

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	<ul style="list-style-type: none"> • Presentation • Group discussion 		Please refer to Workshop 1 Student Notes
2. Corporate governance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 1 & 2	
3. Overview of an audit	<ul style="list-style-type: none"> • Card game 		
4. Audit acceptance / continuance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 4 & 7	
5. Audit planning	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 8, 10, 11 & 12	
6. Project Management in Audit Planning stage	<ul style="list-style-type: none"> • Group discussion 	Ch. 8	
7. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		
Workshop 2			
8. Reboot	<ul style="list-style-type: none"> • Presentation • Group discussion 		
9. Audit execution	<ul style="list-style-type: none"> • Individual work • Progress meeting and reporting • Group discussion 	Ch. 9, 10, 12, 13 & 15	Pg. 1 – 28
10. Project management in audit execution stage	<ul style="list-style-type: none"> • Group discussion 		
11. Audit completion	<ul style="list-style-type: none"> • Group sharing • Group discussion 	Ch. 9, 15, 16 & 17	Pg. 29 – 42
12. Group audit	<ul style="list-style-type: none"> • Group discussion 	Ch. 18	
13. Project and people	<ul style="list-style-type: none"> • Presentation • Group discussion 		
14. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		

Audit execution

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

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

During the audit, five audit issues have been identified.

You have to distribute the respective audit area (in the attached handout sections) to each member at the beginning of the progress meeting. Consider the best way to allocate the work. Seniors should have information of all the cases.

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

Tips in handling the progress meeting:

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

M&K Apparel Limited

Audit area: Fraud & Irregularities

(i) Investigation into fraudulent use of discount vouchers

As a result of the discount voucher fraud identified by the internal audit team in the Singapore region, the audit committee requested that a further investigation be undertaken by the internal audit team, across the whole M&K group, into the use of discount vouchers.

This investigation has recently been concluded and the internal audit team are in the process of documenting their findings and preparing their report for the audit committee. As the report is not yet available you interviewed the internal audit manager responsible for the investigation and ascertained the following information:

- The fraudulent use of discount vouchers identified in Singapore, whereby staff apply a discount to the sale but charge the customer full purchase price with the difference between cash received and price charged being retained by the member of staff, was also found to occur in some stores in all other regions
- An additional fraudulent use was identified whereby customers purchase an item using a discount voucher but later return it to the store for a full refund. The fact that M&K operates a 'no questions asked' policy on returns and does not always require that a receipt is presented for a refund, means that this process was frequently abused by customers
- The internal audit team are also planning an investigation into online discount fraud as a result of an error which occurred on the M&K website on 28 September 2011. You have found the following press article in relation to this issue:

Hong Kong Times

M&K says 'no!' in online discount mix-up

Hong Kong, 1 October 2011

Hundreds of shoppers who exploited a glitch on M&K's clothing retail website to buy high volumes of items at a huge discount were told by M&K yesterday that their actions were fraudulent.

A technical error let visitors to the M&K website repeatedly use voucher codes to claim cumulative discounts of up to 60 per cent. Within hours of the issue and the voucher codes being publicised on the internet, M&K was swamped.

One shopper boasted online that she had used the codes to order hundreds of on-trend items worth HK\$156,000 for just HK\$60,000. But despite initially pledging to honor the discounts, M&K announced that it was cancelling all the transactions.

The store said: "While we would have liked to honor orders made, further investigation does reveal that multiple use of discount codes contravenes the terms and conditions of the offer. As a result these transactions are fraudulent."

Some customers claimed they would fight the decision by M&K in order that the sales were fulfilled.

(ii) Claim for breach of health and safety regulations

As part of your audit work you have undertaken a review of the legal correspondence file held at the M&K head office in Hong Kong. During this work you identified the following letter:



Yu & Lee Legal Advisors
28th Floor
West Wing
Man Sang Square
888 Nathan Road
Hong Kong

To: Head of Legal Department
M&K Apparel Limited
Room 2023
Shun Tak Centre Western Tower
200 Connaught Road
Sheung Wan
Hong Kong

26 August 2011

Personal injury claim, re Ms Mei Lee, case reference 376A9

We are writing to inform you that we have been requested to act on behalf of our client, Ms Mei Lee, in respect of a claim against M&K for personal injury caused whilst shopping at the Mong Kok branch of M&K, Hong Kong on 9 July 2011.

As a result of breaches in health and safety regulations and negligence by M&K store staff, Ms Lee suffered a fractured hip. Consequently she has been hospitalised and unable to work in her business. We are therefore seeking compensation from M&K on our Ms Lee's behalf to reflect lost business income, including lost future income arising from the temporary closure of Ms Lee's business, and for the personal distress caused.

Ms Lee would prefer to settle this matter out of court in order to avoid any further personal distress and we therefore request that you contact our office in order to arrange a meeting with your legal advisors on this matter.

Alan Hon

Alan Hon
Personal injury claims director

You further discussed this matter with the Head of M&K's legal department. She told you that the matter is currently being investigated by M&K's external legal advisors but that the board was of the opinion there was no negligence on the part of M&K store staff. She explained that every store is required to follow strict health and safety guidelines which are issued by head office; these include procedures for recording any accidents occurring in store. In addition each store is regularly inspected by health and safety officials for compliance with relevant health and safety regulations. Reports by such officials are provided to the store and M&K head office.

The draft financial statements for the year ending 30 September 2011 do not include any amounts in respect of this claim.

M&K Apparel Limited

Audit area: Trade payables

(i) Supplier statement reconciliations

As part of the planned audit procedures a sample of supplier statements were selected for reconciliation to the balances, for those suppliers, on the trade payables ledger. The balance in the draft financial statements at 30 September 2011 is HK\$3,661,000. The results of this audit procedure are as follows:

Supplier	Trade payable per purchase ledger at 30 Sept 2011 HK\$000	Balance due per supplier statement at 30 Sept 2011 HK\$000	Difference HK\$000	Amounts paid not shown on statement HK\$000	Invoices on ledger entered after statement date HK\$000	Unreconciled difference HK\$000
Wing Sing	898	1,327	429	(14)*	10^	425
Tai Fong	779	789	10	(8)	-	2
Yun Fat	690	732	42	(12)	-	30
Hong Sing	331	339	8	-	8^	-
Others	127	139	12	(13)*	1^	-

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

Wing Sing, Tai Fong, Yun Fat and Hong Sing are M&K's major suppliers, accounting for approximately 80% of all purchases made by M&K each year. With the exception of Hong Sing, supply chain software was implemented at all of these suppliers during the year ending 30 September 2011.

You have discussed the unreconciled differences with the purchase ledger manager, Richard Ko. He explained that issues have arisen during the year as a result of the implementation of the supply chain software. The aim of the software is to allow the suppliers to respond more quickly to changes in inventory levels at M&K stores by monitoring overall inventory levels and automatically creating purchase orders for further deliveries when inventory falls below a pre-determined level. As a result shipments from suppliers are smaller and more frequent. Richard believes that consequently the suppliers are having difficulty in coping with recording more frequent shipments resulting in errors in their invoices with some shipments.

Richard also commented that his purchase ledger team had been under resourced for a large part of the year. This was partly due to the change in the system which has meant an increase in the number of purchase transactions to check and record but also because the team shrunk from ten to seven, as a result of leavers and long term illness, and these team members had not been replaced. Consequently the team has been working long hours at year end in order to clear the backlog of unprocessed purchase invoices.

Finally Richard gave you some email correspondence relating to a dispute between M&K and Wing Sing (see section (ii) below) which accounts for HK\$400,000 of the unreconciled difference for this supplier.

(ii) Dispute with supplier

As part of your audit work on supplier statement reconciliations you identified that an invoice for HK\$400,000 from Wing Sing was not included as part of the trade payables balance. Richard Ko has given you two emails relating to this matter and confirmed no amounts have been included in the draft financial statements in respect of these items.

Email from M&K to Wing Sing:

To: Ko Tin Hon, Wing Sing customer accounts director
From: Adam Lai, M&K Quality Control Director
Date: 1 September 2011
Subject: **Shipment 2567/B Ladies and children's apparel**

I am writing to you regarding the above shipment which was received by us on 25 August 2011.

As you are aware each shipment we receive from our suppliers is thoroughly tested for quality and safety and compared with the design and textile specifications agreed with your account manager responsible for the manufacture of the shipment.

During testing we have found this shipment to be made from substandard quality textiles and to have deviated significantly from the design specification agreed with you. On discussion with the account manager it was agreed that a replacement shipment would be prepared for us for delivery before 30 September 2011.

We have returned the defective shipment to the Wing Song factory in Shenzhen and request a credit note in respect of the invoice which we received shortly after the shipment.

I look forward to your urgent response

Adam Lai

Email from Wing Sing to M&K:

To: Adam Lai, M&K Quality Control Director
From: Ko Tin Hon, Wing Sing customer accounts director
Date: 10 September 2011
Subject: **Re: Shipment 2567/B Ladies and children's apparel**

Adam,

Thank you for your email. I apologise for the confusion regarding this shipment, however on discussion with my account manager my understanding was not that the original shipment was defective but that M&K requested an additional shipment with a modification in the design and a higher textile specification.

We have received your returned shipment and on investigation do not find any defects when compared with the original design or specifications agreed with your design team. I would be very happy to talk you through the original specifications and how these were met in our design and textile selection process. Please let me know which warehouse you would request us to return this shipment to.

In the meantime, our factory has acquired the higher specification textiles and production has commenced on the new design. I can confirm that the total invoice cost of this will be HK\$509,000 for the same quantity with the differential in price being due to the higher specification textile. We will not invoice in this circumstance for the additional production line costs incurred as a result of the modified design. Your shipment will be dispatched for receipt in your warehouse by 30 September as agreed.

Ko Tin Hon

M&K Apparel Limited

Audit area: Inventory

(i) Year end inventory counts

As a result of the introduction of the new EPOS and integrated inventory systems M&K intends to rely on the inventory system for determining the quantities of inventory at the year end and has only undertaken full year end inventory counts in a small number of its stores and warehouses.

As part of the audit procedures on inventory members of the audit team attended and observed the inventory counts for a sample of stores, where counts were taking place, in order to assess the reliability of the inventory system for determining the year end quantities of inventory.

In all cases the audit team members reported that the procedures for the counts followed by M&K staff were appropriate and the results of each count were obtained and compared with the quantities recorded in the inventory system.

In the case of the inventory counts attended at warehouses no material discrepancies were identified between the actual inventory held and that recorded on the inventory system. However, significant discrepancies were found in a number of the store counts. On discussion with the group inventory manager you ascertain that this was anticipated by M&K as a certain amount of 'shrinkage' is to be expected in inventory held at stores. Shrinkage can be caused by employee theft, shoplifting, damage in transit or in the store, and administrative errors. The group inventory manager confirmed that a deduction (to inventory) of HK\$2,145,030, equivalent to 1.5% of total net revenue has been made in the financial statements to account for shrinkage – this estimate is based on experience of shrinkage levels in prior years.

A summary of the effects of shrinkage in the stores where an inventory count was attended are set out below:

Store location	Total inventory value per inventory system (HK\$'000)	Total inventory value per count (HK\$'000)	Difference (HK\$'000)	Shrinkage as % of inventory recorded on inventory system	Shrinkage as % of store annual turnover HK\$000
Hong Kong:					
Mong Kok	397	339	58	14.6	1.7
Causeway Bay	309	257	52	16.8	1.7
China:					
Peking	439	298	141	32.1	3.8
Shanghai	395	284	111	28.1	3.0
Malaysia:					
KL - Jalan Tuanku	299	231	68	22.7	2.7
Singapore:					
Orchard Road	296	208	88	29.7	3.5
Taiwan:					
Taipei 101	319	268	51	16.0	1.9
Total sample	2,454	1,885	569	23.2	2.7

The audit manager in charge of auditing the Hong Kong stores has brought the following article to your attention:

Global Retail Shrinkage Bulletin: News Release on 10th November, 2011

Study Finds Retail Shrinkage reached \$115 billion World-wide

- *Recession and reduced loss prevention spending lead to largest increase in shrinkage since study's inception*
- *Global shrinkage average rises by nearly 6% reaching 1.43% of retail sales*
- *Apparel theft in accessories and fashion clothing reached 3.85% of sales*

London, UK November 10, 2011 – The level of global retail theft reached \$114.8 billion in 2011, representing a significant increase of 9.8% over last year's total of \$104.5 billion, according to the third edition of the *Global Retail Shrinkage Bulletin*. The study monitored the costs of shrinkage and crime in the global retail industry between September 2010 and August 2011, and found that the rise in shrinkage occurred in all regions surveyed.

Global Retail Shrinkage Rates

Shrinkage, as a percentage of retail sales rose by 5.9% this year to a global average of 1.43%. This is a significant departure from the previous two years, in which shrinkage as a percentage of retail sales decreased. The highest country-specific rates were found in India, Morocco and Mexico and the lowest in Hong Kong, Taiwan and Austria.

Shrinkage by Global Vertical Markets

Shrinkage varies according to business type, vertical market and country. In 2011, some of the highest average shrinkage rates were found in apparel/clothing and fashion/accessories (3.85%) and in fashion/tailored clothing (3.64%). These product groups suffered the highest shrinkage in all regions surveyed.

Most Vulnerable Merchandise

Thieves tend to focus on small and easily-concealed, expensive, branded items that have considerable popular appeal and are easily re-sellable: electronic games, DVDs, iPods/MP3 players, clothing, cosmetics/perfumes, expensive foodstuffs, appear most frequently on the list of most vulnerable merchandise.

The Survey

The *Global Retail Shrinkage Bulletin* is an annual survey conducted by the School of Retail Research in London, UK. This study is now the largest and most comprehensive survey of retail theft and crime in the world.

(ii) Inventory valuation

Whilst reading a magazine on your way to work you notice the following article relevant to the audit of M&K inventory:

You have ascertained that M&K had HK\$1,400,000 of inventory in their warehouses on 30 September 2011 which relates to the spring/summer feathers and lace collection mentioned in the magazine article.

Get Real Magazine

November 2011



Sail away to Spring/Summer 2012 in Gorgeous Kate's brilliant interpretation of the nautical catwalk.

Spring/Summer 2012 Collections revealed: Get Real's Opinion

I always look forward to November when the fashion designers of the world's fashion chains and department stores reveal how they have interpreted the designs shown by the world's elite designers during the catwalk shows of Milan and Paris. The evolution from catwalk to department store is a tricky business and every year there are stores that pick the best of 'wearable' fashion and those that simply go too far. This season is no different. Designers at Gorgeous Kate will be well rewarded for their simple toning down of the nautical theme seen on many Spring/Summer 2012 catwalks. On the other hand the designers at M&K appear to have got carried away and taken the lace and feathers inspiration a step beyond what 'normal' shoppers are willing to spend their cash on!!! It seems that the absence of M&K's head designer, Eddie Cheung, on a career break for health reasons, has put the M&K team under pressure. Verdict: Gorgeous Kate Spring/Summer collection will 'sail out' fast, M&K – wait for the sale!



.....every year there are stores that pick the best of 'wearable' fashion and those that simply go too far.

M&K design team under pressure

M&K Apparel Limited

Audit area: New EPOS system

(i) Data migration

In January 2011, M&K transferred their sales system onto a new electronic point of sales system (EPOS) which was also integrated with the inventory system. At the date the new systems were implemented Woo Lee & Co were not engaged as external auditors and therefore were not involved in the selection of the new systems or in the migration of data from the old to the new systems.

As part of the current year audit you have been asked to test the migration of data onto the new systems. No specific audit procedures have yet been included in the audit plan so you decide to begin work by discussing the processes used with the project manager, Lee Su, who was responsible for implementing the new systems. The following is a transcript from your conversation:

You: “Lee, can you set out for me the areas where data migration processes were required when the new EPOS system was implemented?”

Lee: “We had to migrate all of the standing data in relation to the pricing for each item currently being sold in our stores. In addition, we had to migrate the current inventory quantities for each store – however there were issues with the accuracy of inventory quantities in the old system so every store and warehouse undertook an inventory count and then entered their own inventory quantities manually into the system the day it went live. It was a big task and therefore most stores employed some temporary staff to perform the counts and perform the data entry.”

You: “Were there any checks carried out on these manual processes?”

Lee: “Yes there were some, each store was required to check a sample of quantities recorded during the inventory count to the quantities entered on the system and the results of the checks were sent to the internal audit team. I don’t recall there being any issues.”

You: “Can you tell me more about how the pricing data migration was managed?”

Lee: “This was carried out through an automated migration – we mapped each of the products in the old system to product lines in the new system to create a mapping design. A computer programme was then written for us by the suppliers of the new system which used the mapping design to automatically extract the data (data extractions) from the old system and load it into the new system (data loading).”

You: “Were there any problems when the data extraction and loading programme was run?”

Lee: “There were a few issues as you would expect, where data didn’t quite map across correctly but the computer programme was designed to report any load rejection errors as the load progressed. We then used the report to go back and manually amend any rejected items.

You: “Finally, can you explain how the EPOS system is integrated with the accounting system?”

Lee: “Of course! It’s very simple; each time an item is sold in a store it automatically updates the quantity in the inventory system and records a sale in our sales ledger. The selling prices of items in our stores at implementation were already stored in the database of the sales ledger so we didn’t need to change those. Since implementation, when new inventory comes in, we enter the sales prices into the sales ledger at head office and this then automatically sends the pricing data to the EPOS system in the stores. When a sale is made the EPOS system just sends across the code for the item sold and quantity and the sales ledger records the sale.

You: “Thanks Lee, I need to go away and think about how we should approach our audit testing in this area – can I come back and see you when we have planned this out?”

Lee: “Certainly, nice talking to you.”

(ii) Accuracy of new system

During further discussions with Lee Su, you discover that some issues arose with online sales, in all regions, at the time the new systems were implemented. This resulted from a bug in the computer programme which resulted in duplicate online orders being processed through the new system. Customers received orders twice but their debit or credit cards, used to pay online, were only charged once. However, both the sales ledger and the inventory records showed goods being sold and despatched from inventory twice.

Lee Sue told you that the issue only occurred during the first week the system was in operation and that a “bug-fix” was quickly implemented to correct the problem. All customers affected were contacted at the time and the duplicate goods were all returned. Returned goods were manually re-entered into the inventory system and removed from the sales ledger.

M&K Apparel Limited

Audit area: Sales and cash

(i) Year end cash counts

Cash shown on the Statement of Financial Position at the year-end consists of cash in the bank and cash held on the retail store premises. As part of the year-end audit procedures, you have attended a sample of the cash counts taking place at each of the M&K stores. The audit supervisor responsible for co-ordinating the attendance at the year-end cash counts has prepared the following summary for you:

Client: M&K **Date:** 30 Sept 2011
Initials: AS
Description: Issues arising from year end-cash count observations

Year-end cash count procedures were observed at 15 stores across the M&K group. Control procedures over cash counts were adhered to by M&K staff and in addition audit personnel checked a sample of cash counted for accuracy.

The following issues were encountered during the audit procedures carried out on 30 Sept:

Mong Kok, Hong Kong: the store's cash office informed the audit team that security couriers had collected cash during the day's trading (for transporting to M&K's bank) but the cash office manager could not find the documentation relating to the amount of cash that had been collected. The difference on the end of day cashing up reconciliation was HK\$15,197.

Peking, China: A temporary member of staff in the cash office had inadvertently destroyed the credit card slips for the day's credit card transactions. The z-report had recorded credit card sales equivalent to HK\$12,156 but the difference between cash on hand and total sales recorded for the day was HK\$13,555.

Orchard Road, Singapore: a power surge in the store caused the EPOS system to crash locally. This caused all the tills in the store to re-set to 'zero sales' even though a number of sales had already been processed. The end of day z-report (for the remainder of the day after the power surge) reported sales equivalent to HK\$9,645 whereas the credit card slips and cash held in the tills at the end of the day totalled HK\$17,641.

(ii) Foreign currency translation

M&K holds local currency bank accounts in each of the countries in which it operates. As part of the work to audit the year end consolidated cash position for M&K you have asked a junior member of the audit team to compare the rates of exchange applied by M&K head office accountants with a reliable external source for exchange rates. The table below summarises the findings:

Region	Local Currency	Cash at 30 Sept in local currency	Exchange rate applied by M&K HK\$1 =	Exchange rate per auditor's external source
Hong Kong	HK\$	HK\$222,000	n/a	n/a
China	Yuan (¥)	¥89,856	0.832	0.847
Malyasia	Ringgit (RM)	RM 27,406	0.386	0.396
Singapore	Singapore Dollar (SG\$)	SG\$7,900	0.158	0.164
Taiwan	New Taiwan Dollar (TWD)	TWD103,180	3.685	3.698

In addition, you have ascertained that M&K occasionally makes transfers between the bank account of each region in order to manage regional cash flows and benefit from exchange rate movements and favourable interest rates. On 30 September M&K transferred HK\$32,000 from its Hong Kong bank account to its Malaysian bank account. The amount transferred is not included in the total cash of HK\$222,000 shown for Hong Kong above, however, the amount did not appear on the bank statement of the Malaysian bank account until 4 October 2011.

Discussion points

Audit execution

Audit area – Fraud and irregularities

(i) Investigation into fraudulent use of discount vouchers

What is the issue?

- A number of fraudulent uses of discount vouchers have been identified by the internal audit team
- Abuse of discount vouchers may result in inaccurate recording of transactions, particularly sales, in the financial statements
- Three frauds require consideration in terms of their impact on the financial statements;
 - 1 Staff applying discounts but not passing the discount onto the customer and retaining the cash equivalent
 - 2 Customers purchasing items using a discount voucher and then returning products for a full refund
 - 3 Online discount fraud

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

- Fraud 1 may lead to an understatement of sales as the sale is recorded at the discounted amount whereas it actually occurred at full price. The difference between the discounted amount and full price represents the cost of the fraud.
- Fraud 2 may also lead to an understatement of sales. The initial sale is recorded at the discounted amount say HK\$120 but when the item is returned for a refund at the full price, say HK\$150 this amount will be debited to the sales account – this results overall in a reduction to the sales value recorded (150-120 = HK\$30)
- Fraud 3. Whilst M&K have stated that they will not honour the online sales discounts obtained as part of the error on the M&K website, it is possible that some customers will challenge this decision and M&K may be forced to honour the sales
- This issue arose at year end and there may be an obligation at the year end to fulfil the sales at the discounted amounts.
- If an obligation exists at the year end, some items of inventory may have a net realisable value below cost

What procedures should be adopted to address the issue? How to carry out the procedures?

What evidence should be obtained from M&K?

- The extent of fraud's 1 and 2 needs to be further understood through discussion with management and the internal audit team
- A copy of the internal audit report on the frauds should be obtained as soon as it is available
- Post year end correspondence, press announcements and board minutes should be reviewed to ascertain whether M&K changes its decision with regards to the online discounts or is forced to fulfil the sales
- Discussions with management should ascertain the volume of online transactions in question and identify the sales value of each line compared with carrying value in inventory

(ii) Claim for breach of health and safety regulations

What is the issue?

- M&K have received notice of a claim for an undisclosed amount in respect of an alleged injury at M&K's Mong Kok branch
- The amount of the claim could potentially be material to the financial statements but no amount has yet been included
- The likelihood and/or the amount of the claim may remain uncertain at the time the financial statements are approved by the directors

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

- Audit evidence to verify the likelihood and the amount of the claim may be available before the audit report is signed, such as an amount being paid post year end to the injured party.
- However, it is possible that the auditors will need to gather audit evidence as to the likelihood of the claim being successful in the event that the claim has not been resolved/agreed.
- Where there is evidence that the claim is likely to be successful the auditors will then need to obtain audit evidence as to the potential amount of the claim
- If it is probable that the claim will be successful and material then a liability to reflect the amount due should be included in the financial statements for the year ending 30 September 2011.
- If it is only possible that the claim will be successful then a note disclosing this and the associated facts should be included in the financial statements

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Review correspondence post year end to ascertain whether the claim is settled
- Trace any amounts paid to post year end bank statements and agree to the provision recorded in the financial statements
- Where the claim is not yet settled, review correspondence with legal advisors to ascertain the likely outcome of the claim and any amounts that may have to be paid
- Ascertain whether any similar issues have arisen in the past and how they were settled
- Review the accident book or other documentation prepared at the time to ascertain any information regarding the circumstances surrounding the accident
- Research the business of the customer making the claim to ascertain whether it exists/has value etc
- Agree that findings from above are fairly reflected in the financial statements

Debriefing

The above is based on the following auditing standards:

HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

HKSA 250 (Clarified) *Consideration of Laws and Regulations in an Audit of Financial Statements*

HKSA 240 (Clarified) requires the auditor to evaluate whether the misstatement identified is indicative of fraud and evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of written representations from management.

If the auditor believes the misstatements identified are the result of fraud which involved management (i.e. by management collusion), the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and the impact on nature, extent and timing of audit procedures.

When numerous immaterial misstatements are identified at a specific location, it may indicate there is a risk of material misstatement due to fraud. The auditor should consider whether the fraud involves senior management as this would affect the reliability of written representations. This may indicate employees', management's or third party's collusion.

According to HKSA 240 (Clarified), the auditor shall design and perform further audit procedures by changing the nature, extent and timing of audit procedures that are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

The requirements in HKSA 250 (Clarified) are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor is required by this HKSA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional scepticism throughout the audit, as required by HKSA 200 (Clarified) is important in this context, given the extent of laws and regulations that affect the entity.

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:

- (a) An understanding of the nature of the act and the circumstances in which it has occurred;
- (b) Further information to evaluate the possible effect on the financial statements.

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

The auditor shall include in the audit documentation identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

Learning Pack

Chapter 10, Fraud and irregularities

Audit area – Trade payables

(i) Supplier statement reconciliations

What is the issue?

- There are unreconciled differences between the purchase ledger and supplier statements and it is unclear whether the errors arise due to invoicing or recording errors
- There is some evidence that the new supply chain software may have led indirectly to errors occurring in suppliers invoicing processes or supplier statements
- However, the new software has led to increased pressure on M&K's purchase ledger team at a time when they are less well resourced which would increase the risk of error in recording
- Especially given that the team have worked overtime to clear an invoice backlog

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

- The issues identified may indicate a misstatement in the financial statements as a result of errors in recording invoices
- There is further evidence of this when comparing the trade payables figure included in the draft financial statements with the prior year
- And trade payables days were identified as appearing low compared to budget and prior year
- The audit evidence obtained so far indicates an understatement of trade payables
- The total potential understatement on the sample subjected to audit procedures is HK\$457,000 (425+2+30) which is 0.82% (457/55,799) of gross assets per the draft financial statements. Whilst this is not material it may indicate further errors (understatement) in trade payables which overall may represent a material error
- Therefore further alternative audit procedures will be necessary to obtain evidence as to completeness of year end trade payables or to ascertain the extent of any error

What procedures should be adopted to address the issue? How to carry out the procedures?

What evidence should be obtained from M&K?

- Extend the sample of supplier statement reconciliations to suppliers not affected by the introduction of the new supply chain software to ascertain whether similar differences exist between the trade payables ledger and suppliers statements
- Inspection of any correspondence with the three suppliers affected by the supply chain software to ascertain whether they have identified or communicated any issues to M&K
- Also inspect correspondence to ascertain whether suppliers have chased non-payment by M&K and whether payments were subsequently made
- Review a sample of invoices entered onto the trade payables system near the year end to ascertain whether they have been recorded accurately
- Ascertain and review the procedures in place within the accounts payable team to ensure that all invoices received are recorded
- Select a sample of good received notes from the weeks before the year end and trace to invoices and amounts included on the purchase ledger to identify any errors in invoicing or incomplete recording of invoices on the purchase ledger

(ii) Dispute with supplier

What is the issue?

- There is an apparent dispute over the quality of goods supplied by a major supplier
- The directors of M&K have refused to recognise a liability in the financial statements in respect of the invoice for these goods
- A misunderstanding between M&K and the supplier indicates that a further shipment of goods is already in progress and it is unclear if M&K will be willing to pay for these

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

- The trade payables figure may be understated by HK\$400,000 if M&K are liable to pay for these goods.
- This represents 0.7% (400/55,799) of gross assets per the draft financial statements which in itself is not material
- However, the possibility of a dispute over the additional shipment may mean accruals are also understated by HK\$509,000 leading to an overall understatement of liabilities of HK\$909,000 (400 + 509)
- This represents 1.6% (909/55,799) of gross assets and is therefore considered material
- If the items are shown to be of the agreed design and specification it may also transpire that M&K holds inventory at year end which it is unable to sell – these items would need to be written down to net realisable value
- The evidence obtained so far does not clarify whether M&K is liable for these amounts at the year end and therefore further audit procedures need to be undertaken.

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Discuss matters with the directors to understand their rationale for not including the relevant amounts in trade payables and accruals
- Enquire from directors whether any legal advice is being sought and review any correspondence with legal advisors to ascertain likelihood of M&K being liable
- Review contracts, agreements and design and textile specifications for the items in question to form a view on whether M&K have any grounds for non-payment
- Ascertain whether similar issues have arisen in the past and how they were resolved between M&K and their supplier
- Review evidence up to the date the audit report is signed, including payments made post year end, for evidence of M&K paying or becoming liable for the amounts invoiced.

Debriefing

The above is based on the following auditing standards:

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

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

The concept of materiality is applied by the auditor in:

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

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

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

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

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

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

Learning Pack

Chapter 13: Specific audit procedures

Audit area – Inventory

(i) Year end inventory count

What is the issue?

- The reliance on the inventory system to establish year end quantities of inventory held in stores is complicated by the issue of shrinkage
- The amounts of inventory recorded on the inventory system are higher than the actual quantities held in the stores due to theft, damage and admin errors
- M&K have not completed a full inventory count and therefore the exact quantities of inventory in each store has not been verified
- It is therefore not possible to ascertain the reliability of the inventory system for recording quantities held by stores as shrinkage means there will always be a discrepancy
- M&K have included a reduction to the overall value of inventory (of 1.5% of net turnover) to reflect the loss of inventory during the year
- This appears to be low based on the shrinkage levels identified at a sample of stores where the inventory count was attended
- A recent research paper also indicates that the level of reduction may not be sufficient with average shrinkage rates in retail for clothing apparel and fashion items being in the region of 3.64 – 3.85%
- The nature of the calculation is an estimate which is open to management bias

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

- If the reduction for shrinkage has been under-estimated by M&K the quantity (and hence value) of inventory will be over-estimated at the year-end also leading to inflated profits
- Assuming a 'worst case' scenario, i.e. an appropriate shrinkage rate of 3.85%, the reduction to inventory at year end should have been HK\$5,505,557 compared with the actual reduction of HK\$2,145,030 meaning inventory and profits are potentially overstated by HK\$3,360,527.
- This represents 6% ($3,360,527/55,799,000$) of gross assets and 11.3% ($3,360,527/29,765,000$) of profit before tax – both of which are significantly material
- Further audit evidence must be obtained in order to substantiate the appropriateness of the percentage adopted to reflect shrinkage by M&K
- Further testing may be required to obtain evidence as to the overall reliability of the inventory system

What procedures should be adopted to address the issue? How to carry out the procedures?

What evidence should be obtained from M&K?

- Conduct further research into the level of shrinkage experienced by organisations in the same sector/geographical regions as M&K
- Discuss with management the basis for retaining the % reduction for shrinkage as in prior years in light of evidence that indicates global shrinkage levels have increased
- Ascertain from management what security measures are employed in M&K stores in order to reduce the risk of shoplifting and physically observe/inspect such measures being used. Do such measures reduce the level of shrinkage to below global averages?

- Consider applying test data to the inventory system to establish that goods sent by the warehouse to stores are accurately recorded and that store inventory levels are accurately adjusted each time a sale is made and recorded in the EPOS system.

(ii) Inventory valuation

What is the issue?

- M&K have received poor publicity during November for the spring/summer 2012 collection
- At 30 September 2011 M&K held HK\$1,400,000 of inventory that relates to this collection
- Given the poor publicity M&K may have difficulty selling the inventory which could result in the inventory having a net realisable value below its cost

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

- Although the article was not published until November 2011, the 'poor design' was a condition that existed at the year end
- Therefore the inventory should be written down to the lower of net realisable value and cost, if necessary
- This will also result in a reduction of profit for the year ended 30 September 2011
- The value of the inventory represents 2.5% (1,400/55,799) of gross assets and 4.7% (1,400/29,765) of profit before tax. This is material however; the inventory may not need to be written down to nil.
- Further evidence is required to ascertain whether the inventory does have a NRV below cost but it is unlikely the auditors will be able to rely on post year-end sales as the collection is unlikely to be on sale in M&K stores until after the audit has been concluded.

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Discuss the article with management to ascertain their opinion as to whether the inventory should be written down
- Review the fashion press for any other commentary (positive or negative) on M&K's spring/summer collection
- Ascertain the impact in previous years on the sales value of collections subject to any poor publicity in particular noting whether any collections have had to be written down to nil.
- If management do not consider it necessary to make any adjustment to the value of inventory in respect of this collection the auditors should obtain a written representation from management confirming their opinion on this matter.

Debriefing

The above is based on the following auditing standards:

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

The concept of materiality is applied by the auditor in:

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

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

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

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

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

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

HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit* deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. The auditor's conclusion takes into account the auditor's evaluation of uncorrected misstatements and the materiality level before issuing the auditor's report.

The objective of the auditor is to evaluate:

- (a) the effect of identified misstatements on the audit
- (b) the effect of uncorrected misstatements, if any, on the financial statements

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

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

HKSA 540 (Clarified) *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements. The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable and related disclosures are adequate.

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

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

Learning Pack

Chapter 8: Planning, materiality and risk assessment, section 6

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

Chapter 12: Substantive procedures, including analytical procedures

Chapter 13: Specific audit procedures

Chapter 15: Accounting estimates, opening balances and comparatives

Audit area – New EPOS system

(i) Data transfer

What is the issue?

- Two sets of data were migrated from old systems to the new EPOS system
- Data in respect of inventory quantities at each store were entered manually into the new system by temporary staff
- Manual processes, particularly where undertaken by temporary staff who are perhaps less well trained, are at high risk of errors occurring
- Data in respect of prices were transferred using an automated computer programme
- Systematic errors could occur if the mapping design was inaccurate
- Some errors were automatically identified by the load rejection report, indicating an increased risk of issues
- These were amended manually which may increase the risk of human error
- Prices per the sales ledger may have been different, through error, to prices that were loaded onto the new EPOS system – this could result in the sale being recorded in the store at one price but being recorded in the sales ledger at a different price

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

- Errors in the data entry in respect of inventory quantities would lead to an inaccurate 'opening' position with respect to inventory
- Given that M&K is relying on the inventory system for year-end inventory quantities, this could lead to misstatements in inventory in the financial statements at 30 September 2011
- Errors in prices in the EPOS system would lead to items being sold at incorrect prices, however this would not be reflected in the sale recorded in the sales ledger as the value of sales was calculated using the sales ledger's own pricing data.
- This could lead to a misstatement in sales recorded during the year where discrepancies existed between the sales ledger pricing data and the EPOS system pricing data.

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Obtain results of inventory checks undertaken by stores and sent to the internal audit to identify the extent of any errors that may have arisen
- Ascertain the levels of experience and training of temporary staff used to count and record inventory
- Review the data load rejection reports to ascertain the extent of the errors arising on the migration of pricing data
- Select a sample of pricing data held in the sales ledger at implementation date and agree to pricing data migrated into the EPOS system
- Review the credentials, experience and reputation of the external software supply company

(ii) Accuracy of new system

What is the issue?

- The implementation of the new sales systems led to a bug for online sales which resulted in a systematic error
- The issue was corrected manually which may result in further errors or some corrections not being processed at all
- Some of the duplicate items sent out to customers may not have been returned
- The proportion of sales affected represents 0.23% of revenue (13,088*/39 weeks/143,002) and 1.1% of profit before tax (13,088*/39 weeks/29,765)

*total online sales for 9 months to end June 2011 from management accounts

- Therefore does not appear to be material but if bug-fix is not effective then the size of the issue could be greater and hence material

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

- Duplicate sales would result in an overstatement of sales and understatement of inventory at the year-end if these have not been amended correctly
- This would be compounded further if items were entered as returned to inventory but had not been physically received in the warehouses, leading to an overstatement in the inventory system and hence the year-end financial statements
- If the bug-fix has not resolved the problem systematic errors may still be occurring in the system which would result in further misstatements in the financial statements

What procedures should be adopted to address the issue? How to carry out the procedures?

What evidence should be obtained from M&K?

- The online sales system should be tested by entering test data to ensure that it is now operating properly and the bug-fix has resolved the problems
- A sample of online sales recorded after the bug-fix was implemented should be traced to accounting records to ensure that no further duplication of orders was occurring
- A sample of online sales recorded in the first week after the new system was implemented, should be traced to documentation relating to the correction of the errors and checked for accuracy both in the sales ledger and inventory records
- A sample of duplicated online sales should be traced to documentation of goods returned to the warehouse to gain assurance as to the completeness of returns of duplicated items

Debriefing

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

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HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit* deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. The auditor's conclusion takes into account the auditor's evaluation of uncorrected misstatements and the materiality level before issuing the auditor's report.

The objective of the auditor is to evaluate:

- (a) the effect of identified misstatements on the audit
- (b) the effect of uncorrected misstatements, if any, on the financial statements

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

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

Learning Pack

- Chapter 8: Planning, materiality and risk assessment
- Chapter 9: Audit evidence, procedures, audit methodologies and audit sampling
- Chapter 11: Internal control and tests of controls, section 4
- Chapter 16: Overall audit review and finalisation

Audit area – Sales and cash

(i) Year end cash counts

What is the issue?

- Issues were identified at 3 of the 15 stores attended as part of the audit of cash at year end
- In the case of each store incomplete information at the end of the day on 30 September means that cash balances cannot be verified through the completion of the end of day cashing up reconciliation:
 - Mong Kok: unknown amounts banked during the day
 - Peking: lost credit card slips
 - Orchard Road: EPOS system failure – total sales unknown
- Although the potential errors appear small, cash by its nature is always deemed to be a material balance

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

- Cash and/or sales could be misstated in each of the above cases
- The sample may be indicative of other, similar issues arising at other cash counts not attended by the auditors
- Alternative audit procedures will need to be undertaken to ascertain the accuracy and existence of cash recorded in respect of the 3 stores where problems were identified
- Additional audit procedures will be required to investigate whether other stores experienced issues

What procedures should be adopted to address the issue? How to carry out the procedures?

What evidence should be obtained from M&K?

- Discuss with the head office accounts team whether any issues arose on year-end cash counts which were not attended by the audit team
- Ascertain whether the internal audit team were involved in any year end cash count processes and, where relevant, review their working papers and conclusions
- Review a sample of year end cashing up reconciliations reported by stores to head office in order to ascertain whether any further issues arose at other stores
- Compare the budgeted/forecast cash balances by region/store to the actual amounts reported and obtain explanations for any significant discrepancies

Mong Kok

- Review the post year end bank statements to identify the amount of cash taken to the bank by the security courier
- Obtain documentation direct from the security courier detailing the amounts collected from the Mong Kok store on 30 September
- Ascertain whether any difference then remains on the end of day cashing up reconciliation and consider whether this could represent a misstatement of cash

Peking

- Review the post year end bank statements to identify the amount of credit card transactions for the Peking store on 30 September
- Compare this to the amount recorded by the stores z report on that date
- Ascertain whether any difference then remains on the end of day cashing up reconciliation and consider whether this could represent a misstatement of cash

Orchard Road

- Identify the value of credit sales made during the day through review of post year end bank statements
- Ascertain whether movements in inventory (recorded through the integrated inventory/EPOS system) were captured before the power surge in order to identify the items sold and their total sales value
- Ascertain whether there were any other reconciling items on the end of day cashing up reconciliation (e.g. any voids, vouchers, returns etc)
- Ascertain whether any difference then remains on the end of day cashing up reconciliation and consider whether this could represent a misstatement of cash and/or sales

(ii) Foreign currency translation

What is the issue?

- M&K holds bank accounts in foreign currencies
- Balances in bank accounts at the year-end need to be translated into HK\$ for inclusion in the consolidated financial statements
- Inappropriate rates may be adopted or errors may be made in calculations
- There are potentially cash in transit issues arising at the year end

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

- All foreign currency rates used by M&K to translate year-end cash balances should be checked to a reliable external source
- This audit procedure has highlighted some discrepancies between the rates applied resulting in an overstatement of cash of HK\$5,633 (see below)
- Each of the discrepancies result in an overstatement of cash which may suggest management bias

Region	Cash at 30 Sept in local currency	Exchange rate applied by M&K	Cash in HK\$ using M&K exchange rate	Exchange rate per auditor's external source	Cash in HK\$ using auditor's external exchange rate
Hong Kong	HK\$222,000	n/a	222,000	n/a	222,000
China	¥89,856	HK\$1 = ¥0.832	108,000	0.847	106,087
Malaysia	RM27,406	HK\$1 = RM0.386	71,000	0.396	69,207
Singapore	SG\$7,900	HK\$1 = SG\$0.158	50,000	0.164	48,171
Taiwan	TWD103,180	HK\$1 = TWD3.685	28,000	3.698	27,902
Total			479,000		473,367

- Cash could be understated by HK\$32,000 if the amount transferred from Hong Kong to Malaysia is not included in Malaysia's year-end cash balance.

**What procedures should be adopted to address the issue? How to carry out the procedures?
What evidence should be obtained from M&K?**

- Enquire of management the basis for the exchange rates used to determine reasonableness
- If rates do not appear to be justified, request management correct the overstatement of cash
- If management refuse to correct the overstatement this may have implications for the audit opinion
- Review the balances reported by Malaysia at the year end to ascertain whether the amount transferred by Hong Kong on 30 September has been included in that regions year-end cash balance

Debriefing

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

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

Learning Pack

Chapter 8: Planning, materiality and risk assessment

Chapter 13: Specific audit procedures, section 5.3 and 5.4

M&K Apparel Limited

Draft financial statements

You have been provided with a copy of the draft financial statements for M&K for the year ending 30 September 2011.

Required

Use the draft financial statements to help you during the audit execution phase and, when told to do so by your facilitator, carry out analytical procedures at the review stage.

Key questions/Approach for analytical procedures at the review stage

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

Draft statement of comprehensive income for the year ended 30 September 2011

	Note	2010/11 HK\$000	2009/10 HK\$000
Turnover	2	143,002	135,593
Cost of sales		<u>(50,121)</u>	<u>(50,264)</u>
Gross profit		92,881	85,329
Selling expenses		(3,877)	(3,573)
Administrative expenses		<u>(59,519)</u>	<u>(50,935)</u>
Operating profit		29,485	30,821
Interest income		306	445
Interest expenses	3	<u>(26)</u>	(21)
Profit before taxation		29,765	31,245
Taxation	4	<u>(3,104)</u>	<u>(5,102)</u>
Profit for the year		<u>26,661</u>	<u>26,143</u>

Draft statement of financial position as at 30 September 2011

	Note	2010/11 HK\$000	2009/10 HK\$000
Non-current assets			
Intangible non-current assets		2,231	2,197
Tangible non-current assets	5	<u>32,703</u>	<u>26,690</u>
		34,934	28,887
Current assets			
Inventories		16,874	16,689
Trade receivables	6	3,512	3,220
Cash and bank balances		<u>479</u>	<u>662</u>
		20,865	20,571
Current liabilities	7	<u>(5,737)</u>	<u>(6,507)</u>
Net current assets		15,128	14,064
Total assets less current liabilities		<u>50,062</u>	<u>42,951</u>
Financed by			
Share capital	8	259	259
Reserves		49,803	42,692
Total equity		<u>50,062</u>	<u>42,951</u>

Draft statement of changes in equity for the year ended 30 September 2011

	2010/11 HK\$000	2009/10 HK\$000
Balance as at 1 October	42,950	39,187
Profit for the year	26,661	26,143
Foreign currency exchange differences	1,251	(2,079)
Transactions with owners - dividends	<u>(20,800)</u>	<u>(20,300)</u>
Balance as at 30 September	<u>50,062</u>	<u>42,951</u>

Draft notes to the financial statements for the year ending 30 September 2011

1 ACCOUNTING POLICIES

1.1 Basis of preparation

The financial statements have been prepared under the historical cost convention and in accordance with applicable accounting standards.

1.2 Revenue

Revenue comprises revenue recognised by the Group in respect of the sale of clothing to consumers. Revenue is reported less value added tax, discounts, returns and the returns provision in the statement of comprehensive income.

1.3 Intangible non-current assets

Intangible assets include brands and goodwill.

Intangible non-current assets with a finite useful life are stated at cost less amortisation. Amortisation is calculated on a straight line basis over the asset's expected useful life. Intangible assets with an indefinite useful life are tested for impairment annually.

1.4 Non-current tangible assets and depreciation

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

Buildings	- 3% straight line
Fixtures and fittings	- 12% straight line
Motor vehicles	- 20% straight line
Office equipment	- 20% straight line

1.5 Inventories

Inventories are valued at the lower of cost and net realisable value after making allowance for obsolete and slow-moving inventory.

1.6 Accruals

Accruals is accounted for by a provision for goods sold before 30 September but returned to stores by customers after 30 September.

1.7 Foreign currencies

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

2 TURNOVER

Turnover is attributable to the principal activity of the Group. An analysis of turnover is given below:

	2010/11 HK\$000	2009/10 HK\$000
China (including Hong Kong)	86,392	81,791
Rest of the world	<u>56,610</u>	<u>53,802</u>
	<u>143,002</u>	<u>135,593</u>

3 INTEREST EXPENSES

	2010/11 HK\$000	2009/10 HK\$000
On bank loans and overdrafts	<u>(26)</u>	<u>(21)</u>

4 TAXATION

	2010/11 HK\$000	2009/10 HK\$000
Corporation tax in respect of the year	<u>(3,104)</u>	<u>(5,102)</u>

5 PROPERTY, PLANT AND EQUIPMENT

	Land HK\$000	Buildings HK\$000	Equipment HK\$000	Total HK\$000
Cost				
At 1 October 2010	111	1,267	40,264	41,642
Additions	0	97	10,323	10,420
Disposals	<u>0</u>	<u>(43)</u>	<u>(876)</u>	<u>(919)</u>
At 30 September 2011	<u>111</u>	<u>1,321</u>	<u>49,711</u>	<u>51,143</u>
Depreciation				
At 1 October 2010	0	(275)	(14,677)	(14,952)
Charge for the year	<u>0</u>	<u>(18)</u>	<u>(4,287)</u>	<u>(4,305)</u>
Disposals	<u>0</u>	<u>32</u>	<u>785</u>	<u>817</u>
At 30 September 2011	<u>0</u>	<u>(261)</u>	<u>(18,179)</u>	<u>(18,440)</u>
Net book value				
At 30 September 2011	<u>111</u>	<u>1,060</u>	<u>31,532</u>	<u>32,703</u>
At 1 October 2010	<u>111</u>	<u>992</u>	<u>25,587</u>	<u>26,690</u>

6 TRADE RECEIVABLES

	2010/11 HK\$000	2009/10 HK\$000
Trade receivables	3,004	2,827
Prepayments and accrued income	559	441
Provision for doubtful debts	(51)	(48)
	<u>3,512</u>	<u>3,220</u>

7 CURRENT LIABILITIES

	2010/11 HK\$000	2009/10 HK\$000
Bank loans and overdrafts	972	782
Trade payables	3,661	4,086
Corporation tax	611	1,007
Accruals (provision for returns)	493	632
	<u>5,737</u>	<u>6,507</u>

8 SHARE CAPITAL

	2010/11 HK\$000	2009/10 HK\$000
Share capital called up, allotted and fully paid	<u>259</u>	<u>259</u>

Discussion points

Analytical procedures at the completion stage

Observation	Commentary and potential issues
Cost of sales has decreased even though revenue which has increased by 5%.	This could indicate an understatement of costs, e.g. textiles costs or an error in year-end inventory valuation.
Taxation has fallen by 39% from 2010 to 2011 in spite of profits only falling by 4.7%.	In 2010 an effective rate of tax of 16.5% was applied but in 2011 a rate of 10.4% appears to have been applied. This suggests an understatement of tax.
The tax creditor has also fallen by 39% compared with the prior year	
The average equipment depreciation rate for 2010 was approximately 14% but in 2011 is 9%. This is lower than any of the rates allowed for equipment. The amount of depreciation is also lower than in 2010, even though additions have increased the cost of equipment. There have been a large number of additions in the year.	Depreciation could have been calculated incorrectly, or additions may not be being depreciated in the year of purchase
Inventory days have increased from 121.2 to 122.9 days in spite of the new inventory system.	This is not what was expected given the reasons for implementing the new system. It may indicate that the system is ineffective or that there are error in the year- end inventory valuation
Cash and bank balances have fallen by 28%. Bank loans and overdrafts have increased by 24% and the interest expense has increased by roughly the same amount.	This indicates the company may be having cash flow issues and hence need the loan from the bank.
The accruals (provision for returns) have fallen by 22% compared to prior year and yet net turnover has increased by 5% since 2010.	The accrual for goods returned post year end appear to be too low
Trade payables days have decreased from 29.6 days in 2010 to 26.7 days in 2011.	This may indicate an understatement of year end liabilities

Audit completion

(i) Online discount fraud

On 15 November 2011 you read the following article in a newspaper:

Hong Kong Times

M&K now says 'yes!' in online discount mix-up

Hong Kong, 15 November 2011

In a dramatic U-turn, M&K, the clothing retailer agreed to honor orders made through on the company's online retail website in September in spite of an error which allowed hundreds of shoppers to buy high volumes of items at a huge discounts of up to 60 per cent.

M&K originally announced that the multiple use of discount codes contravenes the terms and conditions of the offer made and that as a result these transactions were fraudulent and would be cancelled.

But, after a great deal of pressure was exerted on the retailer by both press and consumer groups, M&K finally agreed yesterday to honor the transactions.

M&K requested that customers be patient as it tries to identify all those transactions affected by the initial mix-up and stated that in some cases where goods were no longer in stock customers would be asked to select another item of an equivalent value on which they would receive the same discount.

An M&K spokesman commented "It is regrettable that this mix-up occurred and we are in the process of implementing procedures to ensure it does not happen again. We would like to reassure our customers that we are dedicated to the highest standards of customer service. The fact we have reversed our original decision demonstrates the extent to which we listen to and value our customer's opinions."

Required

Identify the issues for M&K's financial statements for the year ended 30 September 2011 and any additional audit steps that should be taken.

(ii) **Product recall**

On 21 November you are informed about the following information being displayed in M&K stores and on its website:

M&K PRODUCT RECALL NOTICE - 20 Nov 2011

Girl's Pink Sundress

Code: MKYG 747



Our quality assurance procedures have identified that the above product does not meet our normal high standards of quality. Buttons on an extremely small number of items, on sale between July and September have been found to be defective and may present a choking hazard to children.

The product is being recalled as a precautionary measure.

To obtain a refund you should return the item to your local M&K store.

If you are in any doubt regarding the above product please phone our Customer Services helpline on (852)-8888-7777.

M&K apologise for any inconvenience caused as a result of this product recall.

Required

Identify the issues for M&K's financial statements for the year ended 30 September 2011 and any additional audit steps that should be taken.

Discussion points

Audit completion

(i) Online discount fraud

What is the issue?

- M&K have decided to honour sales made online at the end of September 2011 which were subject to an error leading to high levels of discount being received by customers
- The reversal of the decision is a subsequent event but relates to an issue that existed at the year end.

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

- The financial statements may need to reflect:
 - The sales made using the online discount (which were originally cancelled) at their discounted value
 - Any reduction in the value of inventory where it is being sold (after discount) at a price below its cost
 - An accrued income balance for the amounts due from customers
- Evidence will need to be gathered to support the value of transactions affected that were previously cancelled

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Ascertain from management the procedures they propose to adopt to identify the transactions affected
- Review the sales ledger for the online sales cancelled before the year end and compare this to the value of the transactions as calculated by the directors
- For a sample of items, compare the inventory value to the sales value to identify whether any items now have an NRV below cost
- Review post year end transactions in respect of this issue to identify the extent to which customers are taking up M&K's new policy on this matter

(ii) Product recall

What is the issue?

- An item manufactured before the year-end is found to be defective
- The defect could potentially be harmful to children
- The product has therefore been recalled and a refund will be offered to customers

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

- Refund relates to sales made in the year ending 30 September 2011 and therefore the product recall is an adjusting subsequent event
- A provision for returns should be included (reducing sales by the same amount)
- Having said this the recall of one item is unlikely to be material but may be indicative of other issues with similar products or products from the same manufacturer

- Evidence needs to be gathered in order to ascertain the extent of the issue and whether any harm has come to any children as a result of the defect
- A legal claim or liability could result for such a situation
- Any items still held by stores or in the warehouse will now have a zero net realisable value assuming that they cannot be modified (or that it is not cost effective to do so)

What procedures should be adopted to address the issue? How to carry out the procedures? What evidence should be obtained from M&K?

- Enquire of management how the defect was discovered and whether it is likely to affect any other items or lines.
- Review correspondence files and board minutes to corroborate management's explanation and ascertain whether any incidents have occurred that would potentially lead to a claim against M&K
- Review the adequacy of management's procedures to identify whether any further items are affected by similar defects
- Interrogate the inventory control system to ascertain the value of items in inventory at year end affected by the defect
- Recalculate any adjustments made by M&K and trace to financial statements

Debriefing

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

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

Learning Pack

Chapter 16: Overall audit review and finalisation

Audit reporting

Company A Limited

Company A Limited (Company A) is a manufacturer of catalytic converters based in Hong Kong. Trade is split evenly between products sold to car manufacturers and products sold to suppliers of spare parts in the motor industry.

You are the external auditor of Company A for the year ended 30 September 2011.

During the year, the sales director was affected by ill health. The rest of the sales team struggled to keep up with their work in his absence. Tests of controls carried out during the interim audit work found that the controls over sales and receivables could not be relied upon.

On 1 October 2011, the servers at head office of Company A were attacked by a computer virus. Company A was able to reconstruct most of the accounting records but it has not been possible to reconstruct the year-end receivables ledger. As a result, you have been unable to carry out any detailed substantive testing on the receivables balance. Total receivables at 30 September 2011 were HK\$9.2m.

It is the policy of Company A to provide for 5% of receivables. A figure for this amount has been included in the trial balance at 30 September 2011.

The reconstructed financial statements show that for the year ended 30 September 2011 profit before tax is HK\$87m and total assets are HK\$124m.

Required

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

Company B Limited

Company B Limited (Company B) is a mining company which owns mines worldwide. The company runs its operations from headquarters based in Hong Kong.

In January 2011 a typhoon caused a toxic leak from one of Company B's copper mines. The leak polluted a river resulting in the devastation of all wildlife in the area. Local people were hospitalised after drinking polluted water.

You are the external auditor of Company B and are currently working on the audit for the year ended 30 September 2011.

The local authorities have filed a lawsuit against Company B and legal proceedings are due to start in February 2012. The directors of Company B believe they have complied with all the necessary building and operating requirements. They have not made a provision in the accounts for legal costs or compensation payable. Reliable legal advice obtained by Company B indicates the claim can be successfully defended.

The directors have included a note to the financial statements highlighting the uncertainty surrounding the litigation. You have reviewed the note and consider it to be sufficient to comply with the relevant financial reporting requirements.

Required

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

Discussion points

Audit reporting

Company A Limited

Impact on auditor's report

- Tests of controls cannot be relied upon for sales and receivables so the audit firm must carry out substantive testing in these areas in order to obtain sufficient and appropriate audit evidence
- The computer virus attack has destroyed the receivables ledger and therefore the audit firm is unable to carry out any substantive testing on receivables
- The allowance of HK\$460k (5% of HK\$9.2m) is less than 1% of profit before tax and total assets and so is not a material figure
- Receivables is a material figure on the statement of financial position at 7% of total assets and 11% of profit before tax
- Since the audit firm has been unable to substantiate the receivables figure, this represents a material inability to obtain sufficient appropriate audit evidence
- The auditor's report would be qualified on the basis that this is material but not pervasive
- As the report has been qualified, the auditors must use the heading "Qualified Opinion" for the opinion paragraph
- The auditors shall also include a paragraph providing a description of the matter giving rise to the qualification and a quantification of the financial effects
- This shall be inserted immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion"

Debriefing

The above is based on the following auditing standards:

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

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

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

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

Company B Limited

Impact on auditor's report

- There appears to be no basis on which to make a provision in the financial statements and so disclosure is adequate
- There is no disagreement as to the basis of preparation or disclosure and so the financial statements are not materially misstated
- However, the nature of the uncertainty means it must be brought to the attention of shareholders
- The auditors shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report
- The Emphasis of Matter paragraph must be inserted immediately after the opinion paragraph in the auditor's report and indicate that the auditor's opinion is not modified in respect of the litigation
- The Emphasis of Matter paragraph must also draw the user's attention to the note regarding the litigation in the financial statements

Debriefing

The above is based on the following auditing standards:

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

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

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

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

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