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Module 8 – Principles of Auditing

This examination is divided into TWO sections.

- Section A (20%). This consists of TEN compulsory multiple choice questions. You should allocate approximately 36 minutes in total for Section A.
- Section B (80%). This consists of FOUR compulsory written questions. You should allocate approximately 2 hours and 24 minutes in total for Section B.

Suggested time allocation (by marks):

Marks	Approximate time in minutes
1	2
2	3
3	5
4	7
5	9
6	11
7	12
8	14
9	16
10	18
11	20
12	21
13	23
14	25
15	27
16	29
17	30
18	32
19	34
20	36

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SECTION A – MULTIPLE CHOICE QUESTIONS (Total: 20 marks)

Answer **ALL** questions in this section. Choose the best answer for each question. Together they are worth 20% of the total marks for this examination.

Questions 1 to 10 carry 2 marks each. (20 marks – approximately 36 minutes)

1. Identify which of the following is / are the auditor's responsibility relating to fraud.
 - A The auditor is required to detect all fraud during an assurance engagement.
 - B The auditor shall maintain professional skepticism throughout the audit and recognise the possibility that a material misstatement due to fraud could exist.
 - C When fraud is identified, a qualified audit opinion is a must for such assurance engagement unless the client provides adequate undertaking to protect the auditor.
 - D Both B and C are true.

2. Identify which of the following would be a discovery of facts that would require follow-up actions by the auditor.
 - (1) Discovery of the inclusion of a material amount of after year-end sales.
 - (2) Discovery of the inclusion of a material amount of consignment goods from consignors as inventory at the year-end date.
 - (3) Discovery of the omission of the disclosure that a fire had broken out after the year-end date which would cause a significant impact to the entity's financial statements.
 - (4) Discovery of the management's intent to increase luxury product lines.
 - A (1) only.
 - B (2) and (3) only.
 - C (1) and (4) only.
 - D (1), (2) and (3) only.

3. Identify which of the following is true regarding internal auditors.
 - A Internal auditors report to the board of directors, or other people charged with governance.
 - B Internal auditors must be qualified members of the Hong Kong Institute of Certified Public Accountants.
 - C Internal auditors are employed by all business entities.
 - D Internal auditors generally report to the accounting department.

4. Identify which of the following assertions is NOT relevant in respect of sending confirmations to trade receivables.
- A Existence.
 - B Completeness.
 - C Valuation.
 - D Rights and obligations.
5. Identify which of the following condition(s) has / have to be met such that a stratified sampling approach is most effective for auditing trade receivables.
- A Stratifies the trade receivables population into discrete sub-populations by dividing them according to the outstanding balance.
 - B The variability between strata is maximised.
 - C The variability of items within each stratum is minimised.
 - D All of the above.
6. Identify which of the following is NOT explicitly stated in the auditor's report with a standard unmodified audit opinion.
- A The financial statements are the responsibility of the management.
 - B The audit was conducted in accordance with the Hong Kong Standards on Auditing.
 - C The audit includes the evaluation of the effectiveness of the company's internal controls.
 - D The audit includes the evaluation of the reasonableness of accounting estimates and related disclosures.
7. Determine which of the following audit procedures is / are appropriate to test the completeness assertion for trade payables and accruals.
- (1) Examine files for any unmatched purchase orders and suppliers' invoices for any unrecorded liabilities.
 - (2) Vouch selected amounts from the trade payables and accruals schedule to the suppliers' invoices.
 - (3) Compare the current year balance of trade payables and accruals to that of the previous year.
- A (3) only.
 - B (1) and (2) only.
 - C (1) and (3) only.
 - D (2) and (3) only.

8. Determine which of the following audit procedures is appropriate to test the completeness assertion for trade receivables.
- A Select samples from the trade receivables ledger and examine the goods delivery notes and invoices.
 - B Understand, ascertain and evaluate the effectiveness of the internal controls over credit policy and control.
 - C Trace a sample of goods delivery notes to the sales journal and into the sales ledger and trade receivables ledger.
 - D None of the above.
9. For sales of specialty products, determine which of the following balance-related audit objectives is affected by the occurrence of a transaction-related audit objective.
- A Existence.
 - B Completeness.
 - C Rights and obligations.
 - D Accuracy.
10. After Christmas 2018, the Hong Kong Department of Health announced that it was investigating 25 clusters of suspected food poisoning related to Company A's products purchased by customers in one of its cake shops. The management of Company A informed the auditor that they have discussed with the company's lawyer and considered that there is no need to make any provision for such claims and to account for it in its financial statements for the year ended 31 December 2018. Identify which of the following is considered as the most appropriate audit procedure for substantiating the amount of litigation claims that may exist.
- A Obtain a management representation letter from the management.
 - B Review all board minutes for the year 2019.
 - C Review all the correspondence with customers.
 - D Send an enquiry letter to the lawyer of Company A for their opinion regarding the probability of the claim being successful and the estimated amount of possible compensation, if any.

* * * END OF SECTION A * * *

SECTION B – WRITTEN QUESTIONS (Total: 80 marks)

Answer **ALL** questions in this section. Marks are indicated at the end of each question. Together they are worth 80% of the total marks for this examination.

Question 1 (21 marks – approximately 38 minutes)

PHD & Co has been the auditor of a Hong Kong listed company – Good Health Limited ("GHL") for seven years. The partner in charge of this audit has always been Kelvin over this seven year period. Same as the prior years, GHL plans to celebrate the completion of the audit by arranging a party for their staff and the audit team. In order to enhance the atmosphere of the party, a lucky draw is arranged every year and everyone can get a piece of gold of a different weight. The chairman of GHL believes that the money is well spent as such an arrangement can enhance the audit efficiency of each year.

Close to the end of the audit team's field work, Kelvin was approached by the chairman of GHL discussing the continuation of the assurance engagement for the next year. The only condition was that the bank loan of GHL could be renewed after the current year's audit with an unmodified auditor's report. The renewal of the bank loan is critical for GHL's continuation of business.

Finally, after evaluating all the audit evidence, Kelvin concluded that there was a material uncertainty regarding the renewal of the bank loan of GHL and such material uncertainty has been adequately disclosed in its financial statements. He also concluded that the management's use of the going concern basis of accounting to prepare GHL's financial statements is appropriate. Accordingly, an auditor's report containing an unmodified opinion is to be issued for GHL's financial statements for the current year.

Required:

- (a) Explain **THREE** fundamental principles of the HKICPA's *Code of Ethics for Professional Accountants*.
(3 marks)
- (b) Analyse the situation of GHL for PHD & Co and explain the potential threats and the ethical principle that may be breached.
(8 marks)
- (c) List **THREE** board committees which serve to ensure the good corporate governance practices of a Hong Kong listed company.
(3 marks)
- (d) List **EIGHT** basic elements of an unmodified auditor's report of a Hong Kong listed company.
(4 marks)
- (e) In respect of the material uncertainty existed at GHL which has been adequately disclosed in GHL's financial statements, explain what other information should be included in the auditor's report apart from the unmodified auditor's opinion.
(3 marks)

Question 2 (23 marks – approximately 41 minutes)

High Technology Limited is engaged in the retail of computers and computer accessories. The company has its own warehouse and more than ten retail shops in Mongkok. Most of the sales transactions are settled by cash or credit card. Customers have to pay bank charges if credit cards are used for payment. Most customers prefer to pay by cash. The company has inventories and cash which are considered as high risks areas for the misappropriation of assets.

Required:

- (a) Explain how to strengthen the internal controls to reduce the fraud risk factors of the misappropriation of assets. (8 marks)
- (b) Determine the substantive audit procedures to address the risks associated with the relevant assertions of the company's bank and cash balance. (5 marks)
- (c) Analyse and explain the inherent risk of material misstatement of the company's inventories in connection with the relevant assertions. (5 marks)
- (d) Analyse and explain the inherent risk of material misstatement of the company's sales transactions in connection with the relevant assertions. (5 marks)

Question 3 (22 marks – approximately 40 minutes)

AEC Limited is a retail company with more than 20 physical stores in Hong Kong, which sold books, VCDs, DVDs, Blu-rays, and CDs in the past. The company has gone through a significant transformation last year and has become an electronic commerce company. It closed many of its physical shops and is now an internet-based retailer selling books, VCDs, DVDs, Blu-rays, CDs, video downloads / streaming, MP3 downloads / streaming, audiobook downloads / streaming, software, video games, electronics, apparel, furniture, food, toys and jewellery.

AEC Limited has separate retail websites for different countries and it offers international shipping to those countries for most of its products. All the goods are priced and transactions are settled in the customers' local currencies. Inventory counts take place at the end of the year for all the stores and for the warehouse by the teams of warehouse staff. However, subject to the availability of staff, inventory counts are conducted within one week before or after the year end day.

PF & Co has been the auditor of AEC Limited for five years. In the past years' audits, the engagement manager noticed that many VCDs were slow moving items. However, the management claimed that those VCDs could be sold more quickly after the online selling platform is ready.

During the current year's audit, after the online store has been set up, it is found that those VCDs are still slow moving and even no movement for many of the items. From AEC Limited's draft financial statements for the current year's audit, the amount of total assets of the company at the end of the year is HK\$120 million, net amount of current assets is HK\$5 million and the profit for the year is HK\$1.2 million.

Required:

- (a) **Analyse additional business risks (including information technology risks) faced in the new business model by the expansion of the company's e-commerce trading business.** (5 marks)
- (b) **Determine the appropriate internal controls (including General IT Controls) that could be implemented in the company's e-commerce trading system to mitigate the business risks.** (5 marks)
- (c) **Determine the appropriate audit procedures for the valuation assertion regarding the slow-moving VCDs of the company.** (6 marks)
- (d) The audit engagement partner concluded that the balance of VCDs should be written off and an adjustment for writing down the inventory of HK\$300,000 to be made in AEC Limited's financial statements but the management insisted that no adjustment is required because they have a broadened market for their products.

Required:

Analyse what type of auditor's opinion should be issued if the management and those charged with governance insist on not taking up the audit adjustment to write down the inventories in AEC Limited's financial statements for the current year. Justify your answer.

(6 marks)

Question 4 (14 marks – approximately 25 minutes)

You are the junior audit trainee of PQ & Co who is the external auditor of Company G, a manufacturing company. The audit manager in charge of the current year's audit of Company G has asked you to perform substantive procedures to audit the year end balance of property, plant and equipment ("PPE"). The account clerk of Company G provided the following PPE schedule to you.

	Buildings and structures HK\$'000	Leasehold improvements HK\$'000	Plant and machinery HK\$'000	Furniture, fixtures & office equipment HK\$'000	Motor vehicles HK\$'000
Cost					
At 1 April 2018	89,500	2,100	33,951	1,843	3,624
Additions	8,700	400	740	900	1,174
Disposals and written off	-	-	(620)	(724)	(526)
At 31 March 2019	<u>98,200</u>	<u>2,500</u>	<u>34,071</u>	<u>2,019</u>	<u>4,272</u>
Depreciation					
At 1 April 2018	14,523	646	12,992	916	2,427
Provided for the year	3,727	30	1,910	290	1,328
Eliminated on disposals and written off	-	-	(343)	(516)	-
At 31 March 2019	<u>18,250</u>	<u>676</u>	<u>14,559</u>	<u>690</u>	<u>3,755</u>
Carrying values					
At 31 March 2019	<u>79,950</u>	<u>1,824</u>	<u>28,512</u>	<u>1,329</u>	<u>517</u>
At 31 March 2018	<u>74,977</u>	<u>1,454</u>	<u>20,959</u>	<u>927</u>	<u>1,197</u>

The above items of PPE are depreciated using a straight-line method at the following rates per annum:

Buildings and structures	2.5% – 5%
Leasehold improvements	1% – 2%
Plant and machinery	4% – 8%
Furniture, fixtures & office equipment	10% – 20%
Motor vehicles	15% – 25%

At 31 March 2019, Company G pledged its buildings and structures and plant and machinery with an aggregate carrying amount of HK\$44 million (2018: HK\$45 million) to secure a bank loan of HK\$10 million (2018: HK\$10 million) and short-term bank facilities of HK\$5 million (2018: HK\$10 million).

Required:

- (a) Identify the potential risks and misstatements of the PPE depreciation methods and the PPE schedule provided by Company G. (6 marks)
- (b) Determine the substantive audit procedures you should apply to address the risks associated with the year end PPE balance of Company G. (8 marks)

* * * END OF EXAMINATION PAPER * * *

Module 8

Principles of Auditing

Answers

SECTION A – MULTIPLE CHOICE QUESTIONS (Total: 20 marks)

Questions	Answers
1.	B
2.	D
3.	A
4.	C
5.	D
6.	C
7.	C
8.	C
9.	A
10.	D

* * * END OF SECTION A * * *

SECTION B – WRITTEN QUESTIONS (Total: 80 marks)

Answer 1(a)

A professional accountant shall comply with the following fundamental principles of the HKICPA's Code of Ethics for Professional Accountants:

Integrity – to be straightforward and honest in all professional and business relationships.

Objectivity – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.

Professional Competence and Due Care – to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation; and to act diligently and in accordance with applicable technical and professional standards.

Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.

Professional Behaviour – to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

Answer 1(b)

Familiarity threat is created due to the long tenure of seven years with no audit partner rotation. The long term relationship between the client and the engagement partner may influence the judgement of the partner.

Self-interest threat is created due to the fact that the value of the gold from the lucky draw is probably not insignificant. The lucky draw gifts for the audit team members may influence the judgement of the audit team.

Intimidation threat is created due to the condition for the continuation of the assurance engagement. The pressure to issue an unmodified auditor's report for GHJ for the successful renewal of bank loan may influence the judgement of Kelvin.

The ethical principle of objectivity may be breached in this situation.

Answer 1(c)

Board committees which serve to ensure good corporate governance practices of a Hong Kong listed company include:

- Remuneration committee
- Nomination committee
- Audit committee
- Risk committee
- Corporate governance functions

Answer 1(d)

According to HKSA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*, the basic elements of an unmodified auditor's report of a Hong Kong listed company include:

- Title of the report
- Addressee
- Auditor's opinion
- Basis for opinion
- Key audit matters
- Other information
- Responsibilities of Directors and Those Charged with Governance for the financial statements
- Auditor's responsibilities for the audit of the consolidated financial statements
- Other reporting responsibilities
- Name of the engagement partner
- Auditor's name and signature
- Auditor's address
- Date of the report
- Other relevant points

Answer 1(e)

According to HKSA 570 (Revised) *Going Concern*, if adequate disclosure about the material uncertainty is made in the financial statements, PHD & Co shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

Draw attention to the note in the financial statements that discloses the matters; and

State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Answer 2(a)

The following are suggested to be carried out to reduce the fraud risk factors relating to the misappropriation of assets:

- Management should maintain an attitude of emphasising the need for monitoring and reducing risks of misappropriation of assets and communicate such attitude to the employees.
- Segregation of duties to strengthen the internal controls over assets with clear responsibility of shop managers and other employees regarding the safety of assets.
- Proper record keeping of movement in inventories and cash.
- Proper authorisation and approval of movement in inventories and cash.
- Adequate physical safeguards over inventories and cash.
- Timely and proper documentation of transactions.
- Maintaining control over the access security of the information system.
- Daily cash reconciliations by personnel delegated by management.
- Timely banking in of cash.

- Perpetual inventory system.
- Timely inventory count and reconciliation of inventory with the inventory record.

Answer 2(b)

The substantive audit procedures are as follows:

Count all cash balances simultaneously in the presence of the individual who is responsible for the cash at a particular date on a surprise basis.

Review the cash book for any large or unusual items, particularly around year-end, as this may indicate window dressing.

Trace all outstanding lodgements to the pre-year-end cash book and post-year-end bank statements.

Send bank confirmation to verify bank balances.

Obtain the bank reconciliations for all accounts.

Agree the balance per the cash book and per bank statements with the year-end bank reconciliations.

Agree the amounts of the counted cash on hand and the balance per the cash book to the trial balance or general ledger.

Answer 2(c)

The risk of material misstatement of inventories on the valuation assertion is high in High Technology Limited. The potential obsolescence of high technology inventories can lead to problems in the proper valuation of inventory in terms of lower of cost and net realisable value.

The risk of material misstatement of inventories on the existence assertion is also high in High Technology Limited due to the nature of goods (e.g. computer accessories) which are high-tech consumer products, small in size, and easy to be stolen. The potential loss of inventories by theft affects the existence assertion of inventories.

Answer 2(d)

The risk of material misstatement of the company's sales transactions is high. There are numerous sales transactions for a retail business of computers and computer accessories. The potential human error of making recording errors may cause the misstatement of sales which affects the completeness and accuracy of the sales transactions. The potential fraud risk of misappropriation of cash by staff affects the completeness assertion of sales.

Answer 3(a)

Additional business risks faced by AEC Limited in the new e-commerce trading business include the following:

The loss of adequate audit trails in either paper or electronic form regarding the e-commerce retailing trading transactions.

The e-commerce security risks such as virus attack or fraud by customers, employees and others through unauthorised access to the e-commerce trading system of the company.

Non-compliance with the laws and regulations of other countries due to the absence of knowledge.

Non-compliance with the tax rules of other countries due to the absence of knowledge.

Risks of systems and infrastructure failures due to poor system development and implementation as well as hacking.

Foreign currency risks as the purchase of goods and sales of goods are denominated in different currencies.

International shipping risks.

Risks associated with the e-payment system.

Other relevant points.

Answer 3(b)

Internal controls can be implemented to mitigate these risks and are as follows:

Controls over the development and implementation of systems used to support the e-commerce retailing trading transactions and the keeping of business records for financial reporting and other purposes.

Using encrypted websites and electronic shopping carts.

Not to store sensitive consumer information to avoid any information leakage in the online system.

Limiting employee access to information.

Using fire walls and virus protection software to protect the e-commerce trading system of the company.

Maintaining a good control environment to support the implementation of control procedures (e.g. human resources policies to ensure staff have the appropriate skills, expertise and experience to engage with the expansion of business).

Maintaining foreign currency hedging procedures to address the foreign currency risks from the expansion of the business.

Updating knowledge on the new technologies that give rise to the risk exposed to the internet security and keeping up to date the effective use of technology for the protection of the e-commerce trading system.

Maintaining a compliance department to ensure compliance with tax rules, law and regulations.

Other relevant points.

Answer 3(c)

The following audit procedures should be performed:

- Compare the inventory list of this year and last year to see whether there is any inventory movement for each VCD item during the year.
- Check whether there is any subsequent movement of the VCD items.
- For items with movement during the year and after the year end date, check whether the selling price is lower than the cost.
- For items without movement during the year and after the year end date, discuss with the management and request evidence of the realisable value.
- Inspect the periodic obsolete inventory review reports prepared by AEC Limited if there are any. Obtain understanding of the inventory impairment policy of the company and check the reasonableness of the impairment of inventory estimated by the management for the current year.

Answer 3(d)

In this case, the management has not applied the appropriate accounting policies consistently with the financial reporting framework. The amount of misstatements of cost of goods sold and net income is material as compared to the net income of HK\$1.2 million. The auditor should express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements of inventory, cost of goods sold and net income, individually or in the aggregate, are material, but not pervasive, to the financial statements.

Answer 4(a)

The potential risks and misstatements of Company G's PPE depreciation methods and PPE schedule are as follows:

PPE is overstated in Company G's financial statements due to the casting error in the plant and machinery balance for the current year end.

PPE is understated in Company G's financial statements due to the depreciation charge for motor vehicles being overstated.

PPE is misstated in Company G's financial statements due to no elimination of accumulated depreciation for the disposed motor vehicles.

PPE may be misstated in Company G's financial statements due to the depreciation rate of leasehold improvements being smaller than the depreciation rate of buildings and structures which is not reasonable.

Answer 4(b)

The substantive audit procedures are as follows:

Agree the opening balances with last year's working paper / audited annual report and check the closing balances of the cost and accumulated depreciation to the trial balance general ledger and fixed asset register.

Check the casting of the PPE schedule and review the fixed asset register to ensure that depreciation has been charged on all assets with a limited and reasonable useful life and accounting policies are applied consistently.

Select samples from the additions list and check against suppliers' invoices / debit notes for the additions of PPE.

Review the repairs and maintenance account to identify any misclassification of revenue expenditure and capital expenditure that should be capitalised as PPE.

Check the cost and accumulated depreciation of the disposed assets to the fixed asset register and sales agreements and receipts for items disposed. Cross check against the statement of profit or loss and other comprehensive income the amounts of depreciation and gain or loss on disposal of fixed assets to ensure their accuracy.

Verify the title of the buildings by inspection of title deeds or perform a land search.

For a sample of assets, recalculate the depreciation charge for the year and agree with the fixed assets register.

Perform a proof in total calculation for the depreciation charge for each category of fixed asset and discuss any significant fluctuations with management.

Review the bank confirmation for the details of the pledging of assets and check against the draft financial statements for proper disclosures.

Review leasing agreements to see if there are leased assets and consider whether the right-of-use assets were properly accounted for.

Review the financial statement disclosure in respect of the accounting policies for depreciation and check that these policies have been consistently applied.

Verify the existence of fixed assets by the physical inspection of selected items from the fixed asset register for each category of the assets (e.g. inspect the car licence for the motor vehicles).

Verify the completeness of fixed assets by selecting of a sample of physical assets and inspecting the fixed assets register to ensure they have been included.