Student Notes

Module C (December 2012)

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Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Corporate governance	• Case study • Group discussion	Ch. 1 & 2	Pg. 1 – 6
3. Overview of an audit	• Card game		
4. Audit acceptance / continuance	• Case study • Group discussion	Ch. 4 & 7	Pg. 7 – 11
5. Audit planning	• Case study • Group discussion	Ch. 8, 9, 10, 11 & 12	Pg. 12 – 35
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Workshop 2			
8. Reboot	• Presentation • Group discussion		
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10. Project management in audit execution stage	• Presentation • Group discussion		
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13. Conclusion	• Presentation • Group discussion		

Audit execution

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

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

During the audit, a number of 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. The SIC should have information on all the issues.

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)

You should inform the members of your team of the following information in order that they can consider materiality when reviewing the relevant audit issues:

- Materiality benchmarks:

  ½ - 1% revenue

  1 – 2% total assets

  5 – 10% profit before tax

- Information regarding draft figures from BST financial statements for the year ended 30 September 2012

  Revenue – HK$19,471m

  Profit before tax – HK$55m

  Total assets – HK$9,559m

Big Spender Travel Services Limited 'BST'

Audit area: Cash and bank

(i) **Year end bank reconciliation**

As part of the planned audit procedures, the audit junior has audited the bank reconciliation for one of BST's ten bank accounts, account number 2009234. All uncleared lodgements, cheques and items on the bank statement not in the cash book were agreed to the cash book and post year-end bank statements. He has now passed the work on to you to review.

Account number 2009234			HK$	HK$
Balance per bank statement at 30 September 2012*				80,973,400
Add: uncleared lodgements				
Cash book date	*Batch number*	*Date cleared*		
27/09/12	5654	-	22,516,782	
29/09/12	5674	02/10/12	4,487,728	
29/09/12	5775	01/10/12	18,219,682	
30/09/12	5798	02/10/12	2,203,228	
30/09/12	5801	01/10/12	5,959,011	
				53,386,431
Less: uncleared cheques				
Cash book date	*Cheque number*	*Date cleared*		
02/09/12	7467	-	33,405,699	
27/09/12	7900	02/10/12	5,289,904	
30/09/12	7903	01/10/12	9,232,229	
30/09/12	7904	03/10/12	14,177,212	
30/09/12	7910	02/10/12	3,154,999	
30/09/12	7915	04/10/12	21,988,970	
				(87,249,013)
Items on bank statement not in cash book				
Bank statement date				
29/09/12			(22,561,782)	
30/09/12			(2,000)	
				(22,563,782)
Balance per cash book at 30 September 2012				24,547,036
* agreed to bank statement				

The ledger clerk is responsible for the reconciliations for each of BST's ten bank accounts. He explained he is new to the role and gave the following explanations in respect of account 2009234:

– Batch number 5654 relates to a batch of cheques from the travel shop in New Town Plaza, Sha Tin. The ledger clerk is unsure why these cheques have still not cleared. He thinks it may be linked to the HK$22,561,782 that is shown in the bank statement but not in the cash book and asked what he should do next.

– Cheque 7467 was never received by the supplier. A new cheque was issued on 10/10/12. The ledger clerk did not cancel the original cheque.

– The HK$2k which is on the bank statement but not in the cash book relates to a bank error the ledger clerk was not aware of until the bank statement became available after year end. This amount was entered into the cash book on 2/10/2012.

(ii) **Customer deposits held by travel agents**

The audit junior has also finished auditing the bank reconciliation for BST's third party agent deposit account. This is the account where third party agents remit customer deposits received less any commission earned by the agent. He now passes this to you to review.

Account 3193922			HK$	HK$
Balance per bank statement at 30 September 2012*				71,973,907
Add: uncleared lodgements				
Cash book date		*Date cleared*		
28/09/2012	Transfer to account 2009234	01/10/12	(21,335,136)	
30/09/2012		12/11/12	1,120,452	
30/09/2012		15/11/12	2,497,890	
30/09/2012		11/11/12	4,251,832	
30/09/2012		16/11/12	5,490,909	
30/09/2012		13/09/12	11,373,211	
30/09/2012		14/10/12	9,798,011	
30/09/2012		16/10/12	12,102,971	
30/09/2012		15/10/12	18,978,111	
30/09/2012		11/10/12	1,228,920	
				45,507,171
Balance per cash book at 30 September 2012				117,481,078
* agreed to bank statement				

Notes

All uncleared lodgements were agreed to bank statement for account 3193922

The transfer to account 2009234 could not be found on the post year end bank statement relating to this account.

BST

Audit area: Revenue and Trade receivables

(i) **Revenue recognition**

As part of the audit procedures, a member of the audit team has carried out work on the cut-off of revenue. Following your instructions, he has selected a sample of customer holidays taken in the first week after the period end and traced these back to the original booking confirmations and final invoices sent to customers for the remaining balance of their holiday payment.

The sample was chosen at random from a list of customer names and departure dates. It contains holidays booked via BST travel shops, the BST website and third party travel agents. The results are as follows.

	Date of departure as per booking confirmation	Date of booking confirmation	Deposit HK$ as per booking confirmation	Date deposit recognised as revenue in general ledger	Date of final invoice	Final invoice amount	Date final balance recognised as revenue in general ledger
1	01-Oct-12	01-Jul-12	720	01-Jul-12	23-Jul-12	1,680	01-Oct-12
2	01-Oct-12	12-Dec-11	429	01-Oct-12	23-Jul-12	1,001	01-Oct-12
3	02-Oct-12	04-Apr-12	840	04-Apr-12	24-Jul-12	1,960	02-Oct-12
4	02-Oct-12	25-Jun-12	648	25-Jun-12	24-Jul-12	1,512	02-Oct-12
5	03-Oct-12	16-Nov-11	609	03-Oct-12	25-Jul-12	1,421	03-Oct-12
6	03-Oct-12	18-Jul-12	480	18-Jul-12	25-Jul-12	1,120	03-Oct-12
7	04-Oct-12	03-Mar-12	621	04-Oct-12	26-Jul-12	1,449	04-Oct-12
8	04-Oct-12	16-Apr-12	987	16-Apr-12	26-Jul-12	2,303	04-Oct-12
9	05-Oct-12	22-May-12	1,182	22-May-12	27-Jul-12	2,758	05-Oct-12
10	05-Oct-12	11-Feb-12	888	05-Oct-12	27-Jul-12	2,072	05-Oct-12

The audit manager has reviewed the work and has flagged it for you to go over urgently. He reminds you that when carrying out interim audit work at BST he was concerned that the revenue forecasts from Shanon Kei, the chief financial officer were unrealistic.

(ii) **Allowance against receivables**

Trade receivables shown on the statement of financial position includes an allowance for estimated irrecoverable amounts. As part of the period end audit procedures you are reviewing the basis for the allowance and have noticed the following relationship.

	2012 HK$m	2011 HK$m	2010 HK$m
Gross trade receivables	1,661	1,144	1,212
Allowance	83	115	121
Allowance as % of gross trade receivables	5%	10%	10%

You discuss this relationship with the financial controller at BST. He explains that in the past, the receivables allowance was always a general rather than a specific provision. His allowance calculation was a straight 10% per cent of gross trade receivables.

During the period he had discussed the accuracy of the provision with Shanon Kei. Shanon felt that improvements to IT systems and credit checking controls had resulted in a fall in irrecoverable debts and faster collection times and that the receivables allowance should reflect this. They agreed that the basis of the allowance should be amended to be 5% of gross trade receivables.

BST

Audit area: Audit of group component financial statements

(i) **Component auditors**

The group engagement partner has asked you to carry out a detailed review of the working papers from Kwan Yan & Co. on its audit of Ticketmate Hong Kong Agency Ltd ™ for the year ended 31 December 2011, and alert him to any issues. He has asked for the review as he is very concerned about quality control after reading an article in a professional accountancy magazine earlier in the year which he passes to you.

> Kwan Yan & Co. are in the news after it was revealed that the firm has been cost-cutting by getting rid of half its audit managers. Mr. K Kwan, senior partner, stated that "Kwan Yan are constantly looking at ways we can update our services to provide better value to our clients. We hope this restructuring will allow us to deliver a more efficient audit service".

Halfway through reviewing the file, you come across the following working paper:

Ticketmate Hong Kong Agency Ltd ™
Audit of the period ended: December 31st 2011
Analytical Review of Prepayments

Prepared by GL
Reviewed by

Prepayment	at 31 Dec 2011 HK$ 000's	at 31 Dec 2010 HK$ 000's	Explanation
Electricity	109	343	Dec 2010 prepayment for 1 month (Jan 2011) but Dec 2011 prepayment for 2 months (Jan and Feb 2012)
Telephone	0	22	Prepayment zero - no work required
Internet services	273	198	Growth in business has resulted in more broadband internet lines being required
Deferred income	(95)	(95)	no change
Total	287	468	

Conclusion: no further work required

You met with the audit partner at Kwan Yan & Co. earlier in the year and they confirmed they had the professional and technical competence to deal with the audit.

(ii) Consolidation adjustments relating to intercompany sales

Earlier in the week, the audit junior telephoned to ask you for information on the intercompany process at BST. You emailed the following instructions to him.

To: Audit junior
From: Audit senior
Date: 10 December 2012
Subject: **BST intercompany reconciliation**

Here is the information you required following our call earlier today,

A copy of the instructions issued by BST Group to their components is in the current audit file and these will explain the process for individual components. I have reviewed these instructions and are happy they are adequate. A brief summary of the group intercompany process is as follows.

All components at BST have access via a password to the group financial reporting system. Components can only view and modify the data for their own component (BST group accountants have access to view all components). As part of the period end process, each component is required to upload data into the system so that the group accountants can prepare the monthly consolidated accounts. The uploaded data includes a list of intercompany balances with other components in the BST group.

To eliminate all intercompany balances, the group finance assistant produces a spreadsheet using the listing of intercompany balances the components have uploaded to the system. Components are informed of any differences and asked to email the group finance assistant with their resolution. The group finance assistant will then make an adjustment and update the spreadsheet with the correct balances.

When all differences have been resolved, the group finance assistant prepares the consolidation adjustment for each of the components. This is then input into the system to remove intercompany balances from the consolidated accounts.

I need you to obtain a copy of the consolidation adjustments, intercompany balance spreadsheet and prints of the intercompany balance listings from all components including nil balances. Please carry out the following work and let me know if any issues arise as we had an issue with intercompany balances in the prior period.

1. Agree all balances on the spreadsheet to the uploaded data from the components
2. Where there are differences ask the client to provide you with copies of the emailed resolution from the component
3. Agree the consolidation adjustments made to the spreadsheet

Good luck!

Audit Senior

The audit junior has now sent you the following email.

To: Audit senior
From: Audit junior
Date: 10 December 2012
Subject: **Re: BST intercompany reconciliation**

I have been unable to find consolidation adjustments for intra-group revenue relating to six components of BST. The balances for which I can find no consolidation adjustment total HK$1,781m of revenue. The BST group financial controller claims these adjustments were overlooked.

Please can you let me know how to proceed.

Audit Junior

BST

Audit area: Provisions

(i) **Closure plan for high street travel shops**

During your audit work on provisions you have read the following business website news article and the finance department has provided you with a schedule of the impacts that will be included in the financial statements for the year ending 30 September 2012:

BST announces strategic re-focus 27 September 2012

BST, Hong Kong's leading premium tour operator, has historically expanded quickly through constant re-focussing of its operations to meet customer needs. It is no surprise therefore that today it announced a significant change in its strategic direction with online distribution set to become its primary sales channel.

A spokesperson for the company said that the growth in online sales through its own website as well as extreme competition from new 'web-only' operators in the travel market space have led the company to reconsider its distribution channels.

The company today announced the change in strategic direction to its staff stating that plans had been drawn up to reduce the company's high street travel shops by some 60% over the next four years, with half of those expected to close by this time next year. Those employed in the high street travel shops now face the risk of redundancy if they cannot be redeployed elsewhere in the business. The spokesperson said that whilst every effort would be made to redeploy staff to other parts of the business it was regrettable that the new strategic direction would require a different set of workforce skills to deliver the company's ambitious plans for growing online sales.

According to unofficial sources, the number of BST employees working in the company's travel shops amounts to approximately 4,800 and it is estimated that only up to 15% of those affected will be successfully found other roles within the group.

The company will also now have to set plans in motion to deal with the real estate issues that this decision will create. Whilst some premises leases will naturally come to an end through non-renewal, the group has a large number of unexpired leases which it may not be able to sub-let, resulting in the need for the company to recognise such onerous contracts as liabilities on its statement of financial position.

In spite of the likely significant future costs of the strategic plans the markets saw an increase in the share price of BST of 12 cents per share – suggesting that they approve of the direction the company has chosen to take.

Schedule of provisions in respect of travel shop closure plans – year ending 30 September 2012

	HK$m
Provision for redundancy costs[1]	52
Provision for onerous contracts in respect of leased properties[2]	648
Total provision re travel shop closure plan	700

Notes:

1 The provision for redundancy costs has been based on the total estimated number of staff whose role will be made redundant as a result of the detailed travel shop closure plans prepared by the board. Amounts due to individual staff have been calculated based on their contractual terms and BST's legal obligations in a redundancy scenario. It is estimated that 10% of staff can be redeployed either to travel shops that do not form part of the closure plans or elsewhere within the business, no redundancy provision has been included for those staff that are expected to be redeployed.

2 The provision for onerous contracts represents the anticipated future costs, relating to leased properties, where the property forms part of the company's travel shop closure plans. The provision has been calculated on a property by property basis and represents the lower of:

(i) The net cost of fulfilling the contract (= total future lease payments – future expected lease income from sub-letting); and

(ii) The penalty payable as a result of terminating the lease before its contractual end date.

(ii) **Compensation claim by customer**

During your work on provisions you discover the following letter in a correspondence file.

Hoi Tang & Partners
Legal Advisers
Floor 17, Des Vouex Tower
238 Des Vouex Road
Central
Hong Kong

5 September 2012

Ms. Gemma Middleton
Group Legal Director
Big Spender Travel Services Limited
18/F International Finance Complex Phase II
238 Tai Fat Road,
Tsim Sha Tsui

Dear Ms. Middleton

Notice of group legal action

I am writing to you on behalf of our client, The Hong Kong Travel Consumer Association (HKTCA), who have instructed this firm to proceed with a class legal action against BST in respect of BST's negligence and a serious breach of health and safety regulations at the 'Theatre of Rocking Aqua', Macau, which resulted in the death of 489 of BST's customers who were attending the show as part of their holiday package organised by BST.

HKTCA , which represents the families of the 489 victims, believes, based on police investigations, that the fire that broke out on 16 May 2012 leading to the collapse of the theatre, was entirely preventable and resulted from the breach of regulations regarding the fire resistance of fabrics used in venues with theatrical lighting.

The families believe BST was negligent due to its failure to carry out a proper risk assessment or any health and safety checks on the theatre before selecting it as a venue for customers on its Macau package holidays. This included basic checks regarding the health and safety procedures employed by the owners of the venue and the adequacy of emergency exits.

HKTCA will seek compensation on behalf of the victims' families as part of a class action against BST. Please advise your legal teams.

JLee

Jane Lee

Senior Legal Executive

BST

Audit area: Liabilities

(i) **Commissions due to travel agents**

As part of your audit procedures you are looking at non-routine and unusual transactions. You have come across a payment of $HK56m to an account registered with a bank in the Cayman Islands. No other payments were made to this account during the year. Documentation shows this was authorised by Shanon Kei.

When you query this with Shanon Kei, the CFO at BST, you are told this relates to an awkward situation with Mong Kok Travel Services Ltd ('Mong Kok'), an important third party travel agent. Whilst Shanon was on holiday earlier in the year her assistant received an angry call from the managing director of Mong Kok. He claimed that mistakes in documentation from BST had resulted in his firm receiving 3% commission instead of the agreed 5% before remitting customer monies to BST. Shanon Kei's assistant had said that the agent accused BST of trying to trick his company and that he threatened to do no further business with BST. She said she had checked the figures with the finance department and the total overpaid to BST was $HK56m.

Shanon went on to explain how her assistant for the past ten years was her sister Jean Kei, whose judgement she trusted completely. Her sister had never troubled her with work matters while she was on holiday before and so she knew this must be a serious issue. She asked Jean to arrange payment to the agent immediately.

As you leave the client premises that evening you wave to Jean Kei as she gets into her car, a brand new Aston Martin.

(ii) **Trade payables**

When carrying out an analytical review of trade payables you notice that the trade payables figure for White Star Travel Services Co. Ltd ('White Star') is a nil balance at September 30th 2012. You questioned this with the purchase ledger supervisor who told you that BST was no longer doing business with White Star and referred you to Freddy Garcia, the managing director for Asia, for more details.

Freddy explained that White Star is a hotelier with 400 hotels across Asia. Complaints about White Star's hotels had soared last year and BST had to refund customers where quality was not as advertised in BST brochures. According to Freddy, customers were arriving at hotels to find dirty rooms, broken furniture and televisions not working. BST was trying to recoup this amount from White Star but so far had not been able to come to an agreement.

Freddy felt that White Star's hotels could no longer provide BST customers the quality they required. He decided they would not use or pay for the allotments booked for 2013. At the time, White Star had just invoiced for these allotments.

Freddy then went on to say that White Star are arguing that BST have breached their contract as they had already agreed to the allotments and are now threatening legal action. He passes you the following memo from Gemma Middleton, group legal director at BST.

To: Senior management team
From: Gemma Middleton
Date: 11th July 2012
Subject: **White Star Legal Claim**

I have now examined the contract with White Star and it is unlikely that we will need to make the HK$500m payment for the cancelled 2013 allotments.

I would still advise departments to prepare a back-up plan as a contingency.

We have been unable to persuade White Star to refund BST the compensation paid to our customers of HK$523k and I will be instigating legal action shortly. Please ensure you let legal know of any further compensation claims that may arise.

No adjustments have been made in the financial statements in respect of this matter.

Discussion points
Audit execution

Audit area – Cash and bank

(i) **Year end bank reconciliation**

What is the issue?

- A cheque of HK$33.4m was issued before the period end but was never received by the supplier
- This cheque was reissued after the period end presenting a cut-off issue
- Additionally, the original cheque was never cancelled and so the payment may be reflected twice in the ledgers at BST, once before the period end and once after
- There is also a batch of cheques totalling $22,516k which have not cleared by the audit date and an unknown payment in the bank account of $22,561k
- These figures are very similar and it seems likely there has been a transposition error by the new ledger clerk
- The banking error that the ledger clerk was unaware of until after the period end has a satisfactory explanation and requires no further work

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

- By including the cheque payment that was reissued to a supplier, the bank balance and trade payables are both understated in the statement of financial position by HK$33.4m
- This amount is 0.3% of total assets so is not material to the financial statements
- No adjustments need to be made to the financial statements with regards to the reissued cheque but Luk Brothers may wish to examine the strength of controls over cheque authorisation and adjust their risk assessment accordingly
- The transposition error nets to an amount of HK$45k and is not material to the financial statements
- The volume and nature of these errors highlights a possible issue with the competence of the bank ledger clerk at BST
- The ledger clerk is responsible for nine other bank accounts at BST so there may also be an issue with the accuracy of his work on these
- Luk Brothers will need to carry out further audit procedures to gain sufficient reliable audit evidence to verify accuracy and cut-off in order to ascertain whether the misstatements are one-off events

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

- If not already done, the cheques on the bank reconciliation should be agreed to the cash book or bank statements and all dates verified

- It may be worth examining the bank reconciliations for the weeks previous to the period end bank reconciliation for items that may not have been taken forward to the period end bank reconciliation
- Samples should also be extended for all audit procedures already carried out on the bank statement
- Luk Brothers will need to ensure that audit procedures are extended for all ten bank accounts the ledger clerk has worked on due to the increased risk of misstatements
- Luk Brothers will need to keep a record of all misstatements for the review stage of the audit when they will evaluate the effect of uncorrected misstatements
- They will need to inform the directors of BST of these misstatements

(ii) **Customer deposits held by travel agents**

What is the issue?

- There are two issues with this reconciliation
- Firstly, the uncleared lodgements have not been cleared until on average two weeks after the period end
- This could indicate a cut-off issue where deposits received by BST after the period end are reported in the current period
- It is particularly suspicious as third party agents are required to remit all deposits to BST within five days
- Secondly, a transfer to another BST account of $21.3m on the bank reconciliation cannot be found on the corresponding post year end bank statements
- This raises the possibility of a misposting in the financial statements

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

- The uncleared lodgements total HK$66.8m and are 0.7% of total assets so are not material by size but may be considered material by nature owing to this being a cash balance
- Including deposits not actually received by BST until after the period end, increases bank and reduces trade receivables in the statement of financial position
- Overall, assets are the same but are more liquid in nature and a reclassification audit adjustment will need to be proposed
- Luk Brothers must consider whether this is indicative of fraudulent financial reporting at BST or a result of the incompetence of the new bank clerk
- The transfer where the corresponding entry cannot be found is not material but yet another error adds to the concern about the competence of the ledger clerk

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

- Luk Brothers should carry out further audit procedures around bank cut-off to collect sufficient reliable audit evidence

- Samples can be extended for all audit procedures already carried out on the account
- Luk Brothers should trace the uncleared lodgements to agent bookings in the company booking system to ensure the bookings were actually made before the period end
- If this does not provide sufficient reliable evidence, Luk Brothers could send external confirmation requests to third party travel agents asking them to list outstanding balances at the period end date
- If fraudulent activity is suspected after additional procedures have been carried out, Luk Brothers must communicate this to the appropriate level of management or, if it is suspected that management is involved, to those charged with governance
- Luk Brothers will need to enquire of the client as to where the $21.3m was posted to assess whether a misstatement has been made
- Although the amount is immaterial, Luk Brothers will need to keep a record of all misstatements for the review stage of the audit when they will evaluate the effect of uncorrected misstatements

References

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 likelihood 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

In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

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

Chapter 13: Specific audit procedures – section 5 Bank and cash

Audit area – Revenue and Trade receivables

(i) **Revenue recognition**

What is the issue?

- Revenue has been recognised in the incorrect period from the deposits of six customer bookings from a sample of ten
- From the sample, the problem seems to only affect bookings after March 2012, but further investigation would need to be undertaken to ascertain this

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

- The total revenue recognised inappropriately from the bookings in the sample is HK$4,857
- Revenue will be overstated by this amount in the income statement and trade receivables will be understated in the statement of financial position
- The amount is small and immaterial, however, the number of problem items found in the sample is concerning as this could be indicative of a wider problem of revenue recognition
- Luk Brothers will need to consider whether the issue is indicative of fraud and evaluate the implication in relation to other aspects of the audit such as the reliability of representations from management at BST

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

- Luk Brothers will need to extend their audit procedures for revenue
- The sample for the revenue cut-off test will need to be extended in order to assess whether there are other bookings where the deposit has been recognised in the incorrect period
- Luk Brothers could consider using CAATs in order to test a higher volume of bookings
- Substantive analytical procedures could be used to analyse revenue on a monthly or weekly basis during the current period with comparisons to the equivalent months or weeks from prior periods to identify any unusual relationships
- Luk Brothers will need to be careful they are not tipping-off staff at BST while carrying out these extended audit procedures because of the suspected fraud
- If fraud is suspected, Luk Brothers will need to re-evaluate the assessment of the risk of material misstatement due to fraud and consider extending the nature, timing and extent of audit procedures in other areas
- They will also need to ensure they report any fraud to those charged with governance

(ii) **Year-end allowance against receivables**

What is the issue?

- The basis of the estimate of the trade receivables allowance has changed from 10% to 5% of gross trade receivables
- Under the previous method the allowance would have been HK$166m, meaning that the allowance is HK$83m lower than it would have been
- BST claim this is as a result of improved debt collection times and a fall in irrecoverable debts
- However, trade receivable days has increased from 23 days at 30 September 2011 to 31.1 days at 30 September 2012
- There may be no real basis for the change in estimate and management bias may be involved in making BST appear more liquid than it really is

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

- Trade receivables may be overstated by $83m and the charge to the income statement will be understated by the same amount
- The understatement in the allowance is 1% of total assets so is immaterial but is highly material in the context of profit before tax
- Luk Brothers will need to exercise professional scepticism in judging whether the change in the basis of calculation is due to intentional management bias
- If an element of management bias is suspected, Luk Brothers will need to assess the impact on the reliability of other audit evidence, particularly representations from management

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

- While carrying out further audit procedures on the receivables allowance, Luk Brothers will need to exercise professional scepticism
- Luk Brothers should compare the allowance for receivables in the previous period with the actual level of irrecoverable debts written off to ascertain whether the receivables allowance was overly prudent in the past
- Evidence should be sought to verify Shanon Kei's claims that irrecoverable debts have fallen since prior periods
- Luk Brothers should obtain explanations from management as to why they believe debt collection times have improved when trade receivables days have risen

References

The above is based on the following auditing standards:

HKSA 200 (Clarified) ***Overall Objectives of the Independent Auditor and the Conduct on an Audit in Accordance with Hong Kong Standards on Auditing*** states that the auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

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.

The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

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

If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

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.

Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result).

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

In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Learning Pack

Chapter 10: Fraud and irregularities

Chapter 13: Specific Audit Procedures – section 12 Sales

Chapter 13: Specific audit procedures – section 4: Receivables

Chapter 15: Accounting estimates, opening balances and comparatives – section 1: Accounting estimates

Audit area – Audit of group component financial statements

(i) **Component auditors**

What is the issue?

- There are several problems with the quality of the audit work on prepayments by the component auditors
- Problem areas include: the working paper does not appear to have been reviewed, the auditor has not noticed deferred income is classified incorrectly, no explanation sought for lack of telephone prepayment, explanation for electricity does not match figures
- Kwan Yan & Co have recently halved the number of audit managers in the firm
- The quality of the working paper highlights that there may be a risk with the professional competence of Kwan Yan & Co as a result of the cost-cutting measures at the firm

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

- Kwan Yan & Co may not have collected sufficient appropriate evidence on which Luk Brothers can base their group audit opinion
- Luk Brothers may not be able to rely on any work undertaken by Kwan Yan & Co for the period after 31 December 2011

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

- Luk Brothers will need to thoroughly review the other working papers from Kwan Yan & Co to assess their quality
- If the work of Kwan Yan & Co is found to be insufficient, Luk Brothers will need to determine what additional procedures need to be performed and who they should be performed by
- If additional audit procedures cannot be carried out, Luk Brothers will need to consider the implications for the group auditor's report

(ii) **Consolidation adjustments relating to intercompany sales**

What is the issue?

- It appears that consolidation adjustments relating to six components of BST have not been posted as an oversight by the group finance assistant at BST
- There was also an issue with the audit of intercompany balances in the prior period and so Luk Brothers may need to reassess the risk associated with intercompany balances given that this is a problem area again

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

- Revenue and purchases will be overstated by HK$1,781m in the income statement
- This is 9% of consolidated revenue and as this is a material amount, Luk Brothers will need to propose an audit adjustment – nothing suggests BST will oppose this
- The oversight raises a concern that intra-group payables and receivables may also have not been eliminated and audit procedures will need to be undertaken in this area if they have not already been performed
- Luk Brothers will need to maintain professional scepticism when considering if this issue is a genuine oversight or an attempt to inflate the income statement figures

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

- Confirm intra-group revenue and purchases balances with the auditors of all components to ensure that the group spreadsheet and consolidation adjustments are accurate
- Obtain or create a spreadsheet of intra-group receivable and payable balances and agree to information uploads from individual components and component auditor confirmations
- If financial statements have been submitted to BST group by components, agree these to the intra-group spreadsheets and investigate any differences
- Speak to the group finance assistant and try to ascertain why the consolidation adjustments were not posted – did he or she simply forget or were they following instructions from the group financial controller or another employee at BST?
- Enquire as to the process for checking the spreadsheet and consolidation adjustments in case controls are lacking in this area – this may be an area where Luk Brothers can suggest improvements

References

The above is based on the following auditing standards:

HKSA 600 (Clarified) ***Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*** says that the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities.

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion

If the group engagement team concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request the component auditor to perform additional procedures. If this is not feasible, the group engagement team may perform its own procedures on the financial information of the component.

The group engagement partner's evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated

The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems, and may not be subject to the same internal controls to which other financial information is subject. The group engagement team's evaluation of the appropriateness, completeness and accuracy of the adjustments may include:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;
- Determining whether significant adjustments have been correctly calculated, processed and authorised by group management and, where applicable, by component management;
- Determining whether significant adjustments are properly supported and sufficiently documented; and
- Checking the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances.

Learning Pack

Chapter 18: Group Audits

Audit area – Provisions

(i) **Closure plans for high street travel shops**

What is the issue?

- BST has publically announced the closure of a number of travel shops. The announcement has been made prior to the year end and appears to represent plans from which management cannot realistically withdraw.
- Consequently, BST is likely to incur unavoidable costs in the future associated with the decision made prior to the year end.

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

- It appears therefore that the company should provide for the costs of the closures in the year end financial statements. This will include the redundancy costs for staff and any onerous contracts resulting from the early termination of leases or leaving vacant buildings not in use.
- There may also be other costs associated with the closures that should be provided for but which BST have not included in their current calculations.
- Audit evidence will need to be obtained in order to support management's estimates for the provisions included in the financial statements in respect of the redundancy costs and onerous contracts.
- Audit procedures will also need to be undertaken in order to ascertain whether the decision creates any other future obligations for which BST should be providing in the year end financial statements.

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

- Review the internal and external announcements prepared by the company including the date on which the announcements were made.
- Review the internal plans drawn up by management and consider whether they represent plans from which management cannot realistically withdraw at the year end.
- Discuss with management the basis of its estimates for the provisions for redundancy and onerous contracts and consider the reasonableness of that basis.
- Obtain a schedule of management's calculations and check for arithmetic accuracy. Verify, where possible, those amounts included in the calculations to relevant documentation, e.g.:
    - Agree estimated number of staff redundancies to management's internal plans
    - Agree estimated redundancy payments to employment contracts and legal requirements
    - Agree assumptions around onerous contracts to terms of lease, future lease payments

- Review the internal closure plans in more detail in order to ascertain whether management have considered and provided for all relevant costs.
- Discuss with management the procedures that it adopted in order to ensure all relevant future costs were identified and consider the adequacy of such procdures.

(ii) **Compensation claim**

What is the issue?

- A class action is being brought against BST for compensation due to the death of a number of BST customers at a theatre in Macau
- The class action claims that BST was negligent in that it did not carry out the proper risk assessments or health and safety checks
- BST may therefore be liable to the families of the victims
- The size of the claim could impact on the going concern status of the company if it is very large

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

- BST may need to provide for the costs of the claim in the financial statements if the success of such a claim is considered to be probable and the amount material
- If the success of the claim is considered to be possible then BST would need to make disclosures in the financial statements regarding the circumstances and the financial implications of the claim
- If the success of the claim is considered to be remote then no provisions or disclosures would be required

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

- Discuss the claim with the directors to ascertain their view on the claim, its likely outcome and their intentions with regard to the financial statements, for both treatment and disclosure
- Review the available documentation surrounding the incident at the theatre, including any views given by the legal department of BST or its legal advisers
- Request permission to write directly to BSTs legal advisers in order to obtain evidence as to whether the management's estimates of the financial implications are reliable.
- Review any documentation relating to BST's risk assessments and health and safety procedures in respect of the theatre to ascertain whether the relevant procedures were carried out by BST

References

The above is based specifically on the following auditing standards:

Part of **HKSA 501 (Clarified)** ***Audit Evidence –Specific Considerations for Selected Items*** covers contingencies relating to litigation and legal claims.

Litigation and claims involving the entity may have a material effect on the financial statements, and so are required to be disclosed or accounted for in the financial statements. The auditor should carry out procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include the following:

(a) Make appropriate inquiries of management and others within the entity including in-house legal counsel

(b) Review minutes of meetings of those charged with governance and correspondence with the entity's lawyers

(c) Examine legal expense accounts

(d) Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department

When litigation or claims have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's external legal counsel. This will help to obtain sufficient appropriate audit evidence as to whether potential material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable. When the auditor determines that the risk of material misstatement is a significant risk in which this case relates to litigation and claims, the auditor shall evaluate the design of the entity's related controls and determines whether they have been implemented. The communication may be in writing and should be consented by management due to confidentiality.

Learning Pack

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

Chapter 13: Specific audit procedures – section 8.1, section 9

Audit area – Liabilities

(i) **Commissions due to travel agents**

What is the issue?

- A payment has been made to an unknown account in the Cayman Islands
- It is possible that this is a result of Jean Kei being able to fabricate a story, override controls and arrange for money to be paid into her own account
- Jean Kei seems to have a very expensive car in relation to her role at the company which could be an indication of her misappropriating company assets
- The situation indicates weak internal controls at BST

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

- The payment of $56m is immaterial to the group financial statements but Jean Kei may have been able to use her position to misappropriate assets previously and when aggregated these amounts could be material to the financial statements
- Luk Brothers will need to re-evaluate their assessment of the risks of material misstatement due to the suspected fraud
- They will also need to review the nature, timing and extent of planned audit procedures to respond to the assessed risks

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

- To confirm whether this is a fraudulent transaction, Luk Brothers should request to contact Mong Kok, asking them to confirm receipt of the payment to the account in the Cayman Islands
- If Mong Kok do not know of the payment, Luk Brothers must report the suspected fraud to the appropriate management (assuming Luk Brothers do not suspect management collusion) at BST on a timely basis
- Luk Brothers will need to evaluate the implications of the misstatement in relation to other aspects of the audit, particularly any information provided by Jean Kei
- It may be appropriate that this work is carried out by a senior member of the audit team in light of the increased risk

(ii) **Trade Payables**

What is the issue?

- There are two separate issues here, neither of which have been reflected in the financial statements
- The first is legal action that BST is taking to recoup HK$523k paid to customers as a result of inferior services provided by White Star for which the outcome is unknown
- The second issue relates to the cancellation of the allotments and whether BST will be liable for payment for these

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

- The HK$523k that BST is trying to recoup from White Star is not material and so has no financial statements implication
- The HK$500m relating to the cancelled allotments is material as it is 2.6% of draft consolidated revenue for 2012
- Although payment to White Star has been described as unlikely, BST has a possible obligation to White Star depending on an uncertain future event
- Gemma Middleton has advised departments to make back-up plans and so the likelihood of payment is not remote
- A contingent liability needs to be disclosed in the financial statements as it is possible but not probable
- The contingent liability should be disclosed but not recognised in the financial statements of BST
- BST should disclose the nature of the liability, an estimate of its financial effect and the uncertainties relating to any possible payments

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

- Luk Brothers should review a copy of the contract with White Star to ascertain the maximum amount that White Star would be entitled to and any provisions that would prevent White Star from making a claim
- They also need to make appropriate inquiries of in-house legal counsel and seek written confirmation from any external legal counsel about the likelihood of White Star being successful in any claim
- They must review minutes of meetings of those charged with governance and correspondence with the entity's lawyers
- Luk Brothers can then examine the legal expense account and consider whether any legal costs need to be accrued
- They must ensure evidence is reviewed up to the date the auditor’s report is signed

References

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*** says that a perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

HKAS 37 ***Provisions, Contingent Liabilities and Contingent Assets***, defines a contingent liability as a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An entity shall not recognise a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

In rare cases, for example in a lawsuit, it may not be clear whether an entity has a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period. An entity recognises a provision for that present obligation if the other recognition criteria are met (it is probable that an outflowof resources will be required to settle the obligation and a reliable estimate of the amount payable can be made). If it is more likely than not that no present obligation exists, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Student Notes

Learning Pack

Chapter 10: Fraud and irregularities

Chapter 13: Specific audit procedures

BST

Draft financial statements

You have been provided with a copy of the draft financial statements for BST Group for the year ending 30 September 2012. The financial statements do not yet include Ticketmate Hong Kong Agency Ltd ™ which was acquired on 30 June 2012 as the amounts to be incorporated are still being calculated owing to Ticketmate Hong Kong Agency Ltd ™ non-coterminous year end.

Required

Identify any issues by using the analytical procedures technique and identify what further investigations or actions you will take

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 your 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 you are aware of?
- Is the presentation/view given in the financial statements overly biased?
- Are the financial statements consistent with your knowledge of the business?

DRAFT
Consolidated statement of comprehensive income for the year ended 30 September 2012

	Note	2012 HK$m	2011 HK$m
Revenue		19,471	18,153
Cost of sales		(18,108)	(16,596)
Gross profit		1,363	1,557
Administrative expenses		(1,167)	(1,352)
Operating profit		196	205
Finance costs		(141)	(42)
Profit before taxation		55	163
Taxation		(12)	(70)
Profit for the year		43	93

DRAFT
Consolidated statement of financial position as at 30 September 2012

	Note	2012		2011	
		HK$m	HK$m	HK$m	HK$m
ASSETS					
Non-current assets					
Intangible assets	2		5,784		5,100
Property, plant and equipment	3		615		998
Investments			427		179
Prepayments			180		250
			7,006		6,527
Current assets					
Inventories		246		285	
Trade receivables	4	1,578		1,029	
Cash and bank balances		330		715	
Assets classified as held for resale	5	399		16	
			2,553		2,045
Total Assets			**9,559**		**8,572**
EQUITY AND LIABILITIES					
Equity					
Share capital		138		138	
Accumulated profit		1,093		1,050	
			1,231		1,188
Non-current Liabilities					
Long term borrowings			987		610
Current liabilities					
Trade and other payables	6	6,189		5,782	
Taxation payable		32		164	
Provisions	7	1,120		828	
			7,341		6,774
Total equity and liabilities			**9,559**		**8,572**

DRAFT
Notes to financial statements for the year ended 30 September 2012

1 ACCOUNTING POLICIES

1.1 Basis of preparation

The consolidated financial statements for the year ended 30 September 2012 are prepared on the historical cost basis. Non-current assets held for sale are stated at the lower of their carrying amount and fair value less costs to sell.

1.2 Basis of consolidation

The group financial statements consolidate those of the company and its subsidiaries (‘the group’). Accounting policies of subsidiaries are amended where necessary to be consistent with those adopted by the group. Where audited financial statements are not co-terminous with those of the group, the financial information is derived from the latest audited accounts available and unaudited management accounts for the period up to the group's year end.

1.3 Foreign currency

Transactions in foreign currency are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the year end date are translated to HK$ at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the statement of comprehensive income.

1.4 Revenue

Revenue comprises the amounts earned from package holidays, scheduled and charter flights and other services supplied to customers in the ordinary course of business. Revenue excludes intra-group transactions.

Revenue in respect of package holidays is recognised on the date of departure. Revenue in respect of individual holiday components, such as hotel room bookings and flights, is recognised when the customer departs or uses the respective service.

Customer monies received at the year end date relating to holidays commencing and flights departing after the year end are deferred and included within trade and other payables.

1.5 Finance costs

Finance costs comprise interest expense on borrowings.

1.6 Intangible assets

(i) **Goodwill**

Goodwill represents amounts arising on acquisition of subsidiaries and is the difference between the fair value of consideration paid and the net fair value of identifiable assets and liabilities. Goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but tested annually for impairment. There are no non-controlling interests.

(ii) **Computer software**

Computer software is stated at cost less accumulated amortisation. Development costs that are directly attributable to the design and testing of identifiable and unique software products are recognised as intangible assets where the following criteria are met:

- It is technically feasible to complete the software product
- Management intends to complete and use the software product
- There is an ability to use the software product
- It can be demonstrated that the software product will generate probable future economic benefits
- Adequate technical, financial and other resources to complete the development and to use the software product are available

- The expenditure attributable to the software product during development can be reliably measured

Directly attributable costs, which are capitalised as part of the software product, include the software development employee costs and an appropriate proportion of relevant overheads.

Software in development is not amortised. Once the software product is available for use it is amortised on a straight line basis over a useful life of 3 -10 years.

1.7 Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated 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	- up to 50 years
Leasehold improvements	- 15% or over the remaining term of the lease, whichever is shorter
Plant and machinery	- 12% straight line
Motor vehicles	- 20% straight line
Fixtures, fittings, computer and office equipment	- 20% straight line

1.8 Prepayments

Prepayments represent deposits and advance payments to suppliers for future supply of hotel rooms, air travel and other holiday components. The credit-worthiness of suppliers is monitored in order to assess the recoverable amounts of prepayments and amounts are written down when evidence is obtained of future services not being received according to the original terms.

1.9 Inventories

Inventories are valued at the lower of cost and net realisable value.

1.10 Trade receivables

Trade receivables are reduced by an allowance for estimated irrecoverable amounts.

1.11 Trade and other payables

Trade and other payables includes amounts owed to suppliers, accruals and deferred income representing monies received from clients in advance of their date of departure.

2 INTANGIBLE ASSETS

	Goodwill	Computer software	Software in development	Total
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 Oct 2011	5,299	577	300	6,176
Additions	300	412	512	1,224
Disposals	-	(89)		(89)
Transfer to computer software	-	-	(397)	(397)
At 30 Sept 2012	5,599	900	415	6,914
Amortisation & impairment losses				
At 1 Oct 2011	561	515	-	1,076
Amortisation for year	-	54	-	54
At 30 Sept 2012	561	569	-	1,130
Net book value				
At 30 Sept 2012	5,038	331	415	5,784
At 30 Sept 2011	4,738	62	300	5,100

3 PROPERTY, PLANT AND EQUIPMENT

	Land and buildings	Computer equipment	Fixtures, fittings and office equipment	Total
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 October 2011	1,756	138	88	1,982
Additions	-	20	12	32
Disposals	(333)	(3)	(18)	(354)
Transferred to assets held for resale	(617)	-	-	(617)
At 30 Sept 2012	806	155	82	1,043
Depreciation & impairment				
At 1 October 2011	874	67	43	984
Charge for the year	45	7	15	67
Disposals	(217)	(2)	(14)	(233)
Transferred to assets held for resale	(390)	-	-	(390)
At 30 Sept 2012	312	72	44	428
Net book value				
At 30 Sept 2012	494	83	38	615
At 30 Sept 2011	882	71	45	998

4 TRADE RECEIVABLES – CURRENT

	2012	2011
	HK$m	HK$m
Gross trade receivables	1,661	1,144
Allowance for receivables	(83)	(115)
Trade receivables	1,578	1,029

5 ASSETS HELD FOR RESALE

	2012	2011
	HK$m	HK$m
Land and buildings	399	16

Assets held for sale are expected to be sold within 12 months from the year end and comprise retail travel shops.

6 TRADE AND OTHER PAYABLES

	2012	2011
	HK$m	HK$m
Trade payables	1,205	1,896
Accruals, deferred income and customer monies received in advance	4,984	3,886
	6,189	5,782

7 PROVISIONS

	2012	2011
	HK$m	HK$m
Restructuring	700	349
Other	420	479
	1,120	828

Restructuring

Restructuring, which includes severance payments, relates to provisions arising as a result of reorganisation and restructuring plans that are irrevocably committed. The provision is expected to be utilised within 12 months from the year end.

Other

Other provisions relate to litigation and other future obligations, the amount or timing of which is uncertain. The provision is anticipated to be utilised within 12 months from the end of the reporting period.

Discussion points

Analytical procedures at the completion stage

Observation	Potential issues	Further investigations/actions
Revenue has increased by 7.2% on the prior year but this is lower than the 15.5% forecast in the CFO's financial update (workshop 1)	The growth in revenue falls significantly short of forecasts, this may be due to over-optimistic forecasts or may represent a real understatement of revenue. However, the growth on the prior year is still significant and may represent an overstatement if management bias is present. Revenue recognition has been identified as an issue during the audit execution phase	Discuss the discrepancies between the forecast and draft financial statement figures with management. Consider whether any further cut-off testing may be necessary to ensure that no revenue has been recognised that relates to holidays yet to depart.
Gross margin has fallen from 8.6% in the prior year to 7.0% which is slightly lower than the CFO's forecast of 7.4%	The fall in the margin, may indicate an understatement of revenue or an overstatement of cost of sales. In particular costs of holidays prepaid but not yet sold/taken may have been recognised in error.	Consider extending the testing around prepayments and cost of sales, specifically focussing on amounts paid to suppliers that have been recognised in the income statement. Trace amounts paid to allotment contracts and ascertain the dates to which the contracts relate to ensure that costs have been attributed to the correct accounting period.
Prepayments have fallen by 28% compared with the prior year.	The fall in prepayments may represent a genuine change to the business model and more flexible arrangements with suppliers (as recommended by the external consultancy report). However, this may also suggest that some amounts paid in advance have been incorrectly recognised as part of cost of sales (thus reducing the gross margin %)	

Observation	Potential issues	Further investigations/actions
Finance costs have risen sharply compared to the prior year: HK$42m (2011) and HK$141m (2012) – 236% increase. This is not consistent with the level of borrowings which have risen by only 61.8%	Finance costs appear to be overstated and an effective interest rate of 14.3% appears to be too high.	Review loan agreements for the new loans taken out during the year and identify the relevant interest rate. Discuss with management the finance costs recorded in the income statement, compared to those per the loan agreement where these do not appear to be consistent.
The effective rate of tax has fallen from 42.9% in 2011 to 21.8% in 2012	Whilst the effective tax rate in the current years does not appear unreasonable at 21.8% it is significantly lower than in the prior year. This may be due to the high levels of capital expenditure in the year which have attracted tax reliefs, however the change should be investigated.	Discuss with management the reasons for the change in the effective tax rate. Ascertain the reputation/experience of those dealing with the company’s tax affairs (whether they are an internal team or external provider). Compare the amount of tax payable with the company’s tax returns.
Amortisation of computer software in the year was HK$54m compared with HK$64m in the prior year. However, computer software has increased substantially largely due to a transfer of completed software development in the year. The prior year amortisation represented 11% (useful life: 9.1 years) on cost whereas the current year represents 6% (useful life: 16.7 years) on cost	The rate of amortisation appears to be too low and is inconsistent with the company policy of depreciating computer software over a useful life of 3-10 years. As a large amount of software has recently been transferred from ‘software development costs’ (which are not amortised) it may be that amortisation has not been applied in error although this might be explained by the timing of transfers.	For those assets transferred to computer software in the year trace the amounts to the asset register and ascertain whether amortisation rates have been appropriately applied. Discuss with management the basis for the estimated useful lives of the recently transferred assets and consider whether these are reasonable, particularly in the context of a rapidly changing market.

Observation	Potential issues	Further investigations/actions
The net book value of assets transferred to 'Assets held for resale' amounts to HK$227m (617-390) however the balance on the 'Assets held for resale' account amounts to HK$399m	Assets held for resale appear to be overstated based on the information available or the net book value of land and buildings is understated	Discuss this discrepancy with management and ascertain the reasons for the difference. Obtain a schedule from management of assets that are now held for resale and trace these to the amounts included in the fixed asset register before the transfer was made. Enquire of management as to the reasons for any differences.
Trade payable days have fallen from 41.7 days in 2011 to 24.3 days	The fall in trade payables suggests that the company is paying its suppliers more quickly which seems unlikely given the other drains on cash	Discuss with accounts payable whether the speed with which suppliers are paid has changed. If there is no evidence to support this change discuss the reasons for the fall in the ratio with management.
The provision for litigation included in the financial statements is HK$420m. The legal advisers suggested a range of HK$600-1,000m with a 70% chance of the claim being successful.	The provision appears to be too low compared with the suggested range of outcomes. It may be that the company has chosen to offset some potential compensation from the theatre owners, however it is unlikely that this should be recognised at this stage as the inflow is insufficiently certain.	Obtain a schedule from management for the calculation of the provision, check its arithmetical accuracy and compare the basis of the provision to the evidence obtained to date. Enquire from management whether any further events have occurred which impact on the provision or their intentions with respect to the class legal action.

Audit completion

(i) **Compensation claim**

Woo Tao & Partners
Floor 29 Mongkok Building
251 Mongkok Road
Mongkok

Ms. Gemma Middleton
Group Legal Director
Big Spender Travel Services Limited
18/F International Finance Complex Phase II
238 Tai Fat Road,
Tsim Sha Tsui

15 November 2012

Dear Ms Middleton

Class action against BST by the Hong Kong Travel Consumer Association (HKTCA)

Thank you for our recent meeting regarding the above class action. As discussed, LSP Legal Advisors will represent BST in respect of this case. Since our meeting we have taken the opportunity to review the circumstances of the case including:

- Results of the police investigation
- Evidence presented by HKTCA
- Internal documentation in respect of risk assessments and health and safety inspections carried out at the 'Theatre of Rocking Aqua', Macau by both the owners of the theatre and by BST

I set out our preliminary findings in the attached document and would welcome the opportunity to discuss these with you further as well as the next steps required in preparation for defending the action.

Please contact my office to arrange an appointment.

Yours sincerely,

David Chan

David Chan

BST

Preliminary findings in class action brought by HKTCA against BST

Summary

1. BST owes a duty of care to its customers in respect of their safety and well-being including where BST customers are using the venues and facilities of third party providers which have been engaged by BST to supply part of a holiday package provided to customers by BST. Therefore in the case of the 'Theatre of Rocking Aqua' there was an obligation on BST to establish the safety and well-being of its customers using the facility.
2. An initial review of the police investigations into the fire and building collapse at the 'Theatre of Rocking Aqua' on 16 May 2012 indicates that breaches of health and safety regulations by the theatre owners almost certainly contributed to the starting of the fire and the extent of loss of life suffered through inadequate escape procedures.
3. BST undertakes as part of its own internal procedures, a risk assessment of each third party venue with which it engages to provide holiday components to its customers. A risk assessment was carried out and documented by BST at the 'Theatre of Rocking Aqua' on 21 December 2011. However, parts of the documentation were found to be incomplete and a follow-up risk assessment was not carried out in response to correspondence with the theatre owners indicating changes in their emergency procedures.
4. When reviewing other similar cases a significant proportion (c. 70% of those we reviewed) resulted in a successful class action. If the action against BST is successful we estimate the total costs could be in the region of HK$600-1,000m
7. It is possible that BST may be able to bring a claim against the theatre owners whose management may prove to have been in breach of the relevant health and safety regulations. Based on our knowledge of the case to date and our experience of similar claims we would anticipate there is a 80% likelihood that a claim against the theatre owners would be successful.

Woo Tao & Partners
Floor 29 Mongkok Building
251 Mongkok Road
Mongkok

Required

Identify the issues for BST's financial statements for the year ended 30 September 2012 and any additional audit steps that should be taken.

(ii) **Written representation from management**

You have just received the following email from the partner in charge of the BST audit:

RE: BST written representation from management

Wong Hei Fung

Sent: 12 October 2012

To: BST Audit Team

Dear team

As we are finalising our audit work we need to consider the preparation of any necessary points for inclusion in the written representation from management in respect of our audit work. Remember the points for inclusion will fall into two broad categories:

- Representations regarding the responsibilities of management
- Representations required to support our audit evidence

Please prepare a list of relevant management representations, under each of the above headings, that should be included based on your understanding of the audit. Remember, that whilst such representations provide necessary audit evidence they will not provide sufficient, appropriate audit evidence on their own and we should not seek representations from management in respect of issues for which other sufficient and appropriate audit evidence is reasonably available.

Thanks

Wong Hei Fung

Required

Prepare a response to the partner's email.

Discussion points

Audit completion

(i) **Compensation claim**

Potential issues

- Since the year end, 30 September 2012, BST's legal advisers have reported back on their preliminary findings in respect of the likely outcomes of the class action bought against BST
- These preliminary findings may help to inform the inclusion of, or calculation of, any provision to be included in the financial statements in respect of the class action
- The receipt of the preliminary findings on 15 November 2012 is therefore an adjusting event
- There is also the possibility of an action by BST against the owners of the 'Theatre of Rocking Aqua' which would need to be considered in the context of the financial statements
- A 70% chance of success suggests that it is probable that BST will have to make a transfer of economic benefits (to those who are part of the class action) in the future and as the incident occurred prior to the year end there is a present obligation
- The range of possible outcomes is HK$600-1,000m – an estimate as to the amount of the provision will have to be made
- The impact of the possible action against the owners of the 'Theatre of Rocking Aqua' may also need to be disclosed in the financial statements if such an action is taken and there is a probable chance of that action being successful

How to resolve the issues/audit evidence required

- The audit team will need to review the preliminary findings of BST's legal advisers and consider whether such findings impact on any work already completed in respect of the audit of the provision and whether it alters the view presented by the directors in the financial statements
- This additional audit evidence may impact on the calculation of the amount of the provision and the disclosures in the financial statements around the class action
- Discuss with management its intentions regarding the financial statements in light of the information received from its legal advisers
- Review any calculations prepared by management for reasonableness in light of the evidence obtained and check the arithmetical accuracy
- Ascertain whether management have or is likely to make a claim against the owners of the theatre
- Review the draft financial statements for appropriate disclosures

(ii) **Written representation from management**

- The engagement partner has requested that the audit team prepare a list of relevant representations by management for inclusion in its written representation
- Written representations should be obtained from management in accordance with **HKSA 580 (Clarified) *Written Representations***

Representations regarding the responsibilities of management

- The auditor shall request management to provide written representations on the following matters:
  - (i) That management has fulfilled its responsibility for the preparation and presentation of the financial statements as set out in the terms of the audit engagement and whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework ie HKASs and HKFRSs – management acknowledges its responsibility
  - (ii) That management has provided the auditor with all relevant information agreed in the terms of the audit engagement
  - (iii) All transactions have been recorded and are reflected in the financial statements

Representations required to support our audit evidence

- During the audit, the auditor makes **inquiries of management**. It is important for the auditor to document management's representations where they are critical to obtaining audit evidence. In the case of BST the following representations are appropriate:
  - (i) Confirmation of management's intentions with respect to the class action being brought against them by HKTCA
  - (ii) Confirmation from management of their intention to execute the closure plans for the high street travel shops
  - (iii) Confirmation of purpose of HK$56m payment to bank account in the Cayman Islands
  - (iv) Confirmation of management's intentions regarding the dispute with White Star

References

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

HKSA 580 (Clarified) *Written Representations* provides guidance to auditors in this area. The objectives of the auditor are:

- To obtain written representations that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted
- To support other audit evidence relevant to the financial statements if determined by the auditor or required by other HKSAs
- To respond appropriately to written representations or if management does not provide written representations requested by the auditor

Learning Pack

Chapter 16: Overall audit review and finalisation

Sun Rise Limited

Sun Rise Limited (Sun Rise) is a successful manufacturer of batteries and chargers which the company sells to trade customers. The batteries produced have a variety of uses including cars, golf buggies, wheelchairs, mobile phones and computers.

Batteries are designed in Hong Kong at the head offices of Sun Rise. Sun Rise's battery manufacturing plant is based in mainland China in order to take advantage of cheaper labour costs and so lower the costs of production. Inventory is kept in a storage warehouse next to the manufacturing plant. The company operates a just-in-time system and so the amount of inventory is usually low.

You are the external auditor of Sun Rise for the year ended 30 September 2012.

On 16 October 2012, a fire broke out at the battery manufacturing plant. All manufacturing equipment and the storage warehouse were destroyed. Sun Rise estimates that it will take at least eighteen months to rebuild a manufacturing plant and that the company will not be able to produce any batteries during this time.

You have been provided with a copy of the insurance documents for Sun Rise. The fire insurance policy covers the cost of building a new manufacturing plant. Sun Rise does not have any business interruption insurance, to cover the loss of revenue whilst the manufacturing plant is being rebuilt.

The directors of Sun Rise have included a statement highlighting significant doubt over Sun Rise's ability to continue as a going concern given the loss of production and revenue. You have reviewed the statement and are satisfied it meets the relevant reporting requirements.

Required

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

Moon Rise Limited

Moon Rise Limited is a retailer of electronic equipment with 212 stores across Asia and the Middle East. The company structure consists of a holding company registered at Moon Rise head offices in Hong Kong and sixteen subsidiaries, each representing one country's retail outlets.

You are the group external auditor of Moon Rise for the year ended 30 September 2012. Your audit firm does not have offices in Indonesia or Saudi Arabia and so these components are audited by component auditors. You have worked with both sets of component auditors in previous years and are happy that they are competent for the role. All other components are audited by your firm.

Your colleague has alerted you that the component auditor's report for Saudi Arabia has arrived and it is qualified. An extract from the auditor's report reads as follows (note that figures have been translated to Hong Kong dollars for comparative purposes):

'Basis for Qualified Opinion

The company's inventories are carried in the statement of financial position at HK$15,646k. Included in inventory are obsolete items carried at cost but which are of negligible value. The directors have not stated these obsolete items at the lower of cost and net realisable value which is a departure from International Financial Reporting Standards. The Company's records indicate that had these obsolete items been written down, inventory would be HK$3,444k lower.

Qualified Opinion

In our opinion, except for the effects of the matter described in the basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the company's affairs as at 30 September 2012, and of its profit and cash flows for the year then ended…..'

Total assets of the group at 30 September 2012 are HK$257,098k (including inventory of HK$163,765k) and group profit before tax is HK$30,098k.

Required

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

Discussion points

Audit reporting

Sun Rise Limited

Impact on auditor's report

- Following the fire at the manufacturing plant, Sun Rise is unable to produce any batteries to sell to customers for at least eighteen months
- Although insurance covers the cost of rebuilding the battery manufacturing plant, it does not cover for any loss of income following the fire
- This loss of any revenue stream casts significant doubt as to the going concern status of the company
- This is therefore a subsequent event between the date of the financial statements and the date of the auditor's report and disclosure is required
- The auditors believe the doubts about going concern have been adequately disclosed
- There is no disagreement as to the basis of preparation or disclosures
- 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 highlight the conditions which cast significant doubt over Sun Rise's ability to continue as a going concern and draw attention to the related disclosure note in the financial statements
- The Emphasis of Matter paragraph would also state that the auditor's opinion is not modified in respect of this matter

Reference

The above is based on the following auditing standards:

HKSA 560 (Clarified) *Subsequent Events*

HKSA 570 (Clarified) *Going Concern*

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 560 (Clarified), financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

(a) Those that provide evidence of conditions that existed at the date of the financial statements; and

(b) Those that provide evidence of conditions that arose after the date of the financial statements.

HKSA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

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 emphasised 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 emphasised.

Moon Rise Limited

Impact on auditor's report

- The Saudi Arabian component of Moon Rise has a qualified auditor's report and so the group auditors must decide if this is significant for the group
- The misstatement of HK$3,444k is 1.3% of group total assets and 11.4% of group profit before tax and is therefore material for the purposes of the group auditor's report
- The misstatement can be isolated to inventory so is not pervasive to the group financial statements
- The auditor's report would be qualified on the basis that inventory is materially misstated
- 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'

Reference

The above is based on the following auditing standards:

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

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

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

According to HKSA 600 (Clarified), the group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence.

As per HKSA 705 (Clarified), the auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.

The standards 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

Big Spender Travel 'BST'

Acquisition of Ticketmate Hong Kong Agency Ltd (Ticketmate)

On 30 June 2012, BST acquired 100% of the share capital of Ticketmate; one of Hong Kong's largest ticketing agents, selling tickets to tourist attractions and sites in Hong Kong. Tickets are sold direct to the public through Ticketmate's ticketing website. In addition, BST will use Ticketmate to supply tickets to its customers from mainland China who purchase a package holiday with BST. Inter-company sales will be charged to BST by Ticketmate at a mark up on cost of 20%. Ticketmate is a significant component of BST.

Ticketmate will continue to be audited by its current auditors Kwan Yan & Co for its year ending 31 December 2012.

BST acquired the shares in Ticketmate for the following consideration:

- HK$100m – paid at the time of acquisition
- HK$100m – payable on 30 June 2013, subject to Ticketmate achieving a 5% growth in revenue (excluding intra-group sales)

Note: that pre-workshop materials and draft group financial statements do not include the acquisition of Ticketmate.

Required

Discuss the additional risks as a result of the acquisition and determine the appropriate actions to be taken by Luk Brothers & Co.

Discussion points

Workshop 2 Answers – Group Audit

Project Risks and Responses

Project risks	Responses
Component auditors	
Luk Brothers & Co are not the auditors of the financial statements of Ticketmate. The financial statements of Ticketmate will be audited by Kwan Yan & Co who may not have appropriate competence or capabilities.	Luk Brothers & Co will need to evaluate the reliability of the Kwan Yan & Co and the work performed by them. Specifically they will need to determine: (a) Whether Kwan Yan & Co is independent, understands and will comply with the ethical requirements that are relevant to the group audit. This can be confirmed in writing by Kwan Yan & Co. (b) Kwan Yan & Co's professional competence. This may be determined through visits to Kwan Yan & Co, review of Kwan Yan & Co's working papers or confirmation from the relevant professional body. (c) Whether the group engagement team will be involved in the work of Kwan Yan & Co to obtain sufficient appropriate audit evidence. (d) Whether Kwan Yan & Co operates in a regulatory environment that actively oversees auditors. If the audit team is satisfied with the competency of Kwan Yan & Co it can send an audit instruction to Kwan Yan & Co directly. It states the reporting requirements clearly for the purpose of group audit.
Insufficient information and explanations may be received from Kwan Yan & Co and client/entity management at Ticketmate	Luk Brothers & Co has statutory rights to request information and books and records. Group management at BST should be asked to take all reasonable steps to provide such information as the firm considers necessary.

Project risks	Responses
Kwan Yan & Co does not detect an error in Ticketmate's financial statements that would lead to a material misstatement in BST's group financial statements.	Ticketmate will need to be included in the planning and risk assessment stage of the group audit. Luk Brothers & Co should be involved in Kwan Yan & Co's risk assessment. This is likely to include a review of the Kwan Yan & Co's audit strategy and plan as well as its findings. Luk Brothers & Co may decide to carry out its own audit procedures on any areas of Ticketmate's financial statements which include significant risks of material misstatement for the group financial statements. Luk Brothers & Co will need to communicate with the Kwan Yan & Co over significant matters arising; any further procedures required and are likely to review the Kwan Yan & Co's working papers.
Component financial statements	
The financial statements of Ticketmate may be prepared using accounting policies which are different from those applied in BST's financial statements.	Luk Brothers & Co will need to plan procedures to identify differences in accounting policies between Ticketmate and BST. BST will need to adjust the financial statements of Ticketmate for any such differences for the purposes of consolidation. The audit team will need to plan to audit the adjustments prepared by BST.
The financial statements of Ticketmate are prepared to 31 December 2012 which is inconsistent with the year end of BST which is 30 September 2012.	Luk Brothers & Co will need to plan to audit any adjustments resulting from non-coterminous year ends. The timing of the audit of Ticketmate's financial statements may also be problematic as it is unlikely Kwan Yan & Co will commence any audit work before January 2013. Luk Brothers & Co will need to determine how to obtain assurance for the period 1 January 2012 to 30 September 2012 – this perhaps could be achieved through requesting Kwan Yan & Co to perform some interim audit procedures.
Deficiencies may exist in the internal controls relevant to the financial statements at Ticketmate.	Luk Brothers & Co should obtain an understanding of the controls at Ticketmate through requesting Kwan Yan & Co to provide information to them on this matter. Where any deficiencies are identified these will need to be considered for their impact on the financial statements of Ticketmate and the group financial statements of BST.

Project risks	Responses
Investments in subsidiaries and goodwill	
The valuation of investments in subsidiaries, including Ticketmate, may be subjective. Some investments may require impairment whereas others, such as Ticketmate, may have contingent consideration.	The audit team will need to plan to audit the value of the investments for the purposes of BST own (single company) accounts. Where contingent consideration is involved the auditors will need to consider the fair value of future consideration (which will include the likelihood that this future consideration will be paid).
The calculation and valuation of goodwill, for the purposes of the group financial statements, can be subjective and open to manipulation by management.	For new investments acquired the auditor's will need to plan to audit the initial calculation of goodwill which will include the consideration paid (some of which may be contingent) and the fair value of the net assets acquired – which may be subjective and difficult to establish if there are no financial statements prepared at the date of acquisition (as will be the case for Ticketmate) For existing investments, the auditors will need to plan to audit management's assessment of whether the goodwill arising on the acquisition of those investments has in anyway been impaired during the year.
Audit of consolidation/group audit	
The consolidation process is complex with increased risks such as: **– Ticketmate having a different financial year-end to BST** **– Incomplete or inaccurate consolidation adjustments** **– Inappropriate adjustments to component financial statements**	Risks can be mitigated through audit procedures such as: – Review group board minutes, company structures, prior year working papers and discuss with management the completeness of components included in the financial statements – Review the group company's consolidation working papers to ascertain that all components have been included in the consolidation process – Compare consolidation adjustments to prior year to identify any adjustments not included in prior year consolidation – Discuss with management their procedures for identifying all necessary consolidation adjustments – Re-perform management's adjustments to check them for accuracy, including adjustments such as intra-group sales re Ticketmate which are sold to BST at a mark up of 20% – Obtain a list of accounting policies of Ticketmate

Project risks	Responses
	– Identify any significant differences between Ticketmate and group accounting policies – Re-perform any adjustments relating to such differences and compare to adjustments made by management – Where necessary, undertake additional audit procedures for events subsequent to the Ticketmate's year end to gain assurance as to the adjusted figures included in the group consolidation.
Group audit is more complicated and the audit risk is higher.	The audit team should consist of experienced and competent members who are capable of dealing with consolidated financial statements. Engagement quality control review may be required.
The audit scale is larger for a group audit than a single company audit. The risk of project failure is higher.	Proper planning, co-ordination, organisation, monitoring and communication are critical. The audit team should have more progress meetings (with partners as well as the team members) throughout the audit.

Reference

HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors).*