

## **SECTION A – CASE QUESTIONS** (Total 50 marks)

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

### **CASE**

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.

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
<b>Total assets</b>	<b>645,500</b>	<b>684,800</b>
Trade payables	53,000	57,000
Other payables and accruals	23,000	2,000
Bank borrowings	300,000	300,000
<b>Total liabilities</b>	<b>376,000</b>	<b>359,000</b>

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

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

- (a) In response to Happy Toy's nomination of ABC & Co. as their coming auditor, what are the matters your engagement team or the firm would consider and the procedures to be performed before accepting the appointment?  
(8 marks)
- (b) In addition, discuss the responsibility of yourself as an engagement partner in assessing the client acceptance.  
(4 marks)

**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)

**Question 3** (7 marks – approximately 12 minutes)

The toy manufacturing business of Happy Toy has been loss-making in the past years, together with the continuous decrease in demand from the US and Europe customers, increase in fierce competition and decrease in gross margin due to the increase in material costs and labour costs. Happy Toy is facing a significant challenge to turn its toy business from loss to profit. You, as the audit engagement partner of Happy Toy, consider that the risk of material misstatement over the valuation assertion of the property plant and equipment ("PPE") at the Panyu plant is high.

**Required:**

In response to the risk identified relating to the PPE, what are your proposed audit procedures in addressing the risk?  
(7 marks)

**Question 4 (11 marks – approximately 20 minutes)**

Assume you now commence the year end audit and are in discussion with the management of Happy Toy regarding the basis of preparation of their financial statements. You have a query for the management as to whether they can prepare the financial statements using the going concern basis. The cash balance and bank borrowings as at 31 December 2012 are approximately HK\$30 million and HK\$300 million respectively. The profit before tax of Happy Toy for the year ended 31 December 2012 is approximately HK\$7 million.

Happy Toy management explains that they have been taking action to resolve the cash flow problem. They are in discussion with two local banks to arrange new loan facilities. They are confident that the loan facilities can be agreed before the results announcement in late March 2013.

Happy Toy has also applied to The Hong Kong Stock Exchange for a rights issue of HK\$300 million to its shareholders. The major shareholder of Happy Toy, who holds over a 60% interest in Happy Toy, has declared that he will underwrite the full amount of the rights issue. The Hong Kong Stock Exchange is reviewing the application.

**Required:**

**(a) Assess and explain the going concern risk to the financial statements.**  
**(4 marks)**

**(b) Assuming that there is no progress regarding the actions proposed by management when the financial statements are signed and management insists that the financial statements should be presented on a going concern basis, what kind of opinion would you suggest in the auditor's report? Prepare a draft of the report which only includes the basis for opinion paragraph and the opinion paragraph.**

**(7 marks)**

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**End of Section A**

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

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

### **Question 5 (8 marks – approximately 14 minutes)**

You are the audit partner of ABC CPA Hong Kong and have just received a request from ABC CPA London on a fee proposal for the audit of Peter Hong Kong Limited, a subsidiary of Peter Limited which is the potential audit client of ABC CPA London for the year ending 30 June 2013. During the client acceptance procedures, you have identified that the spouse of your fellow tax partner is the Chief Financial Officer of Peter Hong Kong Limited.

#### **Required:**

**What independence issues should you consider for the engagement acceptance of the audit of Peter Hong Kong Limited and what relevant safeguards should be in place?**  
**(8 marks)**

**Question 6 (15 marks – approximately 27 minutes)**

Mary Limited is a company listed on the Main Board of The Hong Kong Stock Exchange and is engaged in the manufacturing and trading of garments.

You are the auditor of Mary Limited and are performing audit planning for the year ending 30 June 2013. The following financial information has been extracted from the latest management accounts prepared by management of Mary Limited:

	For the nine months ended 31 March 2013 (HK\$'000)	For the year ended 30 June 2012 (HK\$'000)	For the year ended 30 June 2011 (HK\$'000)
Revenue	1,000,000	2,000,000	1,500,000
Profit before tax from continuing operations	500	10,000	7,000
Net current assets / (liabilities)	(200)	2,000	2,500
Shareholders' equity	3,000	5,000	8,000

**Required:**

- (a) **What is materiality? In setting the planning materiality for Mary Limited's financial statements as a whole, what factors (including client information and your understanding about the client) you should consider?**  
(5 marks)
- (b) **Auditors often select a benchmark item from the financial statements and apply a percentage when setting materiality. Propose a possible range of benchmarks and the source documents containing them in the case of Mary Limited. What are your considerations when you decide a benchmark and the percentage? What documentation you would suggest for such work?**  
(6 marks)

- (c) Based on the information provided by Mary Limited, the profit before tax from continuing operations for the nine months ended 31 March 2013 includes the following items:
- (i) impairment of property, plant and equipment of HK\$3 million; and
  - (ii) share-based payment expenses on granting one-off share options to a director of Mary Limited of HK\$2 million.

**Required:**

**How would you consider the impact of the above unusual items when determining materiality for Mary Limited?**

**What is your response to these unusual items in concluding a benchmark and its amount or magnitude?**

**(4 marks)**

**Question 7 (16 marks – approximately 29 minutes)**

You are a CPA (Practising) and are engaged as the auditor of Amy Limited, a garment manufacturing company. In the course of audit planning for the year ending 30 June 2013, you noted that the balance of the accounts payable, which is a material item on the financial statements, is 50% lower than the corresponding amount of 30 June 2012 and there is no significant change in the business scale of Amy Limited.

**Required:**

- (a) **Assess and explain the level of risk of material misstatements relating to the completeness assertion of the accounts payable of Amy Limited as at 30 June 2013.**
- (5 marks)**
- (b) **Audit confirmation is a common audit tool. Suggest the audit confirmation procedures you would perform for Amy Limited's accounts payable in the following:**
- **selecting confirmation parties;**
  - **controlling the accuracy and validity of the confirmation letters; and**
  - **controlling proper response to the confirmation request.**
- (7 marks)**
- (c) **What are the appropriate follow up procedures if you do not receive the confirmation reply after a reasonable period of time?**
- (4 marks)**



**Question 8** (11 marks – approximately 20 minutes)

Peace Limited discovered that some bank balances of its factory in the Mainland was unaccounted for and a finance manager was suspected to have been involved. The loss has been reported to the local police. The police were trying to locate the finance manager. Initial findings of the investigation indicated that the loss amount was approximately HK\$20 million.

Peace Limited's management investigated the cause and nature of the loss of funds in the factory and identified that the finance manager stole the company chop and issued a few cheques to withdraw money from Peace Limited's bank account to his personal bank account. Then, the finance manager removed these transactions from the bank statements downloaded from the internet banking facility before sending them to the head office in Hong Kong.

**Required:**

- (a) Identify the possible internal control weaknesses relating to the misappropriation of funds by the finance manager. (4 marks)
- (b) Suggest the relevant control activities management should have implemented to address the weaknesses identified. (7 marks)

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