Student Notes

Module C (Jun 2011)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Corporate governance	• Case study • Group discussion	Ch. 1 & 2	Pg. 1 – 3
3. Overview of an audit	• Card game		
4. Audit acceptance / continuance	• Case study • Group discussion	Ch. 4 & 7	Pg. 4 – 11
5. Audit planning	• Case study • Group discussion	Ch. 8, 10, 11 & 12	Pg. 12 – 29
6. Project Management in Audit Planning stage	• Group discussion	Ch. 8	
7. Conclusion	• Presentation • Group discussion		
Workshop 2			
8. Reboot	• Presentation • Group discussion		
9. Audit execution	• Individual work • Progress meeting and reporting • Group discussion	Ch. 10,12, 13 & 15	Pg. 30 – 55
10. Audit completion	• Group sharing • Group discussion	Ch. 9, 14,15,16 & 17	Pg. 56 – 67
11. Group audit	• Group discussion	Ch. 18	
12. Project and people	• Presentation • Group discussion		
13. Conclusion	• Presentation • Group discussion		

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
Major shareholder; John Wong, CEO and Chairman	John Wong has invested a substantial amount obtained through an inheritance and historically appears to have received a fairly significant dividend income stream. He will primarily be concerned about protecting his investment and hence the ability of Easybi to continue in business including its ability to meet its debts as they fall due and to attract further finance in order to allow the business to remain competitive in the market place.	John Wong will be concerned to see that the directors take appropriate actions with regard to their responsibility for risk management and internal controls and to see that there are adequate reporting systems in place to allow him and the other directors to manage these issues appropriately.
	He will be equally concerned about the company's continued profitability and ability to distribute any profits. Linked to the company's continued profitability will be concerns around how the directors manage the business including procedures around management of business risks and the effectiveness of internal controls to mitigate different types of risk.	
	John will also be concerned that the company is properly controlled by its board and that the right skills are available at board level to ensure effective management and operation of the business.	The board will be expected to follow corporate governance recommendations on board composition. The fact that John holds the post of CEO and Chairman of the board may give cause for some concern regarding the balance of the board as there is a risk that John may dominate board decisions and potentially take decisions purely in his own interest.
	The corporate and social responsibility of Easybi will also be important to John as the perception of other stakeholders, such as the bank, customers and employees, in this area could have a significant bearing on success and profitability.	John will want to ensure that the directors have a consistent view and approach towards Easybi's corporate and social responsibility and to see that there are processes in place to ensure that this view and approach is permeated throughout the organisation.

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
Bank	The bank has been approached by Easybi to provide further finance to the company in addition to the finance already provided. This will therefore increase the bank's exposure (and risk) to Easybi. The bank will primarily be concerned with: • Easybi's ability to service its borrowings (i.e. pay interest) • Easybi's ability to make repayments against its borrowings when they fall due. The way in which Easybi have serviced their current debt with the bank will be of critical importance. This naturally will mean that the bank will be interested in Easybi's ability to continue as a going concern in order to allow the debt to be serviced and repaid. Anything that might give rise to a risk of the company not continuing will therefore also be a cause for concern, such as ineffective management or weak internal controls.	The bank wishes to see a copy of the 2011 audited financial statements before agreeing to provide the additional finance requested. The bank will look at the financial statements to answer some of their concerns around longevity of the business, current and likely future performance as well as identifying any other debts or liabilities. They will expect management to prepare the financial statements so that they give a fair presentation. They will also review the auditor's opinion on the financial statements to see whether the auditor's conclusion is that the financial statements give a fair presentation. The bank will also be keen to see evidence from the board that the company is properly managed and controlled and that there is an appropriate structure of corporate governance in place.
	The bank will also be concerned about the level of assets owned by the company in the event that Easybi could not continue as these would represent the Bank's best chance of recovering the amounts due. This would also be affected by any other debt or liabilities that the company already has and whether any such debt is already secured on the assets of the business or is preferential (paid before) the debt owed to the bank.	It will also expect management to exhibit restraint where there are risks to the servicing and repayment of borrowings. For example, restraint over dividend payments if the company were not performing well.
Employees	Employees will be concerned about a number of issues including the security of their employment, particularly during a period of reorganisation and restructuring, their level of remuneration and the fairness of any schemes to incentivise or reward employees (such as share incentive schemes).	All employees will be concerned that the directors effectively manage and govern the company in order to ensure its success and continuance.

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
	Given the recent restructuring and reorganisation in the sales and marketing operations (and the possible future changes to be made to the production part of the business) employees will be concerned that there are clear reporting lines with well defined job descriptions and performance criteria. They will be concerned that they, and their colleagues, are appropriately equipped to undertake any new roles or changes to their roles.	Employees will expect management to have procedures in place to effectively manage recruitment of new staff and training for all employees. Where roles are no longer needed by the businesses, employees will expect management to follow proper procedures for making such roles redundant.
	Those employees who have been rewarded through the share incentive scheme will be particularly interested in the company's profitability and its policy with respect to the distribution of those profits.	Such employees are also shareholders and will therefore expect the board to adopt appropriate communications with them as set out by corporate governance guidelines.
	All employees will also be concerned about working in an organisation that has regard for their welfare, health and safety.	Directors are expected to address such issues through appropriate implementation of risk management and internal control procedures.
Suppliers	Suppliers will mostly be concerned about Easybi's ability to pay for goods purchased on credit as well as the company's long term viability, as this would impact on the future orders that Easybi is likely to place with its suppliers.	Like employees, suppliers will be concerned that the directors effectively manage and govern the company in order to ensure its success and continuance.
	Suppliers will also be concerned about their own cash flow and therefore Easybi's policies and procedures for remitting payments due to suppliers will be of high importance.	Suppliers will expect management to have an appropriate system of internal control in place to ensure that suppliers are paid accurately and on time.

Directors and managers need to be aware of the interests of stakeholders in governance issues. Stakeholder theory proposes corporate accountability to a broad range of stakeholders. It is based on companies being so large, and their impact on society being so significant that they cannot just be responsible to their shareholders. Stakeholders should be seen not as just existing, but as making legitimate demands upon an organisation. Stakeholders will actively seek to influence what the organisation does; others may be concerned with limiting the effects of the organisation's activities upon themselves. There is considerable dispute about whose interests should be taken into account. The legitimacy of each stakeholder's claim will depend on your ethical and political perspective on whether certain groups should be considered as stakeholders.

References:

Learning Pack

Chapter 1: Scope of corporate governance. Section 3

Easybi Limited

Lee Sun & Co Background information and current year audit

Your firm has been the external auditor of Easybi, an electronics manufacturing company since the company was formed in 2004. You are an audit manager at Lee Sun & Co and work primarily on the audit of companies in the financial services sector.

Lee Sun & Co specialises in the provision of audit, assurance and business advisory services to the retail and financial services industry sectors within Hong Kong. Whilst the firm does not have any other similar clients or experience in the electronics manufacturing sector, Sam Tsui the engagement partner, was keen to accept the audit engagement of Easybi as he had trained as an accountant with John Wong, the CEO of Easybi many years previously.

Sam Tsui has now retired from Lee Sun & Co and the audit manager who has worked on the audit for the past five years has left the firm to work in industry. The new engagement partner, Jane Tong, has asked you to act as audit manager and you will be responsible for planning and supervising the external audit for the year ended 31 March 2011.

You recently received a telephone call from the production director at Easybi to discuss a potential non-audit engagement that Easybi is seeking assistance with. The director explained that the changing demands of customers and the introduction of the online e-commerce system has prompted the company to consider replacing the current information technology system used for inventory control.

He explained that the current system has been in place since the company was formed and due to the increased volume of sales and the service levels and inventory availability expected by customers, the current system is inadequate. Therefore, the company now wishes to replace the system with a new state-of-the-art perpetual inventory control system which would reduce the need for regular inventory counts and provide real-time inventory quantities and valuation which would also eliminate the need for a year-end inventory count.

The key aspects of the engagement include:

- Assessment and recommendations of features for the new inventory control system
- Recommendations as to whether the system could be purchased 'off-the-shelf' or should be a bespoke development
- Advice as to the design and implementation processes for the system

Required

Discuss whether Lee Sun & Co should continue to act as external auditors of Easybi Limited and whether the firm should accept the non-audit engagement.

Easybi Limited

Lee Sun & Co Background information and current year audit – supplementary task

The previous audit manager of Easybi Limited left Lee Sun & Co in order to take appointment as financial controller at Easybi Limited and will hold that position for the year-end audit.

Required

Discuss the additional implications and any safeguards that Lee Sun & Co should consider in light of this information.

Discussion points

Workshop 1 Answers – Audit continuance

What are the client continuance issues? Are there any threats to independence or objectivity?

Quality control issues and competence to perform audit work

The fundamental principles of HKICPA's Code of Ethics for Professional Accountants requires that an auditor should be competent to perform the audit work required and should act diligently and in accordance with applicable technical and professional standards.

Whilst this does not appear to have been an issue for prior year audits of Easybi a number of new issues present themselves for the audit for the year ending 31 March 2011:

- Sam Tsui, the previous engagement partner, has now retired from Lee Sun & Co
- The audit manager who has worked on the audit for the past five years has left the firm to work in industry
- You work primarily on the audit of companies in the financial services sector, not manufacturing/trading companies
- Lee Sun & Co specialises in the provision of audit, assurance and business advisory services to the retail and financial services industry sectors

These factors all indicate that Lee Sun & Co may not be in a position to perform the audit competently for the current year. The individual expertise required for the performance of the audit has now left the firm and there does not appear to be other resources within the firm with the relevant experience.

In addition, the finance director has indicated that, in order to fulfil the bank's requirements of reviewing the audited financial statements, Easybi would like the audit to be completed earlier than usual. This is likely to place additional pressure on an already less-experienced audit team in the context of this audit.

Furthermore, Easybi has launched an online sales channel during the course of the year which is highly integrated with the E-link website. This is likely to require specialist knowledge and potentially the use of an expert in this area in order to gain sufficient assurance over the amounts recorded in the financial statements in respect of these services. Easybi must consider whether it has the competencies and knowledge within the firm to perform this aspect of the audit work.

Self-review threat

A self-review threat arises when a previous judgment needs to be reviewed by the auditor responsible for that judgment. The key area in which there is likely to be a self-review threat is where a firm provides additional services other than audit service to its client.

For clients, auditors are not allowed to:

(a) authorise, execute or consummate a transaction
(b) determine which recommendation of the entity should be implemented
(c) report in a management capacity to those charged with governance

In the case of the additional IT services requested by Easybi in respect of the information technology system used for inventory control Lee Sun & Co would potentially find itself in a situation where the firm is determining which system should be implemented and potentially making management decisions around that system which are then reported to those charged with governance (i.e. the directors of Easybi).

Any new IT system for inventory is likely to have an impact on the financial statements of Easybi. Particularly given the fact that the production director has suggested that the new system would eliminate the need for a year-end inventory count. This would mean that Lee Sun & Co is relying on a system, as part of the audit evidence that would be gathered in future audits, which it, at least in part, has determined and made recommendations on.

In this situation it is very unlikely that the firm would be willing to expose any deficiencies or problems with the IT inventory system during its audit of subsequent financial statements as this would reflect badly on the firm. Therefore, the firm's independence and objectivity would be compromised.

Additionally, if the firm has determined the system to be implemented, members of the audit team may place too much reliance on that system, believing it to be reliable given the involvement of the firm in its implementation. Therefore they may not scrutinise the system sufficiently and again objectivity is compromised.

Are there any issues over management integrity?

The fact that Easybi's bankers have requested to review the audited financial statements before approving any further financing may mean that a degree of management bias may exist in the financial statements. The extent of any such bias may act as an indicator as to the overall integrity of management.

The fact that the business is facing cash flow issues will also increase the risk that management do not act with a high degree of integrity should they find that the business is not able to continue without the additional finance.

The comments from the finance director regarding bringing the auditing timetable forward and completing the audit more expediently than in prior years also raises some concerns about management's relationship with, and attitude towards, the auditors especially given that this could culminate in an intimidation threat.

Are the threats/management integrity issues significant?

Quality control issues: Highly significant. Based on the information available it appears that Lee Sun & Co may no longer possess the technical skills or industry knowledge necessary to perform the audit to an appropriately high standard. This would especially be the case if Easybi is successful in persuading the firm to complete the audit earlier and more expediently than usual.

Further consideration will need to be given to the complexity of the audit engagement and the firm's internal resources before a final decision to continue with Easybi's external audit can be reached.

Self-review threat: Moderately significant. The decision whether or not to accept the non-audit engagement is unlikely to have any bearing on the current year external audit work and therefore does not raise an issue with respect to continuance for the year ending 31 March 2011. However, it may have a bearing on the firm's independence and objectivity for external audits undertaken in subsequent periods.

Whether or not the requested IT services can be provided by Lee Sun & Co will depend largely on the scope of the engagement. Based on the information provided it would appear highly likely that the advice provided by the firm would have a material impact on future financial statements. However, it may be possible to reduce the scope of the engagement to avoid a situation where the firm takes the final decision as to which IT inventory control system is appropriate. This along with other safeguards may mitigate the threat. In addition if Lee Sun & Co cease to perform the external audit due to quality control concerns the self-review threat will no longer be an issue.

Management integrity issues: Highly significant. The extent of any management integrity issues remains to be determined. However, where management integrity issues exist they will be highly significant and will require the firm to plan the audit to take account of the increased risk. This is likely to result in additional or extended audit procedures which may cause problems given management's objective of completing the audit earlier and more quickly. In extreme cases the firm may decide that it cannot continue as auditor.

Can any safeguards be implemented to reduce the threats to an acceptable level?

Quality control issues: If it is determined that Lee Sun & Co should continue with the engagement the firm should consider the possibility of a second partner review of the audit work, consulting with an independent external professional accountant or even involving another firm to perform some parts of the engagement, e.g. those outside Lee Sun & Co's areas of expertise.

Self-review threat: Safeguards could include the following - Separate teams used for the external audit and IT advisory service engagement, undertake an independent partner review of the audit work to ensure that the work has been performed objectively, disclose and discuss the impact on independence to those charged with governance, ensure staff are made aware of the firm's policies and procedures to prohibit them from making managerial decisions for Easybi.

Management integrity issues: Audit procedures can be planned and performed so as to take into account any doubts surrounding management integrity. For example, less reliance would be placed on written representations from management or internally generated audit evidence, and more reliance placed on externally generated evidence. Whether this is appropriate will be determined by the extent of any management integrity issues identified.

Conclusion

The self-review threat does not pose any issues in respect of continuing with the audit engagement for the year ended 31 March 2011. However, based on currently proposed scope it is likely that it would lead to objectivity issues for subsequent audits. This engagement should not be accepted unless (i) the scope can be sufficiently reduced to avoid Lee Sun & Co making any management decisions and (ii) the suggested safeguards can be put in place.

The quality control issues and potential management integrity issues raise more significant concerns in respect of continuing with the current year audit. Unless both of these issues can be adequately overcome then Lee Sun & Co should not accept continuance as external auditors.

Follow up questions

Audit acceptance and continuance

- When approached by a prospective client, what steps should the prospective auditor take with respect to the current auditor?
- What is the auditor required to do under money laundering regulations when considering accepting a new client?
- What rights and responsibilities would the current auditor have if its client decided to remove or not reappoint the auditor?

References

The above is based on the following:

HKICPA's Code of Ethics for Professional Accountants

All members of the HKICPA are required to comply with the *Code of Ethics for Professional Accountants* which became effective as of 30 June 2006. Professional accountants are expected to demonstrate the highest standards of ethical behaviour and to act in the public interest.

A professional accountant shall comply with the following fundamental principles:

(a) *Integrity* – to be straightforward and honest in all professional and business relationships.

(b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional Competence and Due Care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

(d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

(e) *Professional Behaviour* – to comply with relevant laws and regulations and avoid any action that discredits the profession.

The conceptual framework in the *Code* requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles.

Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a professional accountant's compliance with the fundamental principles.
A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle.

The nature and significance of the threats may differ depending on whether they arise in relation to the provision of services to an audit client and whether the audit client is a public interest entity, to an assurance client that is not an audit client, or to a non-assurance client.

Threats fall into one or more of the following categories:

(a) Self-interest;
(b) Self-review;
(c) Advocacy;
(d) Familiarity; and
(e) Intimidation.

Learning Pack

Chapter 4: Code of Ethics, sections 1.2, 2.4, 2.4.2, 2.4.8

Chapter 7: Changes in auditor appointment, section 3

Supplementary task

What are the client continuance issues? Are there any threats to independence or objectivity?

The fact that the previous audit manager has transferred employment from Lee Sun & Co to Easybi represents a threat to independence and objectivity because:

(a) the previous audit manager may have too much knowledge of the Lee Sun & Co's audit systems and procedures

(b) staff continuing to work on the audit will necessarily have contact with the previous audit manager in his/her new capacity and may be too familiar with him/her thus reducing objectivity

(c) equally, an intimidation threat may arise due to the senior position that the previous audit manager held in relation to more junior staff when working on the audit of Easybi

Are there any issues over management integrity?

The fact a member of the firm's staff has transferred to a client does not result in management integrity issues *per se*. However, the behaviour of the previous audit manager in his/her new role towards continuing members of the audit team may highlight integrity issues, for example if he/she intimidated junior staff.

There may also be a risk that the directors of Easybi gain insight, through the previous audit manager, into the audit procedures and processes of Lee Sun & Co for their own benefit. To do so would bring into question the directors integrity.

Are the threats/management integrity issues significant?

The fact that the previous audit manager:

(a) has taken up a role which means he/she is in a position to exert direct and significant influence over the subject matter information (i.e. the financial statements and accounting records) of the assurance engagement (i.e. the external audit)

(b) had significant influence on the audit previously

(c) has recently been appointed as financial controller at Easybi must lead us to conclude that this represents a significant threat

The threat is compounded by the relative lack of experience of Easybi now within the firm compared with the experience attained by the previous audit manager.

Can any safeguards be implemented to reduce the threats to an acceptable level?

Various safeguards might be considered:

(a) Modification of the audit plan (this may be difficult given the lack of experience of this client within the firm)

(b) Involving an additional professional accountant not involved with the engagement to review the work done

(c) Carrying out a quality control review of the engagement

The safeguard of ensuring the audit is assigned to someone of sufficient experience as compared with the individual who has left does not appear to be available to Lee Sun & Co

Conclusion

Unless the safeguards suggested above can be adequately implemented, Lee Sun & Co should not continue to act as auditors of Easybi.

References

Learning Pack

Chapter 1: Code of Ethics, section 2.3.3

Easybi

Board report

10 April 2011

Purpose of document

This report has been prepared for discussion at the meeting of the board of directors on 10 April, 2011.

Financial Report

Figures as of 31 March 2011

Key statement of financial position performance indicators:

	Full year (draft) At 31 March 2011	Prior year (actual) At 31 March 2010
Asset/Turnover:	2.86 times	3.13 times
Inventory Days:	40 days	47 days
Trade Receivables Days:	88 days	67 days
Trade Payables Days:	81 days	93 days
Cash balance:	HK$340,000	HK$1,692,000

Comparisons of budget amounts to actual (draft) revenues/expenses

	Full year draft to 31 March 2011 HK$000	Full year budget to 31 March 2011 HK$000	Variance HK$000 Favourable/ (adverse)
Turnover	311,928	263,017	48,911
Cost of sales	(275,056)	(230,140)	(44,916)
Gross profit	36,872	32,877	3,995
Administrative expenses	(35,940)	(27,617)	(8,323)
Operating profit	932	5,260	(4,328)

Explanations of major variances

- Favourable turnover variance: launch of internet sales channel, industry growth
- Adverse cost of sales variance: manufacturing in smaller batches to meet customers' demands for improved inventory availability and shipping times, resulting in higher production costs due to production line set-up. Average inventory levels during the year were also higher resulting in higher warehousing and associated costs
- Adverse admin expenses variance: costs associated with launch of online sales (including payments to third party websites and costs of systems changes), reorganisation and restructuring costs, higher shipping costs.

Performance summary

The market continues to show strong growth and Easybi has capitalised on that growth with expanded traditional sales as well as a successful launch of the online sales channels.

Costs have increased significantly during the year, eroding margins, but some of these costs are anticipated to be one-off costs and an improved profit margin for 2011/12 is expected.

The cash flow position has weakened considerably, largely due to slower payments from customers and additional costs incurred in the year. We have agreed a revised payment plan with the Inland Revenue Department in order to delay some payments. However, further bank finance will be critical in 2011 in order to ensure the business can benefit from the growth achieved in 2010/11.

Required

Perform analytical procedures at the planning stage of the Easybi audit using the financial information contained in the board's report and the prior year comparative figures included in the draft financial statements.

Narrative board member reports, 31 March 2011

Board member	Report
John Wong, CEO and Chairman	Due to the current drain on our cash resources we propose that there will be no dividend payments made to shareholders in respect of the year ended 31 March 2011. A working group of employees has been formed in order to address employees' concerns regarding the changes implemented as part of the restructuring of sales and operations and the implementation of online sales. The group also includes representatives from the production team in order to take into account employee views on potential future changes in the structuring and organisation of the production team.
David Lam, Finance director	We have opened discussions with our bank in respect of further funding requirements for the development and implementation of a new inventory system and working capital requirements. Due to the extent of our current reliance on bank finance, the bank has indicated it will need to see the audited financial statements before any further loan applications will be approved. In light of this, we will be strongly requesting that the auditors, Lee Sun & Co, move the auditing timetable forward and complete the audit more expediently than in prior years in order to ensure finance is approved at the earliest opportunity.
Rachel Chow, Sales & Marketing director	Sales to b2c customers continue to increase in spite of the errors arising from internet sales in the weeks following the launch of online sales. We believe that all of the incorrect items delivered to customers have now been recovered and that all customers have received either the goods they originally ordered or a refund.
Paul Ho, Production director	The increase in demands from our b2b customers for rapid delivery and high availability of inventory continues. Production costs will continue to increase due to the need to manufacture items in smaller and more frequent batches. In spite of a lower year-end inventory days figure we estimate that this will begin to increase significantly in 2011/12 due to the need to increase our holding of inventory in the warehouse. We have approached Lee Sun & Co to discuss their assistance in the design and implementation of a new inventory system to help us manage our inventory more efficiently. In the meantime we have entered negotiations with a number of our key suppliers to improve availability and speed of delivery of raw materials and components purchased from them. In some cases we are using alternative suppliers who can meet our requirements, however in order to achieve the required service levels a large proportion of suppliers have reduced the credit period they are able to extend to Easybi.

Discussion points

The following financial information is available at the planning stage on which analytical procedures should be conducted in order to identify potential areas of risk:

(1) Board report providing current year (draft) revenue and expenses, budget and key statement of financial position ratios

(2) Draft financial statements providing detailed prior year comparatives

Observation	Potential issues
Draft revenue has grown by 35% compared to prior year	• Increase in revenue above budget may indicate errors in recording revenue, such as cut-off issues • Rapid increase in revenue may be an indicator of overtrading and hence going concern issues
Draft revenue is 18.6% above budget	
Draft gross profit margin is 11.8% compared with budgeted gross profit margin of 12.5%	• Declining performance may indicate going concern issues • Errors in recording revenue or costs • May indicate under-valuation of closing inventory
Draft gross profit margin is 2.1% lower than in prior year	
Draft operating profit margin is 0.3% compared with budgeted operating profit margin of 2%	• Declining performance may indicate going concern issues • Errors in recording revenue or costs – particularly administrative expenses
Draft operating profit margin is 1.6% lower than in prior year	
Draft administrative expenses are 30% higher than budget and 29.7% higher than in the prior year	
Inventory days has declined from 47 to 40	• Decline appears inconsistent with increased demands from customers for inventory availability – may indicate an error in year-end valuation
Trade receivables days have increased from 67 to 88 days	• May indicate that there are old or irrecoverable debts not included in the year end allowance against receivables • May also indicate inefficiencies in the credit control which have cash flow implications
Trade payables days have decreased from 93 days to 81 days	• May indicate an understatement or omission trade payables
Trade receivable days has increased such that it is now greater than trade payables days	• If errors do not account for the change in trade receivable and trade payables days then this gives further concern regarding Easybi's cash flow issues
Cash balance has declined significantly and the business has negative cash flow from operations compared with a positive cash flow in the prior year	• Potential going concern/liquidity issues

References

The above is based on the following auditing standards:

HKSA 315 (Clarified) *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

The objective of an auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Learning Pack

Chapter 8: Planning, materiality and risk assessment, section 2

Discussion points

Workshop 1 Answers – Inherent risks

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
Going concern	• Declining profitability of business • Highly competitive market space • Increased demands of customers • Hi-tech industry: products could be superseded • Rapid expansion - risk of overtrading • Over reliance on bank finance and diminishing cash balance • Negative cash flow from operations • Revised payment plan with HK tax authorities • No dividend proposed at year end	All components and assertions potentially affected if Easybi is not a going concern If directors have significant doubts over going concern then disclosures will be affected
Management bias	• Bank reliance on audited financial statements to make decision on further financing • Share incentive scheme may be performance based	All components and assertions potentially affected although most likely to impact on areas where there is a high degree of estimation or judgment required: • Accounting policies • Inventory valuation • Allowance for trade receivables • Provisions
Misstatement of revenue	• Introduction of online sales channel, E-link • Error arose with integration on E-link: wrong items sent to customers • Recognition of refunds resulting from online sales errors	Revenue Cost of sales Inventories Completeness Occurrence
Misstatement of trade receivables	• A large proportion of customers have extended credit	Trade receivables Profit (affected by movement in allowance against trade receivables) Valuation

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
Misstatement of selling costs	• E-link fees and subscriptions may not be recognised/categorised appropriately in financial statements	Cost of sales Administrative expenses Completeness Allocation Accuracy Cut-off
Misstatement of inventory	• Inventory is assembled from raw materials and components – complex valuation • Reliance on perpetual inventory system for year-end financial statements • Error arose with integration on E-link: wrong items sent to customers, may not have been recovered • Estimation of WIP at year end	Cost of sales Inventory Existence Valuation Cut-off
Foreign currency translation risk	• Raw materials and components imported from overseas • Wholesalers and distributors can now be invoiced in their local currency	Revenue Cost of sales Inventories Trade receivables Accuracy Valuation
Undisclosed or unrecorded liabilities	• Industry is heavily regulated in relation to disposal of electronic waste	Provisions Completeness Obligations

Conclusion

Easybi's declining performance and cash flow position compared to the prior year significantly increases the risks of Easybi no longer being a going concern. This then also compounds the potential for risk of management bias. Management will be keen to ensure that the financial statements present a favourable view of Easybi in order to secure the much needed cash in order to continue to finance working capital.

Revenue is of particular interest given the new online sales channel and the auditors will have to design further audit procedures, including the examination of any controls (including IT controls) which mitigate the risks of incorrect recording of revenue.

Given the nature of the business inventory should continue to be considered a high risk area of the audit and the reliance on the perpetual inventory system means that the auditors will need to ascertain what controls are in place that reduce the risk of error in that system.

References

The above is based on the following auditing standard:

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*

Inherent risk (IR) is the susceptibility of an account balance or class of transactions to a misstatement that may be material either individually or when aggregated with other misstatements, based on the assumptions that there are no related internal controls.

Inherent risks exist on two levels: at the entity level and for single items or balances, where there is a significant risk of misstatement (assertion level). The risk of misstatement may be through error particularly in the cases of very complex transactions, an inexperienced management team or lax internal controls. Examples include the temptation to overstate sales in order to increase revenue, or wrongful timing of revenue recognition and so forth.

The level of inherent risk is affected by the nature of the entity; the experience and ethos of its management; the industry within which it operates; the degree to which that industry is regulated; and also the strategies it chooses to pursue. The degree of inherent risk is a matter for the auditors' professional judgment which must be based on their understanding of the entity, its management, the nature of its transactions and the reliability of the accounting systems. Where knowledge is limited then the inherent risk is deemed to be high.

Learning Pack

Chapter 8: Planning, materiality and risk assessment, section 4.1.1

Chapter 9: Audit evidence, procedures, audit methodologies and audit sampling, section 2

Discussion points

Workshop 1 Answers – Identify controls: part A

Introduction

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

Internal control has five elements:

(i) The control environment
(ii) The entity's risk assessment process
(iii) The information system relevant to financial reporting
(iv) Control activities; and
(v) Monitoring of controls

This task looked at the elements (i) to (iii):

The control environment ( ) is the umbrella which sits over the entire system of internal controls and describes management's attitude to, awareness of and actions in respect of internal controls. It will significantly influence the auditor's evaluation of the effectiveness of controls. Without an appropriate control environment it is unlikely that any system of internal control will be effective.

The entity's risk assessment process ( ) forms the basis for how management determines the risks to be managed. Again, without an appropriate risk assessment process it is unlikely that management will be able to implement an effective system of internal control even if the control environment is strong.

The information system ( ) relevant to financial reporting is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity.

(i) Control environment

Control environment at Easybi	
Management's integrity and ethical values	Management has undertaken a review and revision of the controls and procedures around sales and receivables in order to address any changes needed as a result of the sales and marketing reorganisation and the new online sales channel
Commitment to competence	Management engaged in a communication and training programme around the reorganisation and new controls and procedures, in order to ensure that all staff had the appropriate level of competence to perform their roles
Participation by those charged with governance	Those charged with governance do not appear to be independent from management or those involved in the day to day operations of the business
Management's philosophy and operating style	Management appear to be aware of key business risks around cash flow, meeting client service levels, credit control risk Management ensure that effective internal controls and procedures are in place through training, documentation and regular review of

Control environment at Easybi	
	the effectiveness of internal controls
Organisational structure	Roles appear to be well defined with training undertaken when employees role change The board of directors meet on a regular basis and report on and plan the activities of the business There is some evidence of segregation of duties (for example, between opening post and recording cash receipts in the accounting system), however CEO also fulfils the role of Chairman which under corporate governance guidance would be segregated
Assignment of authority and responsibility	There appears to be an appropriate hierarchy within the board and within each function overseen by a board member Roles and responsibilities within the functions responsible for sales and receivables appear to be clear
Human resource policies and practices	The directors are aware of the need for training as a result of the reorganisation and are involving employees in a working group to address issues around change Appropriate incentive schemes appear to be in place to reward employees

(ii) Entity's risk assessment process

HKSA 315 (Clarified) *s*ays the auditor shall obtain an understanding of whether the entity has a process for:

- identifying business risks relevant to financial reporting objectives
- estimating the significance of the risks
- assessing the likelihood of their occurrence; and
- deciding upon actions to address those risks.

Risk assessment process at Easybi
Evidence of risk assessment process: • Competitor monitoring: identified competitors offering more favourable terms re invoicing in local currencies • Appropriate process when researching third party partner for online channel • Member of the Hong Kong Green Manufacturing Alliance and monitoring of compliance in respect of labelling requirements and waste disposal • Monthly board meetings to discuss risks and issues • Has an information and internet security policy

Areas of potential weakness:

- Integration error with E-link may indicate risk was not appropriately identified or assessed
- Does not appear to have an internal audit team or to have a third party provide the service

(iii) The information system relevant to financial reporting

The information system at Easybi

- Off-the-shelf accounting system designed specifically for the manufacturing sector
- Found to be appropriate and adequate during prior year audits
- Perpetual inventory system integrated with main accounting system
- Manual recording processes for: use of raw materials, transfer of completed items to warehouse, timesheets for production employees
- EDI (electronic data interchange) version of the E-link system

Conclusion

Overall the control environment, risk assessment process and information systems in place at Easybi appear to be appropriate and that is the conclusion that has been reached on prior year audits also.

The attitude of the directors towards internal controls appears positive with evidence that they understand the nature of the internal controls that should be in place in a business such as Easybi and that they take active steps to implement appropriate controls.

The monthly board meetings to review performance of the business and identify issues and risks appear to work effectively, for example the identification of cash flow issues has prompted the board to seek additional finance from the company's bank.

The information system to date has been appropriate for the 'off-line' sales historically made by the business however the prevalence of manual systems around inventory and the introduction of new systems (EDI and CRM) for online sales will mean the auditors will need to investigate and understand these systems in more detail before deciding that they can be relied upon.

Overall, other than the caveats around information systems set out above, there do not presently appear to be any reasons why the auditors could not go on to consider reliance on the control activities and monitoring controls in terms of the audit approach.

Next step to consider whether reliance might be placed on control activities and monitoring of controls.

References

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

Learning Pack

Chapter 11 Internal control and tests of control; sections 1.1, 1.2 and 1.3

Discussion points

Workshop 1 Answers – Identify controls: part B

Introduction

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

Internal control has five elements:

(i) The control environment
(ii) The entity's risk assessment process
(iii) The information system relevant to financial reporting
(iv) Control activities; and
(v) Monitoring of controls

This task looked at the elements (iv) and (v):

The control activities ( ) are those activities which the entity puts into place in order to manage or mitigate the control risks identified as part of the entity's risk assessment process. Where the auditor believes that control activities are likely to be effective in mitigating the risks that affect the financial statements then the auditor may choose to place reliance on such controls and undertake tests of control procedures.

In order for management to ensure that control activities continue to be effective in managing the entity's risks identified in the risk assessment process, the entity should also implement a system of monitoring controls ( ). Monitoring of controls is part of the process of ensuring that control activities are carried out as required and remain effective over time.

(iv) Control activities

Controls identified	Inherent risk addressed/effectiveness	How to evaluate effectiveness	Rely?
All new customers are credit checked		Select a sample of new customers in the year for evidence credit check has been undertaken	yes
Credit limits are set for all customers	reduces risk of irrecoverable trade receivables: valuation	Review sales ledger for a sample of customers to check credit limit is recorded and in line with policy	yes
Credit limits are checked when a customer places an order		Observe sales team receiving orders to ascertain whether credit limit is checked before order processed	yes
Orders picked in warehouse are checked to despatch note before despatching	reduces risk of irrecoverable trade receivables due to the incorrect despatch of goods: existence/valuation	Observe the procedures in the warehouse for the despatch of goods	yes

Controls identified	Inherent risk addressed/effectiveness	How to evaluate effectiveness	Rely?
Invoices are checked for numerical accuracy	reduces the risk of errors being included on invoices: completeness/accuracy	Reperform numerical accuracy checks and review a sample of copy invoices for evidence that numerical accuracy was checked	yes
Remittance advices are included with invoices	ensures receipts from customers can be matched to the correct customer account in the sales ledger: accuracy	Observe post being opened for evidence that remittance advices are received and observe posting of cash to sales ledger correctly using remittance	yes
Prices recorded in the sales ledger are reviewed on a regular basis	ensures goods are sold for the correct amount: accuracy	Discuss with staff responsible the procedures undertaken and where possible observe such procedures taking place	yes
Easybi has a credit control procedure in place for overdue invoices	reduces risk of irrecoverable trade receivables and improves cash flow of Easybi: valuation/going concern	For a sample of overdue invoices review correspondence files to ascertain whether correct communications were sent to customers/credit collection agency at the required point in time	yes
Credit is not extended to customers whose debts have previously been written off	reduces risk of irrecoverable trade receivables: valuation	Identify a sample of accounts with amounts written off and review those accounts for evidence that no further sales have been made	yes
Post is opened by two members of staff			yes
Separate members of the team post receipts to the sales ledger and cash book	reduces risk of errors and misappropriation: accuracy	Observe the procedures in place	yes
A weekly bank reconciliation is performed	would assist with identifying errors arising in the recording of cash including those in respect of cash receipts from customers: accuracy/completeness	Review the cashier's bank reconciliation file for evidence that reconciliations are performed at the required points in time and that reconciling items are appropriately followed up and explained	yes
Integration between the E-link website and Easybi's sales system	will reduce the risk of recording errors as no manual input is required for online sales: accuracy/completeness/ occurrence	Computer assisted audit techniques (CAATs) will be required to ascertain that the integration is working correctly. For example, test data may be used	yes

Issues/risks not addressed by internal controls

- There do not appear to be any controls in relation to the approval or authorisation of refunds/credit notes or other adjustments to customer accounts
- Whilst invoices are checked for numerical accuracy there does not appear to be any checking of prices to price list or goods invoiced to despatch notes
- There is an absence of controls or checking in respect of the preparation and recording of invoices denominated in a foreign currency

(v) **Monitoring of controls**

Controls identified	Inherent risk addressed/effectiveness	How to evaluate effectiveness	Rely?
The weekly bank reconciliation is reviewed by the financial controller or financial director	would assist with identifying errors arising in the recording of cash including those in respect of cash receipts from customers: accuracy/completeness	Review bank reconciliations performed for evidence of review and follow up by finance director/financial controller	yes
The sales and marketing director reviews and approves all changes made to the online product catalogue	would ensure that no inappropriate or unauthorised changes could be made to the product catalogue: accuracy	Obtain a list of changes to the product catalogue during the year and trace to evidence of authorisation by the sales and marketing director	yes
The finance director reviews a report on overdue debts and approves any write offs	would ensure that overdue trade receivables are written off when appropriate: valuation	Inspect copies of the reports and for evidence of review by the finance director. Select a sample or write offs in the year and trace to authorisation by the finance director	yes
The board reviews sales compared to budget and trade receivables days as part of the monthly board report	would highlight any significant issues or errors in sales and trade receivables: potentially covers all assertions	Obtain a copy of the board reports and identify evidence of review during the meeting and subsequent follow up of any issues identified	yes
The board reviews the WebTrust report prepared by E-link's assurance providers	would highlight some risks of errors as a result of problems with the E-link system however unlikely to highlight errors or issues specific to the integration between E-link and Easybi's systems	Obtain a copy of the latest WebTrust report and discuss with directors how it was used and any courses of action taken. Review board minutes for evidence that directors reviewed the report and reached appropriate conclusions	yes partially

Issues/risks not addressed by internal controls

- The apparent absence of any internal audit function or assurance represents a significant monitoring activity which is not being undertaken by Easybi. Therefore there may be an increased risk of controls not working effectively or being overridden

Conclusion

Overall there appears to be a number of control activities and monitoring of controls which could be tested and potentially relied upon by the auditor and which are likely to be effective based upon the findings in Part A, where the control environment, risk assessment process and information systems were considered to appear appropriate. Depending on the findings from such audit procedures it may be that the extent of substantive procedures can be reduced in some areas.

Next step: to consider any related substantive procedures that might be used.

References

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

Learning Pack

Chapter 11: Internal control and tests of control, sections 1.4 and 1.5

Discussion points

Workshop 1 Answers – Identify controls: part C

Introduction

Depending on the outcome of any tests of controls undertaken, the auditor will need to go and undertake full substantive testing (where tests of controls showed that control activities were not effective) or reduced substantive testing (where tests of controls showed that control activities were effective).

Substantive procedures involve the auditor undertaking testing of the transactions and balances included in the financial statements in order to obtain sufficient evidence around the relevant financial statement assertions.

Some substantive testing will always be required due to the fact there are inherent limitations in any system of internal controls

Substantive procedures – based on control activities identified

Controls identified	Inherent risk addressed/effectiveness	Rely?	Substantive procedures	Area/FS assertion tested
All new customers are credit checked	reduces risk of irrecoverable trade receivables: valuation	yes	Trade receivables circularisation Review subsequent settlement of invoices	Existence Valuation Accuracy
Credit limits are set for all customers		yes		
Credit limits are checked when a customer places an order		yes		
Orders picked in warehouse are checked to despatch note before despatching	reduces risk of irrecoverable trade receivables due to the incorrect despatch of goods: existence/valuation	yes	Review customer correspondence files	Valuation
Invoices are checked for numerical accuracy	reduces the risk of errors being included on invoices: completeness/accuracy	yes	Re-perform calculations on a sample of invoices	Accuracy
Remittance advices are included with invoices	ensures receipts from customers can be matched to the correct customer account in the sales ledger: accuracy	yes	Trace a sample of remittance advices to cash recorded in customer account	Accuracy

Controls identified	Inherent risk addressed/effectiveness	Rely?	Substantive procedures	Area/FS assertion tested
Prices recorded in the sales ledger are reviewed on a regular basis	ensures goods are sold for the correct amount: accuracy	yes	Trace sample of prices per price list to sales ledger	Accuracy
Easybi has a credit control procedure in place for overdue invoices	reduces risk of irrecoverable trade receivables and improves cash flow of Easybi: valuation/going concern	yes	Trade receivables circularisation Review subsequent settlement of invoices	Existence Valuation Accuracy
Credit is not extended to customers whose debts have previously been written off	reduces risk of irrecoverable trade receivables: valuation	yes	(as above)	
Post is opened by two members of staff	reduces risk of errors and misappropriation: accuracy	yes	n/a	
Separate members of the team post receipts to the sales ledger and cash book		yes	n/a	
A weekly bank reconciliation is performed	assists with identifying errors arising in the recording of cash including those in respect of cash receipts from customers: accuracy/completeness	yes	Re-perform year end bank reconciliation Trace reconciling items to relevant evidence such as uncleared lodgements to post year-end bank statements	Accuracy Completeness
Integration between the E-link website and Easybi's sales system	reduces the risk of recording errors as no manual input is required for online sales: accuracy/completeness/ occurrence	yes	n/a	

Substantive procedures – based on monitoring of controls identified

Controls identified	Inherent risk/effectiveness	Rely?	Substantive procedures	Area/FS assertion tested
The weekly bank reconciliation is reviewed by the financial controller or financial director	would assist with identifying errors arising in the recording of cash including those in respect of cash receipts from customers: accuracy/completeness	yes	Re-perform bank reconciliation (as above)	Accuracy Completeness
The sales and marketing director reviews and approves all changes made to the online product catalogue	would ensure that no inappropriate or unauthorised changes could be made to the product catalogue: accuracy	yes	Trace sample of prices per price list to sales ledger (as above)	Accuracy
The finance director reviews a report on overdue debts and approves any write offs	would ensure that overdue trade receivables are written off when appropriate: valuation	yes	Select a sample of trade receivables approved for write off and trace to accounting records for appropriate treatment	Accuracy
The board reviews sales compared to budget and trade receivables days as part of the monthly board report	would highlight any significant issues or errors in sales and trade receivables: potentially covers all assertions	yes	Trade receivables circularisation Cash after date testing (as above)	Existence Valuation Accuracy
The board reviews the WebTrust report prepared by E-link's assurance providers	would highlight some risks of errors as a result of problems with the E-link system; however unlikely to highlight errors or issues specific to the integration between E-link and Easybi's systems	yes partially	n/a	

Conclusions and overall audit approach

Overall the control environment, risk assessment process and information systems in place at Easybi were identified as appearing to be appropriate and largely effective.

Therefore it was concluded that the audit team should go on to consider the control activities and monitoring of controls.

Overall the inherent risks associated with sales and trade receivables appear to be well addressed by those control activities and monitoring of controls as set out in the internal controls and procedures manual. Therefore assuming that the controls are operating as described in the manual and that any preliminary assessment of the controls effectiveness is satisfactory, it would be appropriate for the audit team to place reliance on the internal controls at Easybi in respect of sales and receivables.

This would then result in a reduced level of substantive testing in some areas.

However, in some areas, it was identified that there was an absence of a control to address as specific inherent risk, namely around refunds/credit notes, accuracy of invoices and foreign currency transactions. Therefore in respect of these areas it will be necessary to plan more detailed substantive testing.

References

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

HKSA 330 (Clarified) *Responses to Assessed Risks*

Learning Pack

Chapter 11: Internal controls and tests of control, sections 1.7, 2, 3 and 4

Chapter 12: Substantive procedures including analytical procedures, sections 1.4 and 1.5 and diagram on page 293

Audit execution

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

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

During the audit, five audit issues have been identified.

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

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

Tips in handling the progress meeting:

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

Easybi Limited

Audit area: Fraud & Irregularities

(i) Environmental issue

During discussions with Paul Ho, you have discovered that Easybi is currently being investigated by the Environmental Protection Department (EPD) of Hong Kong.

In January 2011, a large quantity of hazardous waste, which is part of the manufacturing of LCD screens, was found by the EPD to be illegally disposed of after a "tip-off" from a member of the public. The EPD identified the waste and believe it is a product of the manufacturing process at Easybi.

The production manager explained that Easybi has an exemplary environmental record and that all waste is disposed of appropriately by the company. He believes that either the waste has not been correctly identified or that one of the licensed waste disposal organisations used by Easybi has not followed the correct procedures for the disposal of an Easybi waste consignment collected by them. For these reasons, the directors believe that the EPD will either drop their investigation or that the company would be found to have complied appropriately should the EPD decide to prosecute.

The investigation is currently ongoing and will result in a decision by the EPD as to whether or not Easybi will be fined or the company prosecuted. The investigation will not be concluded until after Easybi's year end.

The following is an extract from information that you have found on the EPD website:

Environmental Protection Department
The Government of the Hong Kong Special Administrative Region

HONG KONG

LAWS & REGULATIONS : environmental compliance

ENFORCEMENT OF ENVIRONMENTAL LAWS IN HONG KONG

Legal controls on polluters have existed for several decades in Hong Kong, but it was not until the EPD was established in 1986 that these controls were strengthened and fully applied. There are now laws to deal with all types of air, noise, water and waste pollution.

These laws encourage operators not to pollute, and to enable offenders to be punished. Penalties generally include fines of up to HK$5 million, provisions for jail terms and suspension of trading by offending businesses.

Enforcement by EPD

The EPD enforces the main anti-pollution laws primarily through its four Regional Offices and Territorial Control Office under the Environmental Compliance Division (ECD) which carry out inspections and licensing, and respond to complaints.

Various types of enforcement measures are used such as inspections, ambushes and video surveillance.

(ii) Payroll

You have assigned the task of auditing payroll to a junior member of the audit team, Lisa Ng. Lisa selected a sample of payments made to a number of employees during the year and has completed the following work in order to gain assurance over the validity and accuracy of the payroll payments made:

- vouched the hours paid to the timesheets submitted by the relevant employee
- agreed the rate paid to the relevant contract of employment

During this audit procedure, Lisa discovered one payment in the sample for which there was no corresponding timesheet or contract of employment for the individual paid. Lisa then investigated this further and found that payments were made to the same individual for the months of October, November and December 2010 whilst no timesheets were submitted in any of those months.

The payments were all processed in the accounting system by a temporary member of staff employed from September to December 2010 to cover a period of maternity leave. This member of staff has now completed the term of employment and has left Easybi.

Easybi Limited

Audit area: Inventory

(i) Perpetual inventory system

As part of the firm's year-end procedures for inventories, you requested that an audit junior undertake work on assessing the reliability of Easybi's perpetual inventory system.

Easybi operates a perpetual inventory system and uses the amount of inventory recorded in the system as the basis for valuing the raw materials, purchased components and finished goods to be included in year-end financial statements.

You have specifically asked the audit junior to evaluate the accuracy of the system in respect of purchased components by:

(1) selecting a sample of items recorded in the inventory system and comparing them to the physical amounts in the warehouse

(2) selecting a sample of items in the warehouse and comparing them to the amounts recorded in the inventory system

The audit junior undertook the above audit procedures on 21 March 2011 and prepared the following summary:

Client: Easybi Limited **Date:** 21 March 2011 **Initials:** AA

Description: Test of accuracy of perpetual inventory system (purchased components)

1) Sample from inventory system traced to items in warehouse

Product code	Description	Quantity per perpetual inventory system	Quantity counted in warehouse	Difference
KS-282	Antec Computer case	434	434	-
KR7A-133	ABIT motherboard	764	764	-
KB- 876	Thermaltake Volcano 6Cu	176	176	-
Ti 4200	NVidia GeForce4 videocard	49	49	-
K8-098	LiteOn 40x/12x/48x CD-RW	215	15	200

2) Sample from warehouse traced to items on inventory system

Product code	Description	Quantity per perpetual inventory system	Quantity counted in warehouse	Difference
KD1208PTB2	Sunon case fans	129	129	-
F2N1107	Belkin 18" ribbon cable	198	54	144
1800	AMD Athlon XP processor	120	120	-
Bd-0867d	Arctic Silver 3 compound	287	287	-
Fd-988	Zoom V.92 PCI Faxmodem	107	107	-

Notes

The discrepancies between the amounts per the perpetual inventory system and the quantity in the warehouse were discussed with warehouse manager. He explained that components purchased are updated automatically on the system as this was linked directly to the accounting system and items were recorded in inventory when the goods received note was entered onto the system by the accounts team. Items used in production are written down on a component requisition form in the warehouse. At the end of each week the warehouse manager enters the use of components from the requisition forms into the inventory system. However, he had been unwell on Friday 18 March and therefore did not enter the requisition forms – he is planning to finish this data entry on Tuesday 22 March.
Requisition forms yet to be entered onto the system were satisfactorily identified for each of the discrepancies included in the system above.

(ii) WIP valuation

When discussing the year-end valuation of work in progress with Paul Ho, Easybi's production director, he explained that historically a percentage of the company's overheads (e.g. electricity costs) are added to the direct costs recorded (i.e. raw materials, components and time) in order to arrive at the valuation. The directors have agreed that for the current year this will be increased from 30% to 40% as this better reflects the proportion of overheads attributable to production.

You have estimated that the impact of the increased percentage is to increase the value of WIP by HK$1.2m compared to the valuation that would have been arrived at using a rate of 30%.

Easybi Limited

Audit area: Trade payables and accruals

(i) Supplier statement reconciliations

As part of the planned audit procedures a sample of supplier statements were selected for reconciliation to the balances, for those suppliers, on the trade payables ledger. All statements in the sample (other than those noted below) were satisfactorily reconciled with differences being explained largely by timing (e.g. payments made not yet included on supplier statements). However, the following items could not be explained by timing differences:

Supplier	Trade payable per purchase ledger HK$000	Balance due per supplier statement HK$000	Difference HK$000	Cheques paid not on statement * HK$000	Invoices on ledger issued after statement date ^ HK$000	Unexplained difference HK$000
Sunmark Limited	9,765	14,987	5,222	1,276	-	3,946
Sanbi Limited	4,308	6,098	1,790	-	2,976	4,766

*Agreed to cheques clearing bank after supplier statement date

^Agreed to supplier invoice

You have discussed the unexplained differences with the purchase ledger supervisor at Easybi. She gave the following explanations:

- Sunmark Limited: She believes this is an error on the Sunmark supplier statement as there are two invoices (with different invoice numbers) for HK$3,946k included on the supplier statement; however Easybi has only received one invoice for this amount. Sunmark supplies Easybi with raw materials.
- Sanbi Limited: the finance director asked the purchase ledger supervisor to prepare a cheque for the amounts due (HK$4,766k) and record them in the purchase ledger and cash book, however, he asked her not to post the cheque to Sanbi until the first week in April. This was because he knew the sales ledger manager at Sanbi was on holiday at the end of March and he was worried the cheque would get lost if the Sanbi sales ledger manager was not there to receive the post.

(ii) Accruals

As part of the planned audit procedures for accruals you have asked David Lam, the finance director, to provide you with a list of accruals included in the financial statements for the year ended 31 March 2011 along with the prior year comparatives. David has provided you with the following list:

Supplier	Description	At 31 March 2011 HK$000	At 31 March 2010 HK$000
Hong Kong Electric	2 months' electricity usage (Feb and Mar 2011)	135	108
E-link	2% of revenue for 3 months to 31 March 2011 (per contract)	128	-
PCCW Ltd	telephone, broadband and mobile services for 2 months (Feb and Mar 2011)	120	100
Wages and salaries, and associated taxes	March 2011	109	100
Rental and maintenance agreement		-	148
	Total	**492**	**456**

In addition, David has provided you with the following information and explanations:

- The Hong Kong Electric accrual has been based on an estimated 25% increase in production for the same period in the prior year
- It takes a number of weeks for E-link to calculate the revenue due for the previous quarter's sales. In the previous quarter the invoice was not paid for many weeks due to discrepancies between the amounts of revenue recorded by E-link and the revenue in the accounting records of Easybi
- Easybi calculated online revenue for the current period (3 months to 31 March 2011) to be HK$6,404,000
- PCCW provide all of the telephone and broadband internet services for Easybi. The services purchased from PCCW were upgraded in May 2010 ready for the launch of the E-link sales channel
- The service level bonus for employees introduced during the year has not yet been finalised but will be paid in the 5 May payroll in respect of the year ending 31 March 2011

Furthermore, you have obtained the following relevant information:

- At 31 March 2011, Hong Kong electricity prices have risen by 6.2% compared with the prior year
- Easybi's electricity consumption for the three months to 31 January 2011 totalled HK$243,000
- The contract between Easybi and E-link requires Easybi to pay over commission of 2% of its total online revenue generated each quarter to E-link.
- Employees are paid on 5th day of each month for the previous month's work

Easybi Limited

Audit area: Purchases

(i) Purchases in foreign currency

Easybi purchases a number of raw materials and components from overseas suppliers, some of whom invoice Easybi in their own local currency.

As part of the audit procedures a junior member of the audit team has selected a sample of purchase invoices in foreign currencies and verified the exchange rate used to record the invoice against an external source.

Of the 20 invoices tested, 18 were found to have been translated using the correct rate of exchange. However, two invoices did not have the correct rate applied, as follows:

Supplier	Invoice date	Invoice amount Taiwan $	Rate used to record invoice	Correct rate per external sources
Ambertronic Ltd	21 Oct 2010	138,429	TW$1 = HK$3.86	TW$1 = HK$0.259
Hung Chai Corp	28 Oct 2010	248,741	TW$1 = HK$3.79	TW$1 = HK$0.264

On further investigation the audit junior discovered that the purchase ledger clerk, who usually posts all invoices from Taiwan to the purchase ledger, was away from the office from 4 October to 26 November 2010 due to a prolonged illness. Another member of the purchase ledger team had assumed responsibility for this role but was confused as to how to translate these invoices and therefore applied the exchange rate the wrong way round.

The total value of invoices received in TW$ during the period 4 October to 26 November was TW$1,161,510 (including the two invoices in the sample above). The exchange rate between TW$ and HK$ was stable during the period and the correct average rate of exchange was TW$1 = HK$0.26.

None of the items purchased in this period remain in inventory at the year end.

(ii) Bulk purchase discount

Easybi receives a bulk purchase discount from one of its main suppliers in China, Wei On Limited (Wei On). The bulk purchase agreement between Easybi and Wei On specifies a purchase volume, in HK$, above which Easybi is entitled to a 10% discount on all purchases made. Once the specified purchase volume is reached all subsequent invoices automatically have 10% deducted from the total. For purchases which were invoiced before the specified purchase volume is reached a 10% rebate is paid over by Wei On to Easybi.

The current agreement runs from 1 July 2010 to 30 June 2011. The following information is available in respect of the purchases made from Wei On and the current agreement:

	HK$000
Total purchases from Wei On for the period 1 July 2010 to 31 March 2011	25,000
Specified purchase volume per agreement before discount is available	50,000

The directors believe that Easybi will reach the specified purchase volume before the end of the current agreement on 30 June 2011 and have therefore recognised a rebate of HK$ 2,500,000 for the year ending 31 March 2011. This has been deducted from total purchases in the SOCI and recorded as accrued income in the SOFP.

Easybi did not qualify for the bulk purchase discount from Wei On in the year ending 31 March 2010.

Easybi Limited

Audit area: Trade receivables

(i) Customer correspondence

During the audit of trade receivables the audit team discovers the following correspondence from The Simple Corporation, a major customer of Easybi. No adjustments have been made in the financial statements in respect of this matter:

The simple corporation, 1 Chiu Drive

Pokfulam, Hong Kong

To: John Wong
Managing Director
Easybi Limited
5/F, Chai Wan Industrial Centre,
20 Lee Cheung Drive,
Chai Wan, Hong Kong

Dear Mr Wong,

<u>Supply of Easybi Gigabyte GA-G31M-ES2L - Motherboard</u>

I am writing to you regarding the supply by your company of 2,780 Easybi Gigabyte GA-G31M-ES2L – Motherboards on 3 March 2011. After conducting our own internal testing before use on our assembly lines we found a high proportion of the items to be defective due to excessive temperature damage.

We discussed the matter with our Easybi account manager, Anna Yeung, who arranged for a complete replacement of the batch supplied on 3 March. The replacement shipment arrived on 21 March but again after our own internal testing we have found that the same fault is apparent. Ms Yeung has offered to replace the shipment again but unfortunately this experience has caused us to lose confidence in the product supplied by you and we therefore will be seeking an alternative supplier.

I look forward to receiving confirmation that our account has been credited with the full amount per our invoice of HK$297,600

Yours sincerely,

Tom Tse

Tom Tse
Production Manager, the simple corporation

(ii) Aged receivables analysis and cash after date testing

During the testing of receivables the audit team has discovered that there are a number of old trade receivables included in the trade receivables ledger. The team has identified the amount of cash received in respect of these receivables between 1 April and 13 May 2011. The results are set out below:

Age of debt	>90 days HK$000	>120 days HK$000	Total HK$000
gross trade receivables	23,984	11,992	35,976
cash received after 31/3/2011*	18,987	3,087	22,074
trade receivables not collected at 13 May 2011	4,997	8,905	13,902

* Agreed to bank statement and trade receivables ledger

Easybi's accounting policy in respect of making an allowance against trade receivables at the year end is set out below:

- 100% of amounts which have been referred to the credit collection agency
- 50% of amounts 80 days or more <u>overdue</u>
- 10% of remaining balances

Easybi's internal control and procedures document states that:

- Easybi's standard credit terms are 30 days
- It is company policy to refer all balances that are more than 35 days <u>overdue</u> to the credit collection agency

However, on discussion with the directors you discover that, as a result of the increased volume of business and a lapse in controls, none of the balances above were referred to the credit collection agency. For this reason the directors have only made a general allowance of 10% against the gross receivables above because they believe that, once referred to the credit collection agency, the customers will pay.

Discussion points

Audit execution

Audit area – Fraud and irregularities

(i) Environmental issue

What is the issue?

- Easybi is at risk of being fined a substantial amount or its trading being suspended if the EPD finds that the company has disposed of hazardous waste illegally/inappropriately
- No amounts for fines have currently been reflected in the financial statements
- The investigation by the EPD is not yet concluded and therefore there is uncertainty as to the outcome and impact on the financial statements

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

- There is an increased risk of unrecorded liabilities or undisclosed contingencies in relation to any fines that the EPD may impose on Easybi
- The extent of the fine could, given Easybi's current financial position, mean that the company is no longer a going concern
- If the EPD were to suspend trading by Easybi this would clearly affect the going concern presumption
- If Easybi is found guilty of illegal disposal of its waste this may give rise to concerns of further fines or litigation and raises questions as to management's integrity

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

What evidence should be obtained from Easybi?

- Ascertain from management the controls and procedures in place for controlling the disposal of hazardous waste
- Where possible test the controls to establish their effectiveness
- Review correspondence between Easybi and the EPD as well as with Easybi's third party waste disposal contractor
- Review the contract between Easybi and its third party waste disposal contractor to ascertain liability/responsibility for any waste not disposed of correctly
- Review correspondence with Easybi's legal advisors in respect of this matter
- Review press articles and the EPD website for any indication of similar cases and the level of fines imposed

(ii) Payroll

What is the issue?

- Payments were made by a temporary payroll employee to another employee when there were no timesheets submitted or employment contract in place
- If the employee paid is genuine this represents a breach of internal controls – i.e. that a genuine employee could be paid where the appropriate documentation was not in place

- Equally, it would represent a failure of any monitoring controls as the issue does not appear to have been detected by any review of the payroll records during the year
- If the employee is not genuine then this appears to suggest fraudulent transactions being processed by the temporary member of staff
- In addition, if a fraud has occurred, this would also indicate an absence of controls or control deficiencies as a fictitious employee could be set up and paid on the payroll system without detection

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

- The apparent lack of internal controls around the payroll suggests that there is an increased risk of other breaches of control over payroll and potentially other errors/fraud
- The planned audit procedures should now be reviewed in light of these findings and revised in order to take into account the increased risk identified

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

What evidence should be obtained from Easybi?

- The issue should be brought to the attention of the directors (assuming the team does not believe the management are involved in any potential fraud)
- The auditor should attempt to establish whether the situation is evidence of a fraud or a failure of internal controls. This might be done by:
  - Reviewing other evidence, such as application forms, interview notes or taxation documentation to establish whether the employee paid was genuine
  - Ascertaining from the payroll system the bank details of the employee paid and the temporary employee processing the transaction – if these are the same this would indicate a fraud (although if they are not this does not rule out a fraud)
- Discuss with directors whether the temporary employee worked anywhere else within the business as this may indicate other areas at increased risk of fraud or error
- It may be appropriate for a more senior member of the audit team to complete any further testing on payroll including any additional audit procedures to be employed in light of the increased risk

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*

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

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

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

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

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

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

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

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

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

(a) An understanding of the nature of the act and the circumstances in which it has occurred;

(b) Further information to evaluate the possible effect on the financial statements.

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

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

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

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

Learning Pack

Chapter 10, Fraud and irregularities

Audit area – Inventory

(i) Perpetual inventory system

What is the issue?

- Testing of the accuracy of the perpetual inventory system has identified discrepancies between quantities recorded in the system and the physical inventory in the warehouse
- Easybi relies on the amounts recorded in the inventory system for inclusion in the financial statements at the year end
- The errors appear to be have been adequately explained
- However, the failure to record the use of some components in the production process on a timely basis raises concerns over the accuracy of the inventory system as a whole

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

- The errors arising appear to be isolated in nature and therefore the auditor's procedures should try to ascertain whether they are isolated or not
- If there are further errors discovered then the reliability of the perpetual inventory system is brought into question
- The auditors may need to seek alternative evidence to support the inventory included in the financial statements at year end
- Given the issue has been identified before year end it leaves open the possibility of requesting that Easybi carries out a full inventory count at year end
- The fact that entries were not made when the production manager was absent raises questions as to whether other recording tasks were not completed

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

What evidence should be obtained from Easybi?

- Inspect the perpetual inventory system to identify whether the entries made on a weekly basis for the use of components is complete (i.e. entries are made every week)
- Trace a sample of the prior week's requisition forms to adjustments in the perpetual inventory system
- Ascertain from management what procedures are in place for the recording and updating of inventory in the absence of the production manager
- Ascertain from management what other tasks for the recording and control of inventory are the responsibility of the production manager
- Carry out procedures to ascertain whether these tasks were completed in his absence on 18 March (and at any other relevant times)

(i) WIP valuation

What is the issue?

- The basis for absorption of overheads into year-end WIP has been adjusted when compared to the prior year
- This has resulted in a higher valuation (by HK$1.2m) compared with the valuation had the original absorption rate of 30% been maintained

- The change in % may not accurately reflect the proportion of overheads that are applicable to production and may be motivated by management bias

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

- The higher valuation of WIP represents;
  - 15% of WIP
  - 4% of inventory
  - 1.1% of gross assets
- If the lower absorption rate had been used then HK$1.2m would have been included in the current year as costs (rather than deferred to the following year by including them in WIP), this would have resulted in
  - A loss before tax of HK$438,000 rather than a profit
- Based on the effect on profits and gross assets this is therefore material to the financial statements of Easybi
- Evidence needs to be sought that provides assurance that the change in the % of overheads included in the WIP valuation is appropriate

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

What evidence should be obtained from Easybi?

- Ascertain from management the reasons for the change in % applied
- Ascertain from management the basis used to determine the new % to be applied (i.e. why 40%)
- Re-perform any calculations prepared by management and vouch to supporting evidence
- Consider the appropriateness of the basis for allocating overheads to WIP – e.g. square meters of production area, number of employees in production etc

References

The above is based on the following auditing standards:

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

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

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

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

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

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

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

(a) The requirements of the applicable financial reporting framework

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates

(c) How the management makes the accounting estimates

(d) Method of measurement

(e) Relevant controls

(f) Assumptions underlying the accounting estimate

(g) Changes in methods for making accounting estimates

(h) Reviewing prior period accounting estimates

Learning Pack

Chapter 12: Substantive procedures, including analytical procedures – section 1.7
Chapter 13: Specific audit procedures – section 3
Chapter 15: Accounting estimates, opening balances and comparatives – section 1

Audit area – Trade payables and accruals

(i) Supplier statement reconciliations

What is the issue?

- Two unexplained differences have arisen on the supplier statement reconciliations undertaken
- The difference on the Sunmark statement may be due to an error on the statement, however, it is possible that an additional invoice, for the same amount, is due to Sunmark and has not been recorded in Easybi's purchase ledger
- The difference on the Sanbi statement has arisen because a cheque has been raised and recorded in Easybi's accounting records before the year end but has not been posted to the supplier at the year-end date.

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

- In respect of both cases it appears that the trade payables at year end are potentially understated
- In the case of the amounts due to Sunmark this may also indicate that inventory is understated given the direct integration between the inventory and accounting systems
- The error may highlight an issue in the internal control procedures at Easybi for the completeness of recording invoices
- The auditors need to establish whether the error is with the supplier statement or the recording of invoices at Easybi
- In the case of Sanbi this could be a deliberate attempt by the directors at window dressing – i.e. deliberately understating liabilities in order to present a better view of the business in the financial statements
- Whilst this individual cheque does not substantially alter the current ratio it may be indicative of other similar transactions
- In addition, the finance director may also have asked for the cheque to Sanbi to be 'held back' given that there is insufficient cash in the bank at the year end to meet the cheque payment meaning that Easybi would require use of an overdraft facility

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

What evidence should be obtained from Easybi?

- Direct confirmation of balances due from Sunmark to ascertain if there was an error on the supplier statement
- Inspection of any correspondence with Sunmark regarding the error and any resolution
- Identify goods received notes or copy orders for items from Sunmark to ascertain whether goods have been received for the same value (hence indicating there should be two invoices)
- Enquire of the finance director the reasons for holding back the Sanbi cheque – request that the transaction be reversed to reflect the correct year end position
- Ascertain from the purchase ledger supervisor whether any other cheques were written and recorded before the year end but not posted until after the year end

- Inspect accounting records (e.g. bank reconciliation) and bank statements to identify any other payments recorded before year end which seem to have taken an unreasonable amount of time to clear the bank
- Investigate such payments further to ascertain if they also are evidence of window dressing

(ii) Accruals

What is the issue?

- The accruals included in the draft financial statements represents estimates of liabilities and are therefore susceptible to manipulation or error
- The risk is that amounts will be understated or that amounts that should be accrued for are omitted from the list

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

- A number of items on the accruals listing gives us cause for concern:
  – Hong Kong Electric: this is based on an estimate of a 25% increase in production activity on the prior year. However, revenue has increased by 35% and cost of sales by 38% - whilst these are not perfect measures of production activity (and some benefits of economy of scale may have been experienced) the increase does not appear sufficient.
  – No account appears to have been taken of the 6.2% general rise in electricity prices. There is therefore a risk this amount is understated.
  – E-Link: the accrual calculation appears to be correct when based on Easybi's revenue figures for online sales, however it appears there could be a risk of misstatement if E-link's figures do not agree.
  – Wages and salaries: given the increase in the number of employees in the business (online sales and marketing, warehouse) and the introduction of the bonus scheme the increase in the accrual based on the prior year does not appear to be sufficient.
  – Rental and maintenance: there is no explanation as to why there is no comparable amount included in the accruals listing for year ending 31 March 2011
- There are also some apparent omissions based on our understanding of the business:
  – Interest/penalties on the taxes due to the authorities that are part of the deferred payment agreement
  – Interest due on the bank loan

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

What evidence should be obtained from Easybi?

- Ascertain from management the reasons for the concerns/discrepancies identified above
- Review post year-end payments where these are made before the audit report needs to be signed (most likely for Hong Kong Electric, wages and salaries, interest payments on tax and loan)
- Review the E-link payments for the previous quarter to ascertain the extent of the differences between calculations performed by E-link and Easybi
- Review the agreement with the tax authorities for any information regarding interest or other penalties that will become payable

- Review the loan agreement to ascertain the timing of interest payments and agree payments made to cash book/bank statement
- Review key performance indicators for service level agreements to estimate likely level of bonuses to be paid
- Review post year-end payments per the bank statement and trace to invoice to ascertain whether they represent year-end liabilities. Where year-end liabilities are identified, trace to the purchase ledger or accruals listing
- Review post year-end unprocessed invoices to ascertain whether they represent year-end liabilities. When year-end liabilities are identified trace the invoices to the purchase ledger or accrual listing.

References

The above is based on the following auditing standards:

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 qualify the auditor's report.

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

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

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

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

(a) The requirements of the applicable financial reporting framework

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates

(c) How the management makes the accounting estimates

(d) Method of measurement

(e) Relevant controls

(f) Assumptions underlying the accounting estimate

(g) Changes in methods for making accounting estimates

(h) Reviewing prior period accounting estimates

Learning Pack

Chapter 13: Specific audit procedures, section 6.1

Audit area – Purchases

(i) Purchases in foreign currency

What is the issue?

- The exchange rate for purchase invoices in TW$ appears to have been applied to invoices the wrong way round
- The error occurred during a period of absence of the staff member usually responsible
- It is highly likely that the error will have occurred for other invoices during the period of staff absence – i.e. it is a systematic error

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

- Total invoices in TW$ during the period were TW$1,161,510 which would have been translated using an incorrect rate
- The correct average rate for the period was TW$1 = HK$0.26 and therefore a rate of TW$1 = HK$3.85 (1/0.26) is likely to have been applied
- The invoices will have therefore been incorrectly recorded at approximately HK$4,471,814 (TW$1,161,510 × 3.85) instead of HK$301,993 (TW$1,161,510 × 0.26)
- This means that purchases will have been overstated by HK$4,169,821 (4,471,814-301,993)
- This represents 1.3% of revenue and is therefore material

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

What evidence should be obtained from Easybi?

- Ascertain whether the purchase ledger clerk was responsible for translating any other invoices denominated in foreign currency
- Select a further sample of invoices for the period denominated in TW$ to ascertain whether the same error has occurred and hence whether the error is systematic
- Select a sample of invoices denominated in TW$ from outside of the period in question to ascertain that the error is isolated to those invoices received during October and November
- Ascertain how the error affects the trade payables balance – i.e. are the amounts still outstanding on 31 March or, if paid, were the suppliers overpaid, or was a further translation error made?
- Discuss the error with management and request that the draft financial statements are amended

(i) Bulk purchase discount

What is the issue?

- The directors have recognised a rebate from Wei On Limited in respect of a bulk purchase discount should Easybi reach an agreed purchase volume by 30 June 2011
- The discount receivable is 10% and the directors have applied this to the purchase volumes made from the start of the agreement up to the year end
- Easybi has purchased HK$25,000,000 of goods from Wei On in the nine months from 1 July 2010 to 31 March 2011

- The specified purchase volume is HK$50,000,000
- It therefore seems unlikely that the specified purchase volume will be reached by 30 June 2011
- The rebate is not virtually certain and therefore should not be recognised in the financial statements for the current period

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

- If the purchase volume is unlikely to be reached then this means
  - Purchases are understated by HK$2,500,000
  - Accrued income is overstated by HK$2,500,000
- This represents 0.8% of draft revenue and 2.3% of draft gross assets
- In addition, if the rebate were not recognised this would mean Easybi would show a loss before tax rather than a current draft profit
- Therefore the amount in question is material to the financial statements

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

What evidence should be obtained from Easybi?

- Ascertain from directors the reasons why they believe that the specified purchase volume will be reached before 30 June 2011
- Review post year-end orders/purchases for evidence of any significant purchases post year-end which may make reaching the specified purchase volume more likely
- Review production plans for after the year end to ascertain whether further purchases are likely to be needed from Wei On in order to meet those plans
- Review the levels of inventory at the year end to ascertain whether items purchased from Wei On are low, hence indicating a higher likelihood that more will be needed to be purchased shortly
- Review the proportion of total purchases from Wei On made in the period 1 April to 30 June 2010 to ascertain whether historically larger volumes are purchased in this period

References

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 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 in the evaluation is to evaluate:

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

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

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

Learning Pack

Chapter 8: Planning, materiality and risk assessment, section 6
Chapter 9: Audit evidence, procedures, audit methodologies and audit sampling, section 4
Chapter 16: Overall audit review and finalisation, section 8

Audit area – Trade receivables

(i) Customer correspondence

What is the issue?

- A major customer, Simple, has written to Easybi requesting that its account be credited in respect of items that it has received that are faulty
- No adjustments have been made in respect of the matter
- Therefore the amounts due from Simple are included in the draft financial statements at the year end

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

- The letter from Simple provides evidence that it is very unlikely that the amount due from Simple will be recoverable at the year end
- The invoice in question represents 39% of profit before tax and therefore the amount is material and should be written off
- However there may be other implications for the financial statements in terms of:
  - Items returned by Simple to Easybi and whether these have any value or should be included in inventory at the year end
  - Whether other items of the same or a similar nature are included in inventory at the year end which may have also suffered temperature damage and therefore have a NRV below original cost
  - Whether any other customers have recently taken receipt of similar items which may also subsequently be returned to Easybi as damaged – in which case a provision for returns received after the year end should be included in the financial statements
- In addition, Simple is a "major customer" and this incident may have reduced confidence in purchasing any further products from Easybi, which, depending on the proportion of sales to Simple, could create further cash flow or going concern issues for Easybi

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

What evidence should be obtained from Easybi?

- Ascertain from the directors their intention with regard to the outstanding balance due from Simple
- Request an adjustment in the financial statements if they are not planning to write the amount off fully
- Enquire as to the treatment of any damaged items returned to Easybi by Simple
- Discuss with the production manager how the temperature damage may have occurred to these products and establish whether there are other products in inventory at the year end that formed part of the same production batch or that may have been exposed to similar temperature issues
- Review the despatch of those items affected prior to the year end to ascertain the possible extent of returns that may arise after the year end and estimate the potential provision for returns that would be required

- Identify what proportion of sales are accounted for by sales to Simple and review any other correspondence with Simple for indications that it will no longer purchase other products from Easybi

(ii) Aged receivables analysis and cash after date testing

What is the issue?

- The directors have not made an allowance against old trade receivables in accordance with company policy as they believe they will be collected once referred to the credit collection agency
- There was a lapse in internal control with respect to referring old trade receivables to the credit collection agency
- There is some evidence, post year end, of cash being collected against the balances due but a total of HK$13,902k remains uncollected at 13 May 2011

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

- Based on the directors statement regarding the allowance against trade receivables it appears they have made an allowance in respect of these trade receivables of HK$3,598k (10%)
- Given the cash collected after 31 March 2011 of HK$22,074k it does not appear necessary to make a 100% allowance against the gross balance (even though they should have been referred to the credit collection agency)
- However, the amounts that are yet to be collected are likely to be at greater risk of being irrecoverable and therefore a further allowance of, say, HK$10,304k (13,902 – 3,598) would appear more appropriate.
- This amount is material
- The lapse in internal control gives cause for concern – particularly where the audit has relied on controls

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

What evidence should be obtained from Easybi?

- Discuss with directors the possibility of making further allowances against the uncollected amounts
- Carry out external confirmations for those balances that remain uncollected
- Ascertain from directors what other evidence is available to support the collectability of the remaining balances
- Ascertain whether the overdue balances have now been referred to the credit collection agency
- Undertake further review of subsequent settlement of invoices
- Review correspondence files with relevant customers for evidence of any disputes over invoices
- Consider whether further work is required on any areas of the audit that have relied upon internal controls

References:

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

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

The concept of materiality is applied by the auditor in:

(a) planning and performing the audit

(b) evaluating the effect of identified the effect of 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 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 in the evaluation is to evaluate:

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

Under HKSA 505 *External Confirmations,* confirmation is the major substantive test in which the auditor will select a sample of accounts receivables' balances from the sales ledger for confirmation.

The external confirmation is a direct written response to the auditor from a third party in order to design and perform such procedures to obtain relevant and reliable audit evidence. External confirmations can satisfy the financial assertions of existence, completeness and rights and obligations and in addition can provide audit evidence about the absence of certain conditions. External confirmation will produce audit evidence from each respondent whether the amount owed by them to the entity at the date of confirmation is correct.

From an independent source (external parties,) it is reliable audit evidence. It would satisfy the criteria of "appropriate" for evidence. Therefore, when it is reasonable to expect customers to respond, the auditors should ordinarily plan to obtain direct confirmation of receivables to individual entries in an account balance.

The confirmation of receivables on a test basis should not be regarded as replacing other than normal audit tests, such as the testing in-depth of sales transactions, but the results may influence the scope of such tests.

Learning Pack

Chapter 8: Planning, materiality and risk assessment, section 6
Chapter 13: Specific audit procedures, section 4.1
Chapter 16: Overall audit review and finalisation, section 8

Analytical procedures at the completion stage

Required

Using Easybi's draft financial statements for the year ending 31 March 2011 perform the overall review of the financial statements.

Key questions/Approach

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

Discussion points

Analytical procedures at the completion stage

Observation	Commentary and potential issues
Revenue has increased by 35%	The market is expanding so an increase in revenue is expected especially given the introduction of online sales. However, revenue may be overstated due to errors such as: recording of online sales: foreign currency translation differences, cut-off issues
Gross margin has fallen from 13.9% to 11.8%	May indicate that cost of sales is overstated, an error in inventory, such as overestimation of work in progress or further errors in translating purchases in foreign currencies. To a degree it also probably reflects the increasingly competitive nature of the market and the increased service levels to clients
Admin costs have increased by 29.7% and now represent 11.5% of turnover compared with 12% in the prior year	Increases in administrative costs are to be expected given reorganisation costs and increased administration associated with online sales and increased customer service levels. However, they appear to be out of line with the rise in turnover, having actually fallen relative to turnover compared with the prior year. This may be due to over-absorption of overheads into WIP
Interest expense has increased by 183% **Bank loans have increased by 335%**	Interest expense would be expected to rise significantly given the increase in loan finance; however it has not risen proportionately to the size of the long term loans included in the statement of financial position, even when taking into account that the loan was only held for a portion of the year
Effective tax rate has increased from 16.5% to 52.5%	The level of corporation tax recorded in the income statement does not appear to reflect an appropriate rate of tax for the level of profits recognised. There appears to be an error in the taxation calculation
Depreciation charged on plant and machinery represents 3.4% of the cost of plant and machinery at 31 March 2011	This appears to be out of line with the policy of 10% - 33% straight line and may either indicate an error in the calculation of depreciation or suggest that a large proportion of assets are fully depreciated. This raises questions as to whether Easybi will need to fund additional plant and machinery in the near future hence creating a further drain on its limited cash resources
Inventory days have fallen from 47.2 days to 40 days	A fall in inventory days appears to be inconsistent with the requirement for Easybi to carry more inventories to meet customer demands and to have inventory available. This could reflect an issue in valuation of work in progress, errors in the perpetual inventory system or may be a result of the timing of deliveries and shipments.

Observation	Commentary and potential issues
Trade receivables have increased by 77% and trade receivables days have increased from 67 days to 88 days	The reluctance of management to write off old debts suggest a degree of management bias, possibly due to the loan application, which would result in an over-valuation of receivables and hence an increase in receivables days.
Cash balances have dwindled	The going concern status of Easybi needs to be carefully considered especially in light of their application for further loan financing.
Current liabilities have increased by 28.8%	This includes the delayed payment to the tax authorities. Given the increased volume of business we perhaps might expect a higher increase in trade payables; this may be evidence of understatement or omissions of accruals.
There are foreign currency exchange differences of HK$2,350k showing in reserves not included in prior year	This appears to be inappropriate accounting treatment resulting from the new option for customers to purchase goods in their local currency and online sales being recorded in local currency. The correct treatment would be to recognise such translation differences in profit or loss – this would turn Easybi's small profit into a loss and may therefore be a result of management bias. This raises concern over the going concern presumption and management's integrity with respect to other aspects of the financial statements if this represents an attempt to report the company's results fraudulently.

Audit completion

(i) Environmental issue

On 7 May 2011 the Environmental Protection Department (EPD) of Hong Kong wrote to Easybi in order to inform the company of the outcome of its investigation into the allegations of illegal disposal of hazardous waste by the company.

Environmental Protection Department
The Government of the Hong Kong Special Administrative Region

HONG KONG

7 May, 2011

To: John Wong
Managing Director
Easybi Limited
5/F., Chai Wan Industrial Centre,
20 Lee Cheung Drive,
Chai Wan, Hong Kong

Dear Mr Wong

Case 3450/HC/10 EPD investigation into illegal disposal of hazardous waste by Easybi Ltd

We are writing to inform you of the EPD's decision regarding the above investigation with respect to evidence of the illegal disposal of hazardous waste by Easybi Ltd.

The EPD has reviewed all of the evidence, including that submitted by Easybi Ltd and based on the information available believes that the hazardous waste found to be disposed of at an illegal location is directly traceable and attributable to the production processes associated with Easybi LCD's.

Therefore, given the serious nature of the incident, the EPD has now applied to bring the case against Easybi in the Court of First Instance. You are strongly advised to pass a copy of this letter to your legal advisors so that they may advise the company of the steps it now needs to take.

At present, the EPD has not filed to bring any criminal charges against the directors of Easybi but this is not ruled out and will depend upon the proceedings of the above case.

Jeanette Kwok

Jeanette Kwok, Director
For and on behalf of EPD

The directors of Easybi believe that the company will be cleared when the case comes to court but have asked for your advice on this matter with respect to the year-end financial statements. The case will not be brought before the court until after the audit report and financial statements have been signed.

Required

Identify the issues for the financial statements and any additional audit steps that should be taken.

(ii) Trade receivables circularisation

In response to the issues identified as part of the testing of trade receivables, the audit team performed a trade receivables circularisation of the most material old balances where cash had not been collected as at 13 May 2011 (i.e. those in the >90 days and >120 days categories).

The results of this additional procedure are shown below:

	Value HK$000	Number of replies
Replies which agreed to the circularisation or were satisfactorily reconciled	7,953	17
No reply received from customer	603	2
Replies which disagreed with the circularisation and could not be reconciled[1]	159	1
Total balances circularised	**8,715**	**20**
Balances not circularised	5,187	23
Total balances in >90 days and >120 days overdue category	13,902	**43**

1 The reply from King Ltd, a regular customer of Easybi, stated that the balance due to Easybi, as shown on King Ltd's purchase ledger, was zero. King Ltd did not agree with the balance shown in the circularisation sent. No reason could be identified by the audit team for the discrepancy.

Required

Identify the issues for the financial statements and any additional audit steps that should be taken.

Discussion points

Audit completion

(i) Environmental issue

What is the issue?

- The letter from the EDC indicates that a case will be brought against Easybi which could result in severe fines or suspension/cessation of the business
- The case will not be resolved before the audit report and financial statements are signed
- There is a significant uncertainty affecting the financial statements at the year end

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

- The directors should be advised, unless there is compelling evidence otherwise, to include a note to the financial statements explaining the significant uncertainty at the year end and where possible quantifying the potential outcomes of the case
- Where there is evidence to suggest that Easybi may not successfully defend the case the directors may need to consider preparing the financial statements on a break up basis

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

What evidence should be obtained from Easybi?

- Discuss with directors their proposed course of action with respect to the case and its disclosure in the financial statements
- Review any available history of cases brought by the EDC to ascertain whether there is any likelihood of Easybi successfully defending the case
- Ascertain amounts of fines or other penalties imposed by the court in previous cases
- Review the disclosures prepared by the directors in the financial statements for adequacy
- The auditors would also need to include an emphasis of matter paragraph in the auditor's report
- Review correspondence between Easybi and its legal advisors in respect of this case

(ii) Trade receivables circularisation

What is the issue?

- The additional audit evidence in respect of the agreed responses provides adequate audit evidence of the recoverability of the old trade receivables identified
- There are however a number of balances which remain un-circularised, two balances where no response to the circularisation has been obtained and one response which is in disagreement with the balance that is recorded in the sales ledger.

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

- Either further evidence is required for those items mentioned above or the directors should include an allowance against those receivables.
- However, other than in the case of the response which disagreed, the directors are likely to argue, as before, that the amounts will be recovered in due course

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

- Where responses have not been received, follow up procedures should be undertaken – i.e. further circularisation or telephone call (with Easybi's permission) and documentation
- Further cash after date testing may now be possible for the time elapsed since 21 May
- Other audit evidence to verify that goods were dispatched should be sought – e.g. goods received notes signed by the customer, order forms completed by the customer
- A review of the customer's financial statements and credit rating should be undertaken to see if they have the financial resources to pay
- The directors should be asked to enquire of the customer as to the reason for the "nil" balance to ascertain whether an error may have occurred in either the customer's purchase ledger or Easybi's sales ledger (for example, might the cheque received from the customer have been allocated to the incorrect customer account?)

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

Under HKSA 505 *External Confirmations,* confirmation is the major substantive test in which the auditor will select a sample of accounts receivables' balances from the sales ledger for confirmation.

The external confirmation is a direct written response to the auditor from a third party in order to design and perform such procedures to obtain relevant and reliable audit evidence. External confirmations can satisfy the financial assertions of existence, completeness and rights and obligations and in addition can provide audit evidence about the absence of certain conditions. External confirmation will produce audit evidence from each respondent whether the amount owed by them to the entity at the date of confirmation is correct.

From an independent source (external parties,) it is a reliable audit evidence. It would satisfy the criteria of "appropriate" for evidence. Therefore, when it is reasonable to expect customers to respond, the auditors should ordinarily plan to obtain direct confirmation of receivables to individual entries in an account balance.

The confirmation of receivables on a test basis should not be regarded as replacing other than normal audit tests, such as the testing in-depth of sales transactions, but the results may influence the scope of such tests.

Learning Pack

Chapter 16: Overall audit review and finalisation, section 1
Chapter 13: Specific audit procedures, section 4.1

Audit reporting

Fung Man Limited

Fung Man Limited ('Fung Man') is a clothing manufacturer based in Hong Kong. The company specialises in the manufacture of ladies jeans which are sold to clothing retailers worldwide.

Soaring world cotton prices have badly affected Fung Man. Cotton is the key raw material for jeans manufacture and this has doubled in price over the last year. Prices are not expected to drop for several years.

Fung Man's customers have pressured the company to keep the cost they pay per item the same resulting in a squeeze in margins for Fung Man. Twenty staff at Fung Man have already lost their jobs in an attempt to cut costs elsewhere.

You are the external auditor of Fung Man and you are currently working on the audit for the year ended 31 March 2011.

Fung Man has made a net loss of HK$152k in the year. Audit work on the financial statements has shown that net assets total HK$459k and the bank overdraft is HK$503K. The audit file contains a copy of a letter from the bank stating that the overdraft facility will be reviewed at the end of July 2011.

The directors of Fung Man have agreed to include a statement highlighting the uncertainty over the overdraft facility and how this casts significant doubt on Fung Man's ability to continue as a going concern. 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.

San Wing Limited

San Wing Limited ('San Wing') is a manufacturer of office furniture for commercial use. Furniture is produced to order for new offices or large scale office refurbishments.

On 1 April 2007 San Wing invested in new machinery to speed up the production process for its office chairs. Demand for these had grown after receiving an award at an international trade fair. The machinery cost HK$950,000 and supporting purchase documentation estimated the machine could produce 5million chairs. San Wing projected sales of 1million chairs per annum and so the machine was given an estimated useful life of five years. Residual value was nil due to the specialised nature of the machine.

You are the external auditor of San Wing for the year ended 31 March 2011.

Notes from the current year audit file show that the global recession has impacted orders of office chairs significantly since the machine was purchased. In the four years to 31 March 2011 only 2million chairs were sold. San Wing predicts it will sell 500,000 chairs per year for the next six years. In light of these reduced sales and forecasts, the finance manager increased the useful economic life of the machinery to twenty-five years from 1 April 2010.

The directors have refused to lower the useful economic life of the machine as they believe that careful maintenance by their employees will allow it to last for longer than the original estimate of producing 5million chairs. They have produced a strict maintenance timetable, but there is no evidence to show that this will lengthen the life of the machine.

The financial statements show that for the year ended 31 March 2011 profit before tax is HK$230,000 and net assets are HK$765,000.

Required

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

Supplementary task

Tak San Limited

Tak San Limited (Tak San) is a chain of fifteen audio-visual equipment retail outlets in Hong Kong. You are the external auditor of Tak San, a new client for the year ended 31 March 2011.

During the audit there was some confusion over the audit of inventory. The audit senior planned for junior staff to observe the year-end inventory count at the three largest outlets which together accounted for 65% of Tak San's inventories. However, a mix-up resulted in the audit juniors attending inventory counts at the three smallest outlets. Total inventory at these outlets covered just 3% of Tak San's year-end inventory.

You have not been able to confirm the inventory figure by alternative methods. Inventory is 32% of net assets of Tak San at 31 March 2011.

Required

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

Discussion points

Audit reporting

Fung Man Limited

Impact on audit opinion

- The current economic conditions are expected to prevail so Fung Man is unlikely to make a profit next year
- If the bank decides to recall the overdraft in July 2011, Fung Man will be left with a negative statement of financial position
- Therefore, there are significant doubts as to the going concern status of the company
- The auditors believe that these doubts 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 existence of the material uncertainty casting significant doubt on Fung Man's going concern status and draw attention to the related disclosure in the financial statements

The above is based on the following auditing standards:

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 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.

San Wing Limited

Impact on audit opinion

- It is estimated that the machine can produce 5m chairs which will be after ten years of ownership according to current forecasts
- There is no evidence that the machine will be able to produce more than 5m chairs
- The useful economic life of the machine should be adjusted to ten years resulting in an adjustment to the depreciation charge and non-current assets
- Depreciation is currently HK$17,273 but should be HK$54,286 and so the required adjustment is for HK$37,013
- [(950,000-(3 × (950,000/5)))/22] vs [(950,000-(3 × (950,000/5)))/7]
- The adjustment amounts to 16% of profit before tax and 5% of total assets
- It is material but is not pervasive
- The directors have refused to make the adjustment and so the auditor's report must be qualified on the basis that the financial statements are materially misstated
- The auditors must include a paragraph in the auditor's report which describes the basis for the qualification and quantifies its effects

The above is based on the following auditing standards:

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

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

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

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

Audit reporting

Answer to supplementary task

Tak San Limited

Impact on audit opinion

- Inventory is a material figure on the statement of financial position at 32% of net assets
- Since the audit firm has been unable to substantiate the inventory figure, this represents a material inability to obtain sufficient appropriate audit evidence
- The auditor's report would be qualified on the basis that this is material but not pervasive

References

The above is based on the following auditing standards

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

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

According to HKSA 705 (Clarified), the auditor shall express a qualified opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.