independent evaluation was appropriate.

Answer 3(d)

Obtain confirmation from banks in accordance with the requirements of HKSA 505 (Clarified) "*External Confirmations*". In particular, the auditor should have full control over the confirmation process.

Review bank reconciliations for the bank balance as at 31 December 2006, including enquiry into the nature of the major reconciliation items and inspection of documentation of the follow up actions and their disposal.

Perform analytical reviews on cash and cash equivalents records (including scanning through the records) to identify any unusual movements, particularly for short periods before and after the balance sheet date.

Check casting of the total cash and cash equivalents at the balance sheet date OR perform cash count and roll back to the balance sheet date if cash on hand was considered material.

Practice Question 2 – QP MC Dec 12 (extract)**Question 6 (18 marks – approximately 32 minutes)**

In a recent dialogue with the Internal Audit, you understand that the Internal Audit has issued an unsatisfactory report on the bank reconciliation process of your client. The Internal Audit report indicated that there was significant control deficiency over the cash management process, and that the management processes and controls were not properly exercised by the operation team.

Required:

(a) Assess and explain the risk of material misstatement relating to the existence and valuation assertions of the cash and bank balance as at year end.

(3 marks)

(b) Suggest and explain the audit procedures you would perform in response to the risk of material misstatement identified in Question 6(a).

(7 marks)

Practice Question 2 – Answer**Answer 6(a)**

The risk of material misstatement on cash and bank balances is high because of the following:

- the bank reconciliation process does not operate effectively which may increase the risk of unidentified accounting errors and adjustments; and
- there is an increased opportunity for misappropriation of cash given that the management's processes and controls were not properly exercised by the operation team.

Answer 6(b)

The audit team should consider the following audit procedures in response to the risk of material misstatement over cash and bank balances identified in (a):

- review the Internal Audit Report in detail and discuss with Internal Audit findings with management and reassess the risk of material misstatements of cash and bank balance;
- understand from management the remedial action plan and implementation timeline;
- identify whether there are compensating controls and consider performing the testing of the compensating controls by understanding, evaluating and validating the key management compensating controls;
- instead of relying on management's control over cash management, consider a substantive testing approach by performing test of details;
- circulate bank confirmations directly to every bank with which the company conducted business; verify the bank balances with the replies to the standard bank letter;
- check the bank balances against the respective bank statements;
- reperform the bank reconciliation by comparing the cash ledger balance and the balance stated on bank statements/ bank confirmations, obtain an explanation from management for any large or unusual items not cleared at the time of audit;
- obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement and vice versa through discussion with finance staff; and
- check subsequent bank statements to confirm the validity of the bank reconciliation items (e.g. un-presented cheques).

Practice Question 3 – QP MC Jun 13 (extract)**CASE**

You are an audit partner of ABC & Co. One day in July 2012, your old friend, Thomas, called you and told you that Happy Toy Ltd. (“Happy Toy”) was looking for a new auditor and would like to check if you are interested in taking up the audit engagement.

After performing some background search of Happy Toy, you arranged a meeting with the management of Happy Toy to understand more about the entity and its business.

Here are the notes that you have written down during the meeting with Happy Toy’s management:

- Happy Toy listed on The Hong Kong Stock Exchange in 2001. Its principal business is toy manufacturing and trading.
- It has a manufacturing plant in Panyu, China, and two trading companies in Hong Kong and Macau respectively.
- It mainly produces soft toys for overseas customers in the US and Europe. Only approximately 10% of sales are transacted with local customers in mainland China.
- Its toy business has been shrinking after the Financial Tsunami in 2008. Competition is getting fierce. Customer orders from the US and Europe dropped significantly while there is the continuous increase in material and labour costs in the Mainland. Management has been struggling in this business environment.
- In 2010, Happy Toy started to diversify its business portfolio and acquired a shopping arcade in the west of Guangzhou. The shopping arcade brings a stable income to the group and has been profit-making.
- In 2012, Happy Toy further diversified its business portfolio by investing in property development. It acquired a property development company in Henan focusing on developing high-end residential housing.
- The acquisition of the Henan property project was completed in February 2012. Happy Toy paid a total consideration of HK\$200 million. The asset acquired mainly represented a piece of land located in Henan. The management has engaged an external independent valuer to assess the fair value of the land. The valuation of the land as at the acquisition date was approximately HK\$180 million. A goodwill of HK\$40 million was recognized in relation to this acquisition after considering the liabilities of HK\$20 million.
- Management is confident of their property project in Henan in view of the high growth of the property market in the Mainland. They also explained that their piece of land is located in a very good location because a highway and a train station will be built nearby.
- As at 30 June 2012, Happy Toy has HK\$300 million bank borrowings with the maturity date due in September 2013.

Practice Question 3

Subsequent to the meeting, management has sent you their interim report. Here is an extract of Happy Toy's financial information as at 30 June 2012 and for the six months ended 30 June 2012:

Segment disclosures

For the six months ended 30 June 2012:

	Toy Manufacturing Business (HK\$'000)	Property Rental Business (HK\$'000)	Property Development Business (HK\$'000)	Total (HK\$'000)
Revenue	680,000	12,000	-	692,000
Operating Profit / (loss)	(5,000)	9,000	(1,000)	3,000

For the six months ended 30 June 2011:

	Toy Manufacturing Business (HK\$'000)	Property Rental Business (HK\$'000)	Property Development Business (HK\$'000)	Total (HK\$'000)
Revenue	850,000	11,600	-	861,600
Operating Profit / (loss)	(4,000)	8,500	-	4,500

Extract from financial statements:

	30 June 2012 (HK\$'000)	31 December 2011 (HK\$'000)
Goodwill	40,000	-
Investment property	200,000	200,000
Property, plant and equipment	160,000	162,000
Property under development	180,000	-
Inventories	6,500	8,000
Trade receivables	27,000	30,000
Cash and bank	27,000	280,000
Other current assets	5,000	4,800
Total assets	645,500	684,800
Trade payables	53,000	57,000
Other payables and accruals	23,000	2,000
Bank borrowings	300,000	300,000
Total liabilities	376,000	359,000

In early August 2012, Happy Toy would like to nominate ABC & Co. as their coming auditor for the financial year ended 31 December 2012.

Practice Question 3**Question 2** (20 marks – approximately 36 minutes)

You have accepted Happy Toy's appointment as their auditor for the 2012 financial year audit. You are now working on the audit planning and risk assessment.

Required:

- (a) In respect to the property project in Henan, identify and explain the risks of material misstatements at the assertion level.

[Note: Marks will only be given if you can provide specific answers to particular account balance(s) and related assertion(s).]

(7 marks)

- (b) In response to the risks of material misstatements identified in Question 2(a), what are your suggested audit procedures in addressing the risks?

(13 marks)

Practice Question 3 – Answer
Answer 2(a)

The following are the risks of material misstatements identified:

- (i) Existence, valuation and right and obligation of the piece of land acquired
 - The amount of the land acquired is material to financial statements and its valuation is highly dependent on the valuation results of the external independent valuer.
- (ii) Valuation of the goodwill arising from the acquisition of the property development company
 - The amount of goodwill recognized is individually material to the financial statements and highly dependent on the valuation results of the asset and liabilities acquired.
 - Potential goodwill impairment depends on the future development of the property market in the Mainland and the timing of completion of the highway and train station.

Answer 2(b)

In response to the existence, valuation and right and obligation of the piece of land acquired, the following procedures should be considered:

- Inspect the share purchase agreement and ensure the land form part of the asset transferred
- Inspect the land use right certificate and ensure the title of the piece of land is under the company
- Carry out a site visit to inspect the piece of land acquired
- Inspect the valuation report prepared by the external independent valuer and discuss the findings in the valuation report with the valuer
- Evaluate the competence, capabilities and objectivity of the independent valuer to consider whether the work of the valuer is adequate for the audit purposes
- Evaluate the relevance and reasonableness of the independent valuer's findings and conclusions
- Evaluate the relevance and reasonableness of the significant assumptions and methods used by the independent valuer
- Evaluate the relevance, completeness and accuracy of the source data used by the independent valuer
- When it is determined that the work of the independent valuer is inadequate to satisfy the audit purposes, agree with the independent valuer the nature and extent of further work to be performed by the independent valuer or perform additional appropriate audit procedures

Practice Question 3 – Answer

In response to the valuation of the goodwill arising from the acquisition of the property development company, the following procedures should be considered:

- Agree the consideration paid to the sales and purchase agreement by inspection
- Identify potential intangible assets and consider the valuation (e.g. due diligence reports)
- Consider whether asset and liabilities valuation (including assumptions) is reasonable
- Obtain the purchase price allocation and agree the calculation is correct by recalculation
- Check purchased goodwill is calculated correctly (it should reflect the difference between the fair value of the consideration given and the aggregate of the fair values of the net asset acquired)
- Review the impairment test performed by management at year end and discuss with management
- Evaluate the impairment test, ensure the methodology used is in compliance with the Hong Kong Financial Reporting Standard and the assumptions used are reasonable
- Check whether appropriate disclosures has been prepared in relation to the business combination and goodwill impairment assessment in the financial statements

HANDOUT

Section 2 – Group Audit

Concept check:

- What is the setting of group audit?
- What are the specific audit issues in a group audit setting?

Reference: HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

Below are the basic definitions in a group audit:

Group financial statements are financial statements that include the financial information of more than one component.

Component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.

Nature of Group Audit

The audit process in a group audit is in principle the same in a non-group audit. However, the fact the F/S is consolidated brings up additional audit considerations which are addressed by HKSA 600 (Clarified).

The objectives of the group auditor are:

- (a) To determine whether to act as the auditor of the group F/S; and
- (b) If acting as the auditor of the group F/S:
 - (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
 - (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group F/S are prepared, in all material respects, in accordance with HKFRS.

Overview of Group Audit Process

Following on the previous section, the specific considerations required by HKSA 600 (Clarified) in the audit process are set out in the below table:

Stage	Responsibility of Group Auditor
Acceptance and Continuance	<ul style="list-style-type: none"> • Obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components <p>Obtaining such understanding enable the group auditor to fulfil the requirements of HKSQC 1(Clarified) and whether sufficient appropriate audit evidence can be obtained on the group F/S.</p>
Overall Group Audit Strategy and Audit Plan	<ul style="list-style-type: none"> • Review the overall group audit strategy and group audit plan <p>Typically, the overall audit strategy and audit plan for a group is more excessive.</p>

Understanding the Group, Its Components, and Their Environments	<ul style="list-style-type: none"> Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage Obtain an understanding of the consolidation process, including the instructions issued by group management to components <p>The understanding should be sufficient to:</p> <ul style="list-style-type: none"> Confirm or revise its initial identification of components that are likely to be significant Assess the RoMM of the group F/S whether due to fraud or error
Determine significant components and work thereon	Please below for further discussion.
Assess Component Auditors	Please below for further discussion.
Testing Group-Wide Controls	<p>Test (or request a component auditor to test) the operating effectiveness of group-wide controls if:</p> <ul style="list-style-type: none"> NET of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively; or Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level
Determine Component Materiality	Please below for further discussion.
Issue Group Audit Instructions to Component Auditors	Please below for further discussion.
Involvement with Component Auditors' Work	Please below for further discussion.
Test Consolidation Process	This involves the testing of consolidation adjustments and making sure the consolidation F/S is complete.
Subsequent Events	<p>Where component auditors perform work other than audits of the financial information of components:</p> <ul style="list-style-type: none"> request the component auditors to notify the group auditor if they become aware of subsequent events that may require an adjustment to or disclosure in the group F/S
Communication with Group Management and Those Charged with Governance	This includes key group audit issue.
Basis of Group Audit Opinion	<p>This is based on evaluation of whether sufficient appropriate audit evidence has been obtained from:</p> <ul style="list-style-type: none"> the work performed by the group auditor; the work performed by the component auditors on the financial information of the components; and the audit procedures performed on the consolidation process
Forming Group Audit Opinion	<p>The auditor's report on the group F/S shall not refer to a component auditor (even in the case of modification of opinion), unless required by law or regulation to include such reference.</p> <p>If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group auditor's responsibility for the group audit opinion.</p>

Determine Significant Components

Significant component is a component that is:

- of individual financial significance to the group; or
- due to its specific nature or circumstances (likely to include significant RoMM of the group F/S).

A percentage to a chosen benchmark (group assets, liabilities, cash flows, profit or turnover) may be applied as an aid to identify components that are of individual financial significance.

Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgement.

HKSA 600 (Clarified) does not set out a specific threshold. Nevertheless, HKSA 600 (Clarified) includes an example that components exceeding 15% of the chosen benchmark may be considered significant components. However, a higher or lower percentage may also be deemed appropriate depending on the circumstances.

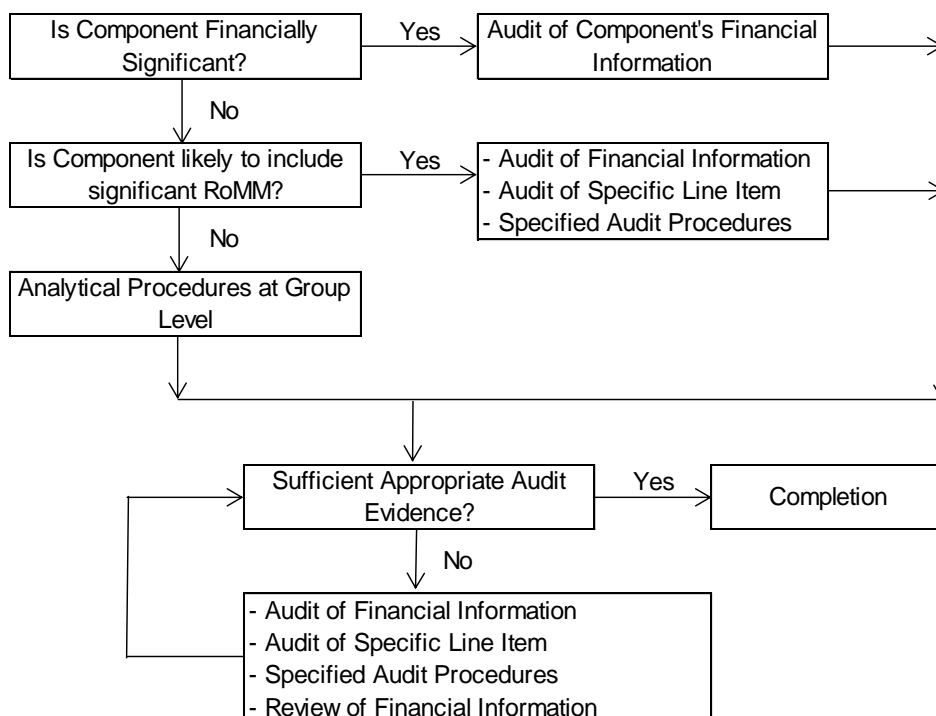
Determine the Type of Work to be performed on Components

HKSA 600 (Clarified) sets out clear guidance as follows:

Circumstance	Type of Work
Significant component due to its individual financial significance	Perform an audit of the financial information of the component using component materiality
Significant component due to its specific nature or circumstances and may pose significant RoMM	Perform one or more of the following: <ul style="list-style-type: none"> • An audit of the financial information of the component using component materiality • An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant RoMM • Specified audit procedures relating to the likely significant RoMM
Components that are not significant components	Perform analytical procedures at group level If the group engagement team does not consider that sufficient appropriate audit evidence will be obtained, then perform one or more of the following: <ul style="list-style-type: none"> • An audit of the financial information of the component using component materiality • An audit of one or more account balances, classes of transactions or disclosures • A review of the financial information of the component using component materiality • Specified procedures

The determination of type of work can be summarised by the following flowchart:

Type of Work to Perform on Components



Assessing Component Auditors

The findings of component auditors will be used by group auditor as basis to form the group audit opinion. Therefore, it is crucial for the group auditor to ensure the creditability of the component auditors.

In particular, the group auditor should assess the following areas in respect of the component auditors:

Areas to assess	Group Auditor’s Procedures
Compliance with ethical requirements, in particular, independence (independent from the parent company and its related parties)	<ul style="list-style-type: none"> • Seek confirmation from the component auditor regarding their independence, objectivity and professional competence • Visit the component auditor to discuss about their independence, objectivity and professional competence • Request the component auditor to complete questionnaires about their independence, objectivity and professional competence
Objectivity, including any bias or conflict of interest	<ul style="list-style-type: none"> • Obtain confirmations from the professional bodies whether the components are professional qualified and licensed with those professional bodies
Professional competence, including: <ul style="list-style-type: none"> • Understanding of HKFRS and HKSA • Sufficient expertise and experience in the component’s industry audit 	<ul style="list-style-type: none"> • Ascertain the quality control policies and procedures used by the component auditors, both firm-wide and those applied to individual engagements • Obtain and review the ethical codes followed by component audit firms and compare them to Code of Ethics for Professional Accountants issued by HKICPA

If there are any issues, the group auditor should increase the NET of involvement in the component auditors' work, including:

- Supervise the component auditor directly and review their working papers
- Review in details the component auditors' findings and evaluate the appropriateness of their conclusion

The group auditor should also consider to perform the audit work themselves instead of using the component auditors.

Group and Component Materiality

The group auditor shall determine the following:

Types of Materiality	Remark
Materiality for the group financial statements as a whole	The principle is the same as normal audit.
Materiality level(s) to be applied to particular classes of transactions, account balances or disclosures (also known as Specific Materiality)	The principle is the same as normal audit.
Component materiality	<p>Component materiality is for those components where component auditors will perform an audit or a review for purposes of the group audit.</p> <p>Component materiality shall be lower than materiality for the group F/S as a whole.</p> <p>Where component auditors will perform an audit for purposes of the group audit, the group auditor shall evaluate the appropriateness of performance materiality determined at the component level.</p>
The threshold above which misstatements cannot be regarded as clearly trivial to the group F/S	The principle is the same as normal audit.

Group Instructions and Reporting Package

After the group auditor determined the type of work in respect of each component, he should send a group instruction to each component auditor.

The group instruction typically includes the following:

- the work to be performed by the component auditor
- the use to be made of that work
- the form and content of reporting to the group auditor
- Reporting timetable
- Accounting policies to be applied at the component level
- A request that the component auditor returns an acknowledgement of receipt
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements
- Component materiality, specific materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the group F/S (in the case of an audit or review of the financial information of the component)
- Identified significant RoMM of the group F/S due to fraud or error that are relevant to the work of the component auditor
- A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware

Following the completion of work, the component auditors would report their findings to the group auditor.

The group reporting package typically includes the following:

- Whether the component auditor has complied with ethical requirements including independence and professional competence
- Whether the component auditor has complied with the group instruction;
- Identification of the financial information of the component on which the component auditor is reporting
- Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group F/S
- A list of uncorrected misstatements of the financial information of the component
- Indicators of possible management bias
- Description of any identified significant deficiencies in internal control at the component level
- Other significant matters that the component auditor communicated or expects to communicate to TCWG
- Any other matters that may be relevant to the group audit
- The component auditor's overall findings, conclusions or opinion

Involvement with Component Auditors

The group auditor is ultimately responsible for the group audit opinion which encompasses the work performed by the component auditors. Therefore, the group auditor should:

- Determine whether he will be able to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence
- Involve with the work performed by the component auditors, especially when the component auditors identify audit issues that are relevant to the group F/S

The group auditor can get involved with component auditor's working by:

- Discuss with the component auditor or component management of the component's business activities and environment
- Discuss with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error
- Review the component auditor's documentation of identified significant RoMM of the group F/S
- Review the component auditors' overall audit strategy and audit plan
- Discuss significant matters with the component auditor, component management or group management, as appropriate
- Understand any audit issues (e.g. limitation of scopes, misstatements) identified by the component auditors and assess their impact on group F/S based on group materiality
- Determine whether it is necessary to review component auditor's audit documentation

The involvement by the group auditors should be conducted on a timely basis.

Practice Question 4 – QP MC Dec 12 (extract)**Question 7 (17 marks – approximately 31 minutes)**

Your team has just won a global audit proposal and is now engaged by Solid Inc. as their group auditor for the year ended 31 December 2011 audit. Solid Inc. is a multinational company with annual turnover and total net assets exceeding US\$1,000 million and US\$30,000 million respectively, and has business worldwide in different industries. In two weeks' time you will be proposing your group audit plan to the senior management of Solid Inc.

Required:

Through your discussion with the CEO and CFO, together with the other information gathered for your audit scoping and planning, what would be your audit response to the information gathered below, as a group auditor, to ensure the quality of the group audit?

- (a) Solid Inc. has a retail business in Asia Pacific which contributed to the group's 20% revenue and 10% net profit. The retail business is audited by another reputable well-known audit firm that you have confidence in the competence of that audit firm. (7 marks)
- (b) Solid Inc. has a real estate project in Brazil with investments of over US\$300 million. This is the first time that Solid Inc. has entered into the real estate industry. The project is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity. (7 marks)

Practice Question 4 – Answer**Answer 7(a)**

HKSA 600 (Clarified) requires the group auditor to determine the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor.

In view of the significance of the retail business in Asia Pacific (i.e. contributing 20% of revenue and 10% of net profit to the group), the group auditor should classify the retail business in Asia Pacific as a significant component as it is individually financially significant.

The group auditor should request the component auditor to perform an audit of the financial information of this significant component using component materiality. In addition, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- meet with the retail business' management or the component auditor to obtain an understanding of the retail business and its environment;
- review the component auditor's overall audit strategy and audit plan;
- perform risk assessment procedures to identify and assess risk of material misstatement of the retail business. This may be performed together with the component auditor or by the group engagement team;
- discuss with the component auditor or the retail business' management regarding the components' business activities that are significant due to fraud or error, by considering fraud risk factors;
- review the component auditor's documentation of identified significant risks of material misstatements;
- consider significant findings of the component auditor; and
- discuss with the component auditor or the retail business' management if there is disagreement on the accounting treatment or other matters among the group auditor, the component auditor and the retail business' management.

Practice Question 4 – Answer**Answer 7(b)**

Given the component is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- assess the competency, independence and objectivity of the component auditor, in particular,
 - competency: whether the local auditor has sufficient expertise and experience in the real estate industry audit;
 - objectivity: whether the local auditor is biased or has conflicts of interest or undue influence to override professional and business judgement; and
 - independence: whether the local auditor is independent from Solid Inc and its related companies;
- seek confirmation from the local auditor regarding their competence, independence and objectivity;
- visit the component auditor to discuss about its competence, independence and objectivity;
- request the component auditor to complete questionnaires about its competence, independence and objectivity;
- discuss the component auditor with colleagues in the group auditor's firm, or with a reputable third party that has knowledge of the component auditor;
- obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties;
- if the group auditor considers that there is an issue regarding the local auditor's competence, independence and objectivity, the group auditor cannot overcome the fact that the local auditor is not independent by being involved in the work of the local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component;
- the group auditor should consider performing the following further audit procedures, such as:
 - perform the audit work themselves instead of relying on the local auditor's findings;
 - supervise the component auditor directly and review their work papers; and
 - review in detail the local auditor's audit findings and evaluate the appropriateness of their audit conclusion; and
- however, the group auditor may be able to overcome less than serious concerns about the local auditor's competency by being involved in the work of local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

HANDOUT

Section 3 – Computer Controls

Concept Check:

- What is the linkage of computer controls with other internal controls?
- Why are computer controls relevant to auditors?

General IT Controls

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. In other words, general IT controls create the environment in which the application systems and application controls operate.

The below table sets out certain examples of general IT controls.

Aspects	Examples
Physical and Access Controls	<ul style="list-style-type: none"> • Use of passwords and security keys to restrict unauthorised access. • Passwords should be confidential and subject to periodic changes. • Passwords for a given user should not be reused in say a 12 month period • Passwords should not be included in any automated log-on process, e.g. stored in a macro or function key. • Automatic log-off after the screen is left idle for a set period of time. • Use of unique user code to limit users' privileges to their job duties. • Upon creation of new user codes, the privileges should be reviewed and approved by appropriate level of management. • User codes of staff who have left should be terminated by IT manager. • Protections against hazards (e.g. fire, blood)
Operation and File Control	<ul style="list-style-type: none"> • Encryption should be applied to protect the confidentiality of sensitive or critical information. • Firewalls and anti-virus should be installed. • Files and data are back-up periodically. The back-up taps should be kept offsite. • Audit logs and exception reports should be prepared, followed up and then reviewed by management. • Operation manual is in place for emergency recovery of data and files.
Program Change	<ul style="list-style-type: none"> • User acceptance test ("UAT") should be performed before implementation. • Segregation of duties between the personnel responsible for designing the programme and testing the programme. • Proper training about the system should be provided to all level of staff. • User involvement and management input are required and considered before implementation. • Requests for changes to computer programmes should be formally submitted in writing by requester. Such request should be reviewed and approved. • Every change made to the computer programmes should be documented and backed up. • Handling of program changes are assigned to experienced staff. • Rooms are reserved for future upgrades. • Procedural manual is in place for programmes installation.

Application controls

Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications.

Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed.

Examples include re-processing authorisation, data validation test and input error reporting.

Aspects	Examples
Input checks	<ul style="list-style-type: none"> • Manual check of input data. • Programmes to check data fields. • Incorrect transactions are rejected, corrected and resubmitted on a timely basis. • Inputs are authorised by appropriate personnel
Processing controls	<ul style="list-style-type: none"> • Screen warning for processing errors. • Exception reports are generated and reviewed on a timely basis.
Output checks	<ul style="list-style-type: none"> • Follow-up of exception reports (e.g. investigation and analysis of errors) • Manual checking of processed output to source documents • Access to output is provided to authorised personnel on a timely basis.

Practice Question 5 – QP MC Dec 12 (extract)**CASE**

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

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

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

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

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

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

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

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

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

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

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

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

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

Practice Question 5 – QP MC Dec 12 (extract)

Question 2 (12 marks – approximately 22 minutes)

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

(12 marks)

Practice Question 5 – Answer**Answer 2**

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

System design and supply

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

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

Training and implementation

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

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

Location of terminal devices

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

Access controls

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

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

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

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

Practice Question 5 – AnswerTransaction trails

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

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

Reporting and review

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

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

Section 4 – Consultation

Any questions?

GOOD LUCK IN MODULE C EXAM!