SECTION A – CASE QUESTIONS (Total 50 marks)

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

CASE

Superior Electronic Limited ("Superior") is a company listed on The Hong Kong Stock Exchange and is engaged in the manufacturing and trading of electronic products with production facilities in mainland China, Vietnam and Africa. ABC & Co. ("ABC") is the auditor of Superior and you are the partner in charge of the audit.

During the financial year ending 31 December 2013, Superior announced the following significant events:

(1) In February 2013, Superior's factory in Africa was flooded because of the intermittent rainfall since January 2013. Due to difficulties in accessing the facility because of the evacuation order issued by the local government, Superior has suspended production in Africa since 15 February 2013. The factory building was flooded and it was difficult to predict when production could be resumed.

The financial information related to the factory in Africa extracted from its audited financial statements for the year ended 31 December 2012 was as follows:

	HK$'000
Property, plant and equipment	75,228
Inventories	23,410
Trade and other receivables	12,450
Bank balances and cash	5,211
Trade and other payables	11,524

(2) In March 2013, Superior was informed that some bank balances of a subsidiary company in Africa were queried by the branch manager of the company's local bank because a large quantity of bank notes were deposited into the company's bank account instead of a cheque receipt. With concern about involvement in money laundering activities, an independent non-executive director of Superior voiced out in a monthly board meeting that Superior's internal audit function should be strengthened, in particular to monitor the risk assessment process of the company.

(3) In May 2013, Superior entered into an agreement to subcontract the manufacturing process to a company which is owned by a director of Superior with an annual consideration not exceeding HK$200 million.

In the course of planning for the audit of Superior for the year ending 31 December 2013, ABC obtained the management accounts from Superior. The financial information extracted from the management accounts is as follows:

	Nine months ended 30 September 2013 (unaudited) HK$'000	Year ended 31 December 2012 (audited) HK$'000
Revenue	1,134,617	1,814,896
Cost of sales	(1,185,084)	(1,652,456)
Operating expenses	(45,928)	(99,820)
Impairment of property, plant and equipment	(62,000)	0
(Loss) / profit for the period/year	(158,395)	62,620

	30 September 2013 (unaudited) HK$'000	31 December 2012 (audited) HK$'000
Property, plant and equipment	480,228	612,334
Inventories	76,523	120,221
Trade and other receivables	250,895	321,852
Bank balances and cash	240,111	245,223
Trade and other payables	128,552	249,541
Bank and other borrowings	13,456	18,478

Question 1 (22 marks – approximately 40 minutes)

(a) **In respect of the flood damage to Superior's factory in Africa, identify and explain the risks of material misstatements at assertion level.**

(10 marks)

(b) **What are your suggested audit procedures in addressing the risks identified in Question 1(a)?**

(12 marks)

Question 2 (8 marks – approximately 14 minutes)

For an organisation such as Superior, what are the roles of the internal audit function in risk management? As an audit client, what factors do you consider when you set up the internal audit department in relation to risk management? Briefly explain your reasoning and expectations behind the factors you considered.

(8 marks)

Question 3 (10 marks – approximately 18 minutes)

(a) **Identify and explain the risk of material misstatements relating to the disclosure of the related party transactions.**

(2 marks)

(b) **Suggest the audit procedures you would perform on related party transactions related to the subcontracting fee.**

(8 marks)

<u>Question 4</u> (10 marks – approximately 18 minutes)

In February 2014, due to a shortage in materials, Superior shipped some raw materials from its African factory to Vietnam to meet the production demand of a high value purchase order. Some cartons of raw materials received by the Vietnam factory were found to contain only the packaging materials. The value of the missing raw materials was estimated at HK$5 million. The Chief Executive Officer ("CEO") of Superior was very angry. He undertook an investigation of this incident and had the following initial findings for the auditors:

- the loss appeared to take place during the time of shipment and the identity of the thief is not known at this moment
- the loss did not appear to be caused by the non-functioning of the internal controls of the African and Vietnam factories
- the raw materials were related to purchases after the year end and insurance has been purchased such that the company's financial loss was minimal
- the audited financial statements for the year ended 31 December 2013 should not be revised as such

You are the audit manager of ABC. You completed the audit of Superior satisfactorily and your engagement partner signed the clean opinion auditor's report before you received the briefing by the CEO of Superior about the inventory loss in Vietnam. The auditor's report has not been sent to shareholders yet.

<u>Required:</u>

As a pre-meeting before meeting the CEO, prepare your notes to discuss with your engagement partner the subsequent event and list out the audit procedures you would recommend to re-assess the impact on the auditor's report.

(10 marks)

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End of Section A

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

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

Question 5 **(12 marks – approximately 22 minutes)**

Discuss and explain the difference between the following engagements:

- **An audit engagement**
- **A review engagement**
- **An agreed-upon procedures engagement**

(12 marks)

Question 6 **(28 marks – approximately 50 minutes)**

Assume you are Daniel Lai, an audit partner of ABC CPA Co. ("ABC"). Recently you accept a new audit engagement of a listed company in Hong Kong, Big Bang Limited ("Big Bang").

You have reviewed the latest audited financial statements of Big Bang and noted that an unqualified opinion was issued by the predecessor auditor in the last financial year. Big Bang is principally engaged in apparel manufacturing with annual turnover exceeding US$500 million. Its organization structure is simple with only one manufacturing plant in China and a trading company in Hong Kong. Big Bang's business is very stable. There has been no material fluctuation in the statement of financial position items over the years.

Below is an extract of the significant statement of financial position items from the audited financial statements for the year ended 31 December 2012. Other items are regarded as insignificant.

	US$'million	
Property, plant and equipment	1,500	
Accounts receivables	100	
Inventory	200	
Cash	30	
Accounts payables	240	
Convertible bond issued to a private equity investor	300	(Note - Face value equals carrying value)

(a) Assume that ABC has accepted the audit engagement, you are now considering the overall audit approach for the opening balances.

<u>Required:</u>

(i) **Discuss your overall opening balance audit strategy, with consideration that the last appointed auditor might have had performance issues.**

(5 marks)

(ii) **Suggest and explain your audit procedures for each of the statement of financial position items listed above.**

(10 marks)

(b) For the purposes of improving production efficiency and better management of work in progress and inventory, Big Bang has implemented a new enterprise resources planning ("ERP") system, TIME system, during the year which allows real time recording of inventory in and out and automates the weighted average inventory costing calculation. Daniel learnt this information from his interview with the IT head and is considering this change in the audit plan.

<u>Required:</u>

What audit procedures should Daniel plan to perform?

(7 marks)

(c) After understanding the processes and controls in place in the sales rebates cycle, Daniel considered a control reliance testing approach for sales rebates is preferable in view of efficiency and effectiveness. However, after completing the test of control, the audit team reported to Daniel that one sample of the sales rebates was not properly supported by the approved documents.

<u>Required:</u>

Discuss whether Daniel should continue a control reliance testing approach for sales rebates and what additional audit procedures are required.

(6 marks)

<u>Question 7</u> (10 marks – approximately 18 minutes)

With 25 branches in the New Territories, Bank of New Territories ("BNT") is a top tier retail bank in Hong Kong specialised in home loans. SMP & Co. ("SMP") has been the external auditor of BNT for five years.

BNT operates a staff mortgage scheme offering all members of staff concessionary mortgage rate deals. The staff rate is currently at one-month HIBOR plus 0.5% while the market rate is plus 1.5%.

Before the upcoming Annual General Meeting, Charles Chow, BNT's Head of Consumer Credit, suggests to Peter Chan, the SMP audit engagement partner, that BNT would like to extend the concessionary staff mortgage scheme to all SMP members of staff, in recognition of SMP's services. Charles and Peter have been golf teammates in the Annual Golf Team Tournament organised by the HKICPA for the last three years.

<u>Required:</u>

Assess and explain the professional and ethical issues in each of the situations above. State the possible safeguards to address the professional and ethical issues.

(10 marks)

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