

# Student Notes

Module C (June 2013)

## Workshop Outline and Learning Methodologies

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Session	Methodologies	Chapters covered	Student Notes
<b>Workshop 1</b>			
1. Introduction	<ul style="list-style-type: none"><li>• Presentation</li><li>• Group discussion</li></ul>		
2. Corporate governance	<ul style="list-style-type: none"><li>• Case study</li><li>• Group discussion</li></ul>	Ch. 1 & 2	Pg. 1 – 5
3. Overview of an audit	<ul style="list-style-type: none"><li>• Card game</li></ul>		
4. Audit acceptance / continuance	<ul style="list-style-type: none"><li>• Case study</li><li>• Group discussion</li></ul>	Ch. 4 & 7	Pg. 6 – 10
5. Audit planning	<ul style="list-style-type: none"><li>• Case study</li><li>• Group discussion</li></ul>	Ch. 8, 9, 11 & 12	Pg. 11 – 35
6. Project management in audit planning stage	<ul style="list-style-type: none"><li>• Group discussion</li></ul>	Ch. 8	
7. Conclusion	<ul style="list-style-type: none"><li>• Presentation</li><li>• Group discussion</li></ul>		
<b>Workshop 2</b>			
8. Reboot	<ul style="list-style-type: none"><li>• Presentation</li><li>• Group discussion</li></ul>		
9. Audit execution	<ul style="list-style-type: none"><li>• Individual work</li><li>• Progress meeting and reporting</li><li>• Group discussion</li></ul>	Ch. 9, 11, 12, 13, 14 & 15	Pg. 1 – 35
10. Project management in audit execution stage	<ul style="list-style-type: none"><li>• Presentation</li><li>• Group discussion</li></ul>		
11. Audit completion	<ul style="list-style-type: none"><li>• Group sharing</li><li>• Group discussion</li></ul>	Ch. 9, 15, 16 & 17	Pg. 36 – 58
12. Group audit	<ul style="list-style-type: none"><li>• Group discussion</li></ul>	Ch. 18	
13. Conclusion	<ul style="list-style-type: none"><li>• Presentation</li><li>• Group discussion</li></ul>		



## Audit execution

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

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

During the audit, a number of audit issues have been identified.

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

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

Tips in handling the progress meeting:

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

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

- Materiality benchmarks:
  - 0.5 – 1% revenue
  - 1 – 2% total assets
  - 5 – 10% profit before tax
- Information regarding draft figures from HKSEC financial statements for the year ended 31 March 2013:
  - Revenue – HK\$191,976,000
  - Total assets – HK\$4,919,034,000
  - Profit before tax – HK\$1,948,000
  - Net cash outflow – HK\$284,577,000

## Hong Kong Show and Exhibition Colosseum Limited 'HKSEC'

### Audit area: Tangible non-current assets: Land and buildings

(i) **Valuation & Classification of hotel under construction at year end**

As part of your audit testing of property, plant and equipment you have obtained the following schedule of costs incurred by HKSEC to date on the construction of a new hotel. Construction commenced in October 2012 and is due to be completed in September 2013 when the hotel will open to the public. The directors of HKSEC propose to include these costs in the statement of financial position at 31 March 2013. The audit junior working with you on this audit area has undertaken work to verify the amounts.

	Note	HK\$'000
Legal fees incurred in lease negotiation	A	350
3 months of Marsha Choi's salary, benefits and employment costs	B	900
Architect and design costs	C	12,901
Site preparation costs	D	176,249
Stage payments made to CK Construction Contractor Limited	E	825,000
Marketing costs of new hotel	F	718
		<u>1,016,118</u>

**Note A:**

Amount agreed to invoice from KL Legal – HKSEC legal advisors for lease negotiation.

**Note B:**

Amount relates to gross salary, pension and medical insurance costs and employer taxation costs and has been agreed to payroll records, and pension and medical insurance payments. Ms Choi was responsible for the lease negotiation and the directors consider she spent three months on this work.

**Note C:**

The costs have been agreed to invoices received from Kowloon Architect Co. The amounts represent two invoices for architect and design costs - invoice 2901 for HK\$5,450,000 and invoice 3007 for HK\$7,451,000. Invoice 2901 relates to a design which was rejected by the HKSEC directors and invoice 3007 relates to the design which has been adopted.

**Note D:**

An invoice for the site preparation costs cannot be found but a payment for the same amount was traced to the bank statement on 18 July 2012 and was shown in the cash book to be made by electronic transfer to 'Mr A Charles'. The purchase ledger team were requested to make the payment by Mr Robert Tay (CEO) but were not provided with any other information. No further work has yet been carried out in respect of this amount.

**Note E:**

Stage payments made to CK Construction Contractor Limited have been traced to the agreement between HKSEC and CK Construction Contractor. A copy of a letter from CK Construction has also been obtained (attached).

**Note F:**

A marketing campaign has been designed to ensure that hotel occupancy is high as soon as the hotel opens in September. The amounts have been agreed to an invoice from Big Moon Marketing Group. The invoice was received and paid by HKSEC in February 2013 and the marketing campaign is scheduled to commence in June 2013.

## Chan Kee Construction Contractor Limited



Mr. Phillip Chan  
Managing Director  
Hong Kong Show and Exhibition Colosseum Limited  
West Kowloon Golden Strip  
West Kowloon  
Hong Kong  
31st March 2013

Dear Mr. Chan

### Update on hotel construction

I set out below a brief update on the progress of the HKSEC hotel construction in Kowloon as requested for the purposes of preparing the HKSEC financial statements for the year ended 31 March 2013.

*Andrew Wing*

Andrew Wing  
Senior Project Manager, Chan Kee Construction Contractor Limited

HKSEC hotel construction project - Summary at 31 March 2013			
<b>Total contract cost:</b>	HK\$1,500,000,000		
<b>Stage payments received from HKSEC per contract (HK\$'000)</b>			
01/10/2012	275,000		
01/12/2012	275,000		
31/03/2013	275,000		
	<u>825,000</u>		
<b>Project progress</b>			
The project plan shows that construction is planned to be 55% complete at 31 March 2013.			
However, due to a delay in receiving the final designs and subsequent delayed site preparation, CK surveyors estimate that the construction is 45% complete on this date.			

(ii) **Property revaluation**

As part of your audit of property, plant and equipment, you have been provided with a copy of the March 2013 board report from Eddie Wu, Head of Property Services:

**To:** HKSEC Board of Directors  
**From:** Eddie Wu, Head of Property Services  
**Re:** Property revaluation  
**Date:** 15 March 2013



**Background**

On 13 March 2013 the board of directors requested that the HKSEC property services team engage a property valuer to value the HKSEC property with a view to including the property at a revalued amount in the financial statements for the year ending 31 March 2013.

This board report provides a summary of the information requested.

**HKSEC property valuation**

Due to the short time scales available to engage a property valuer, the HKSEC property services team approached New Hung Kee Property Investment Limited (NHK) to undertake the valuation. This avoided the need to contact and assess property companies unknown to us and allowed for the provision of a property valuation for inclusion in the year-end financial statements

The valuation was carried out by NHK's valuation department on 31 March 2013. A full report and valuation certificate from NHK has been provided. A summary of the findings are as follows:

Estimated market value (fair value) of main HKSEC buildings:	HK\$2,865,532,000
Outside scope of valuation:	Tai O Country Golf Club buildings Hotel premises in course of construction Land leasehold

The audit junior working with you on this audit area has reviewed the valuation report from NHK and satisfactorily agreed the information to that contained in the board report. She has also considered the expertise and qualifications of the valuer and concluded that these are also satisfactory.

The directors have provided you with the following schedule detailing how they propose to include the revaluation in the financial statements to the year ended 31 March 2013:

# Student Notes

## Module C (June 2013) Workshop 2 – Handout 9.1 Audit Execution

	HK\$'000	HK\$'000
<b>Building revaluation</b>		
Estimated market value at 31 March 2013		2,865,532
Building carrying value at 31 March 2013		
Cost (excl. land)	1,500,000	
Less: Accumulated depreciation	<u>-315,000</u>	
		<u>1,185,000</u>
Revaluation		<u><u>1,680,532</u></u>

## Discussion points

### Audit execution

#### Audit area – Tangible non-current assets: Land and buildings

(i) Value and classification of hotel under construction at year end

**What is the issue?**

- Costs of HK\$1,016m relating to the construction of the new hotel have been capitalised, which are 20.7% of total assets and therefore material to the financial statements
- Management have capitalised costs which are not permitted under HKAS 16 *Property, Plant and Equipment*, namely the internal staff costs and marketing costs
- Costs have been capitalised relating to a design that was not used and these should have been written off to the statement of comprehensive income during the year
- Stage payments to the construction company do not appear to reflect the work carried out and the amount capitalised has been overstated by HK\$150m (825m- [1,500,000mk x 45%]), an amount which is material at 3% of total assets
- Evidence for the site preparation costs of HK\$176,249k is missing and this amount alone is material at 3.6% of total assets.

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

- An audit adjustment will need to be made so that appropriate amounts are capitalised as non-current assets in the financial statements
- Expenditure not meeting capitalisation criteria set out by accounting standards must be charged to the statement of comprehensive income
- The overstatement of stage payments will need to be capitalised in 2014 and, as the amount has been paid, will result in a reclassification on the statement of financial position from non-current assets to current assets
- The number of items found to be capitalised incorrectly is concerning given the risk of management bias (due to the company wanting to make its financial position look more favourable for the loan application)
- SMP will need to maintain professional scepticism when considering if the inappropriately capitalised items are a deliberate attempt to inflate the statement of financial position figures
- SMP will need to consider whether the lack of evidence in Note D is indicative of fraud or simply a management override of controls. They will have to evaluate the implications of this in relation to other aspects of the audit such as the extent to which controls can be relied upon and reliability of representations from management at HKSEC



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

- Audit procedures over non-current asset additions should be extended in light of the large amount of items capitalised incorrectly, with an emphasis on obtaining evidence from external sources
- Invoices for legal fees need to be reviewed to ensure that all items capitalised are appropriate
- SMP should try to obtain alternative audit evidence to support the site preparation costs, such as a signed contract or an external confirmation
- It may be appropriate for a more senior member of the audit team to complete this further work in light of the increased risk of fraud
- If fraud is suspected, SMP will need to re-evaluate the assessment of the risk of material misstatement due to fraud and consider extending the nature, timing and extent of audit procedures in other areas
- They will also need to ensure they report any fraud to those charged with governance

(ii) **Property revaluation**

**What is the issue?**

- The motivation for management for the revaluation is to improve the view presented by the financial statements in light of the loan application - there appears to be an element of management bias in the decision to revalue
- The revaluation of the HKSEC property has been carried out by NHK who are not an independent management's expert
- As shareholders of HKSEC, NHK have a vested interest in overstating the value of the property especially if they are aware that the company is applying for a new loan
- By only revaluing the main building, HKSEC have not followed the requirements of HKSA 16 *Property, Plant and Equipment* which states that 'if an item of property, plant and equipment is revalued, the entire class of property plant and equipment to which that asset belongs shall be revalued'
- The calculation of accumulated depreciation in the building revaluation seems wrong and should be HK\$240,000k ( $\text{HK\$1,500,000k} / 50\text{years} \times 8$ ) instead of HK\$315,000k

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

- The accumulated depreciation difference has resulted in the revaluation being overstated by HK\$75m, an amount that is 1.5% of total assets – this may be a genuine error or deliberate manipulation to present HKSEC in better financial shape
- The risks associated with management bias means that SMP will need to carefully consider the source of evidence they obtain – a preference for third party or auditor generated evidence will be key and where written representations from management are part of audit evidence, procedures will be required to sufficiently corroborate such evidence

- The reliability of the evidence provided in the revaluation report produced by a shareholder of HKSEC is questionable - even if the individual valuer has the sufficient expertise and qualifications there could be manipulation of figures due to the independence issue
- The accounting for revaluation of assets is complicated and there may have been further errors in recording the revaluation in the accounting records or making disclosures in line with Hong Kong accounting standards

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

- SMP shall maintain an attitude of professional scepticism when carrying out further audit procedures on the revaluation amount
- Prices of similar properties in the area, if these exist, can be reviewed and compared to the valuation proposed for reasonableness
- SMP will need to consider the appropriateness of using an auditor's expert to assess the reasonableness of the property valuation
- The accounting treatment of the revaluation can be reviewed in the financial statements and amounts recalculated to ensure no further errors have arisen
- The notes to the financial statements must be reviewed for appropriate disclosures
- If an element of management bias is suspected, SMP will need to assess the impact on the reliability of other audit evidence

## References

The above is based on the following auditing standards:

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

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

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

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

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

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

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

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

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

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

**HKSA 620 (Clarified) *Using the work of an Auditor's Expert***

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services
- The extent to which management can exercise control or influence over the work of the management's expert

**Learning Pack**

Chapter 10: Fraud and irregularities

Chapter 13: Specific audit procedures – section 1 Tangible non-current assets

Chapter 14: Using the work of others

## HKSEC

### Audit area: Valuation of intangible non-current assets

The directors have provided you with the following extracts from the draft financial statements for the year ended 31 March 2013 to assist you in auditing intangible non-current assets:

#### Accounting policies

##### 1.4 Intangible assets

###### (i) Goodwill

Goodwill represents amounts arising on acquisition of subsidiaries and is the difference between the fair value of consideration paid and the net fair value of identifiable assets and liabilities. Goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but tested annually for impairment.

###### (ii) Patents

Patents are initially recognised at cost on acquisition and are then revalued to the present value of the future income streams expected to be derived over the life of the patent. Amortisation is charged on a straight line basis over the life of the patent.

#### Intangible non-current assets

	<i>Goodwill</i>	<i>Patents</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000
<i>Cost/Revalued amount</i>			
At 1 April 2012	-	-	-
Additions	67,290	1	67,291
Revaluation	<u>-</u>	<u>174,000</u>	<u>174,000</u>
At 31 March 2013	<u>67,290</u>	<u>174,001</u>	<u>241,291</u>
<i>Amortisation and impairment losses</i>			
At 1 April 2012	-	-	-
Amortisation for year	<u>-</u>	<u>21,750</u>	<u>21,750</u>
At 31 March 2013	<u>-</u>	<u>21,750</u>	<u>21,750</u>
<i>Carrying amount</i>			
At 31 March 2013	<u>67,290</u>	<u>152,251</u>	<u>219,541</u>
At 31 March 2012	<u>-</u>	<u>-</u>	<u>-</u>

(i) **Patent acquired in year (FlexPod)**

The directors have informed you that the patent for the FlexPod system was obtained in March and that they wish to recognise it in the financial statements for the year ending 31 March 2013. You have traced the original cost of obtaining the patent to relevant documentation which showed the cost to be HK\$1,000.

On further discussion with the directors you are told that the directors intend to include the patent at a revalued amount which better reflects its market value and therefore value to HKSEC. They have provided copies of correspondence with Evan & Mason Patent Agent regarding the market value as well as calculations to support the revaluation.



Evan & Mason Patent Agent

18 March 2013

Ms Marsha Choi  
Commercial Director  
The Hong Kong Show & Exhibition  
Colosseum Limited  
West Kowloon Golden Strip  
West Kowloon  
Hong Kong

Dear Ms Choi

**HKSEC FlexPod patent approval**

Following our earlier telephone conversation I am delighted to formally confirm the approval of the HKSEC FlexPod patent. As agreed the patent is valid for 8 years and enforceable within the Hong Kong jurisdiction.

Regarding your question of valuation, there are a number of valuation methods available to patent owners where, as in the case of FlexPod, there is not a market in which patents such as this are traded on a regular basis. The most appropriate method for HKSEC would be to prepare a discounted cash flow calculation which estimates the present value of the future net cash flows which HKSEC considers it will generate through having the patent.

You will need to determine an appropriate discount factor to apply to future cash flows.

Yours sincerely,

JLee  
Jane Lee  
Senior Patent Officer

FlexPod Patent valuation								
<b>Assumptions:</b>								
One FlexPod unit will generate net cash inflows of HK\$60,000 per event								
HKSEC will construct 4 FlexPod units								
Each unit will be used in 120 event per annum								
5% is an appropriate discount rate based on the rate of interest on our bank loans								
<b>Discount cash flow calculation</b>								
(HK\$'000)								
	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>	
net cash inflow	28,800	28,800	28,800	28,800	28,800	28,800	28,800	
Discount rate	1.00000	1.05000	1.10250	1.15763	1.21551	1.27628	1.34010	<b>Total</b>
Present value of net cash inflow	28,800	27,429	26,122	24,879	23,694	22,566	21,491	174,979.93
Therefore present value of future cash flows = HK\$174, 979, 930								
Proposed prudent valuation HK\$174,000,000								

As this is an audit area that you are not familiar with you have contacted your firm's technical department for guidance as to how the patent should be dealt with in the financial statements and you have received some technical information from them:

### Conditions for recognition of intangible non-current assets

In order to recognise an intangible asset in the statement of financial position the following conditions must be met. The asset:

- is identifiable (i.e. capable of being sold separately)
- is controlled by the entity
- gives rise to probable future economic benefits
- has a cost that can be reliably measured

### Initial recognition

Intangible assets, such as patents, are initially recognised at cost.

### Subsequent revaluation

After initial recognition intangible assets shall be carried at a revalued amount, i.e. fair value, less accumulated amortisation. The revalued amount must be determined by reference to an **active market**.

### Discounted cash flow techniques

Discounted cash flow uses future net cash flow projections and discounts them (most often using the weighted average cost of capital - WACC) to arrive at a present value, which gives the value of the future cash flows in today's terms.

WACC is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All capital sources – ordinary shares, preference shares and any long-term borrowings are included in a WACC calculation.

(ii) **Goodwill arising on acquisition of trade and assets of local golf course**

In November 2012 HKSEC acquired the trade and major assets of Tai O Country Golf Club, situated adjacent to the site on which HKSEC are building the new hotel. The directors have provided you with the following summary detailing the purchase consideration, valuation of the assets acquired and the goodwill arising. No current assets or liabilities were acquired as part of the acquisition.

**Acquisition of Tai O Country Golf Club**

	HK\$'000	HK\$'000
Purchase consideration		327,592
Valuation of assets acquired:		
land & buildings	221,985	
computer equipment	10,405	
Fixture & fittings	<u>27,912</u>	
		(260,302)
Goodwill arising on purchase		<u>67,290</u>

Whilst travelling into work on 12 June 2013 you read the following newspaper article:

## Hong Kong Times

12 June 2013

The saga of the Tai O Country Golf Club, one of Kowloon's most prestigious golf courses continued to rage today. The battle between the golf club members and new owners, HKSEC, who acquired the golf club in November last year took another twist as the golf club's patrons collectively decided to walk away from the club.

The row began in January of this year with member complaints that the golf course was not being maintained to the high standards of its previous owners and that parts of the course were becoming unplayable, partly due to the building works for a new hotel adjacent to the course. After a number of members, including politicians and high profile businessmen, publicly threatened to withdraw from their membership in January, HKSEC promised to invest more in the maintenance of the course. However, it appears that this did not happen and in March the organisers of the Hong Kong Open announced they would be moving the championships from Tai O to

Clearwater Bay. HKSEC management commenced a bid to change the organisers minds but today it was confirmed that the Hong Kong Open would be played at Clearwater.

Membership at the club over this time has been dwindling and the club is now accepting new members after the traditionally long membership waiting list has disappeared.



Damage on the green

## Discussion points

### Audit area – Valuation of intangible non-current assets

(i) Patent acquired in year (Flexpod)

**What is the issue?**

- A patent for FlexPod has been recognised in the year meeting recognition criteria set by Hong Kong Accounting Standards
- However, the patent has also been revalued to the present value of future income streams over its useful economic life which is not permitted
- Technically, the patent can only be revalued through reference to an active market and according to the patent agent, this does not exist for FlexPod
- There may be an element of management bias in the motivation for the revaluation in order to present a better view of the company for the loan application, especially when considering the highly optimistic valuation assumptions made by management

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

- The patent will be overstated in the financial statements by HK\$152,250k which is a material amount at 3.1% of total assets and 79% of revenue and would turn the profit into a significant loss
- The revaluation reserve will be overstated by the same amount and an adjustment will need to be proposed for the financial statements
- The potential management bias issue has a wider implication in terms of the reliability of audit evidence from other areas of the audit, such as management representations

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

- Agree the cost of the patent which has been correctly recognised to supporting documentation and trace payment to bank statements
- Ensure that the disclosure of the patent in the financial statement meets the requirements set by Hong Kong Accounting Standards
- Discuss with management their reasons for revaluing the patent to ascertain whether this was a genuine error in accounting in a new area or management bias
- For a genuine error, consider extending audit procedures and closely check disclosures for other areas of accounting that are new or non-standard to HKSEC this period end, including goodwill and the purchase and revaluation of land and buildings
- If management bias is suspected, SMP will need to re-evaluate the risk of material misstatement and consider extending the nature, timing and extent of audit procedures in other subjective areas



(ii) **Goodwill arising on acquisition of trade and assets of local golf club**

**What is the issue?**

- Goodwill may have been impaired as the news article describes how the deterioration of Tai O Country Golf Club has resulted in the loss of members and the chance to host the Hong Kong Open
- However, no impairment of goodwill has been recognised in the financial statements, even though HKSEC state the policy is to test goodwill annually for impairment

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

- The goodwill may be overstated in the statement of financial position and may need to be written down
- Goodwill is HK\$67,290k and at 1.4% of total assets and 35% of revenue is highly material to the financial statements and would turn the profit into a significant loss

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

- Agree the purchase consideration to the purchase agreement and bank statements
- Consider whether the valuation of assets acquired in the purchase of the golf club is reasonable and whether the help of an auditor's expert is required
- Check the value of purchased goodwill is calculated correctly which should reflect the difference between the fair value of the consideration given and the aggregate of the fair values of the separable net assets acquired
- Review HKSEC's annual impairment test for reasonableness, looking at the assumptions made and the appropriateness of the assessment method
- Discuss with HKSEC management why goodwill has not been impaired and assess the reasonableness of explanations

## References

The above is based on the following auditing standards:

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

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

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

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

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

**HKSA 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 13: Specific Audit Procedures – section 2 Intangible non-current assets

## HKSEC

### Audit area: Revenue, accrued revenue & trade receivables

#### (i) Customer event contracts – customer circularisation

To obtain audit assurance over revenue and trade receivables, the HKSEC audit team has undertaken a circularisation of a sample of HKSEC customers. Statistical sampling techniques were used in order to design the sample and select the customers for circularisation. Revenue from customers whose events had been billed and cash received by HKSEC prior to 1 April 2013 has been audited through verification of contracts and cash receipts, therefore these customers were not included in the circularisation. Customers who were circularised have either:

- (a) been billed prior to 1 April 2013 for an event taking place before this date but cash receipts had not been received by HKSEC at the time of the circularisation
- (b) completed an event prior to 1 April 2013 but had not been billed by this date and revenue has been recognised at 31 March 2013
- (c) been billed at year end for deposits due on events occurring after 31 March 2013

The audit junior working with you on this area has summarised the results of the circularisation below:

Revenue, accrued revenue & trade receivables circularisation			
			HK\$'000
<b>Gross accrued revenue &amp; trade receivables at 31 March 2013:</b>			
Billed:	- events prior to 1 April 2013		12,172
	- deposits for events scheduled after 31 March 2013		3,300
Not billed:	- events prior to 1 April 2013		1,087
			<u>16,559</u>
<b>Amounts included in circularisation testing:</b>			
Billed:	- events prior to 1 April 2013		1,791
	- deposits for events scheduled after 31 March 2013		1,300
Not billed:	- events prior to 1 April 2013		872
			<u>3,963</u>
<b>Results of testing:</b>			
A satisfactory response was received from all customers circularised with the following exceptions:			
<b><u>HKSEC customer</u></b>	<b><u>HK\$'000</u></b>	<b><u>customer response</u></b>	
<b><i>Billed: event prior to 1 April 2013</i></b>			
Fook Hing Holdings Co.	HK\$23	Customer replied amount had been paid on 20th March 2013	
<b><i>Billed: deposit for event scheduled after 31 March 2013</i></b>			
Concert Factory Inc.	HK\$1,300	No response received from customer	
<b><i>Not billed: event prior to 1 April 2013</i></b>			
The Hong Kong Chamber of Chinese Retailers	HK\$198	Customer responded event scheduled for May 2013	
Hong Kong Institute of Certified Public Accountants	HK\$311	Customer responded event scheduled for June 2013	

(ii) Ticket sales

Your firm has decided to adopt a controls based approach to testing the ticket sales made by HKSEC box office on behalf of promoters. Tickets are sold to the general public at face value plus a booking fee. The monies collected in respect of the face value of tickets are payable to the promoter after the event settlement meeting. The monies collected in respect of the booking fee are retained and recorded as revenue by HKSEC. The audit manager has not had time to write the audit programme for this area and has asked you to identify the audit procedures required, based on the risks associated with this area of the audit. He has set out, in an email, the steps that you should undertake:

**Re: Testing of HKSEC ticket sales**  
**From:** HKSEC Engagement Manager  
**To:** HKSEC Audit SIC

As we discussed I have not had time to complete the audit programme for the testing of HKSEC ticket sales (and associated booking fees) which are made on behalf of promoters running events at the HKSEC venue. I am on annual leave next week, please could you prepare the audit programme for this audit area and I will review it on my return. I have set out the steps below and the things that you should consider.

1. Identify the key inherent and control risks that need addressing using the audit planning (including the risk assessment) and the information we obtained from the internal control procedures manual (section 8).
2. Design tests of control to address these specific risks. I anticipate that given the volume of transactions we are considering we will need to undertake this testing on a sample basis.
3. Therefore, we must also consider the sample design and sample selection – please therefore consider the following matters relating to sampling and prepare some recommendations for me to review:
  - a. Sample population to be used
  - b. Sample selection method
  - c. Considerations for determining sample size

I look forward to reviewing this piece of work on my return.

## Discussion points

### Audit area – Revenue, accrued revenue & trade receivables

(i) **Customer events contracts - circularisation**

**What is the issue?**

- One response for Concert Factory Inc totalling 33% of the balance has not responded
- One response from Fook Hing Holdings Co indicates a recording error in relation to cash received from a customer
- Two other responses highlight errors in recording event dates (cut-off)
- This may impact on the extent to which it is considered appropriate to rely on internal controls in respect of the trade receivables balance

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

- In all cases further investigation is required in order to establish whether the issues identified are isolated instances or whether they are indicative of further potential errors in the population as a whole
- In the case of the response which has not been received, the balance accounts for 100% of the tested population (i.e. billed deposits for events after 31 March 2013) and is 66.7% of PBT and 0.68% of revenue so is material
- Further audit work will be required to either attempt to illicit a response from Concert Factory Inc or to corroborate the balances using alternative audit procedures
- In the case of the response from Fook Hing Holdings Co, the amount of HK\$23k is not material in itself. The error is 1.2842% of the population tested and if this error is extrapolated to the whole population of HK\$12,172k, it indicates potential errors of HK\$156k. This amount is marginally material to PBT (at 8%) but not material to revenue or total assets and so no further audit work is required
- The two balances where the event date was recorded incorrectly total HK\$509k and are 58.37% of the population tested. If this error is extrapolated to the whole population (of HK\$1,087k), it indicates potential errors of HK\$634k. This amount is material to PBT (at 32.5%) but not revenue or total assets and further audit procedures will be required
- These items should be excluded from accrued revenue as the event has not yet occurred. This may be indicative of other cut-off issues or deliberate misstatement by management

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

- Follow up the circularisation where no response was obtained by writing a further letter
- Where a response cannot be obtained, alternative audit procedures must be undertaken which may include: review of cash from the customer post period-end and contracts

- In respect to the issue over recording the event date, further procedures to establish whether other cut-off errors might have occurred need to be undertaken
- Cut-off procedures need to be extended and should include reviewing a sample of revenue recognised before the period end and comparing this to contracts to confirm the event date
- The errors raise concerns about the reliability of controls at HKSEC and SMP may need to consider whether their assessment of risk of material misstatement at the assertion level remains appropriate

(ii) **Ticket sales - sampling**

**What are the key inherent risks that need addressing using the audit planning and the information obtained from the internal control processes manual?**

- Booking fee revenue from promoter events may be recognised in the incorrect period, in particular where an event runs over year-end or where the event takes place after year-end but ticket sales are made in the current year (cut-off)
- Cash collected on behalf of promoters may not be held in an event specific bank account
- Monies may be paid to promoters before a settlement is reached
- Risk of disagreement as to the amount to be paid to a promoter at a settlement meeting held after the period end for a promoter event taking place before the period end
- HKSEC box office system may not allocate ticket sales/booking fees to the correct event

**What are the tests of control to address these specific risks?**

- For a sample of ticket sales in the current period, check that:
  - The event financial accountant notified the accounts department to recognise the booking fees on the correct date for the relevant event
  - A separate bank account was opened (for each event) and the proceeds from the ticket sale (excluding booking fee) were deposited in it
  - A report was prepared from the HKSEC box office system and provided to the event promoter for the event relating to the ticket sale
  - A settlement meeting was held in respect of the event relating to the ticket sale, amounts documented and signed by the promoter and HKSEC project manager
  - Where any disagreements have arisen these have been referred to the HKSEC legal team
- Run test data on the HKSEC box office system to ascertain that ticket sales and booking fees are allocated to the correct events (with the correct amount being recognised as a ticket sale and booking fee) and ascertain whether the reports produced from the system accurately reflects what is recorded

**Consider the sample population, sample selection method and considerations for determining sample size?**

- The sample population consists of tickets sold (face value plus booking fee) to the general public by the HKSEC box office for events run by promoters
- For the purpose of the controls testing, one sampling unit can be taken to be a 'booking' made at the HKSEC box office which may consist of the sale of one or more individual tickets
- To select ticket sales for a sample, random sampling, systematic sampling or haphazard selection are most likely to be appropriate as this will mean all items in the population have an equal chance of selection
- Two key factors need to be considered when determining sample size
  - Firstly, SMP has decided to use a controls based approach to test ticket sales made on behalf of promoters. We are therefore placing a greater reliance on the operating effectiveness of controls and sample sizes will need to be great enough to take this into account
  - A letter from Sally Brown, head of internal audit has identified instances where controls have not been effective, increasing the risk of a material misstatement. Again, the sample size needs to be increased so that it is sufficient to reduce risk to an acceptably low level

The above is based on the following auditing standards:

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

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

The concept of materiality is applied by the auditor in:

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

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

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

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



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

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

**HKSA 505 (Clarified) External Confirmations** requires that for an external confirmation, in the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with HKSA 705 (Clarified).

**HKSA 530 (Clarified) Audit Sampling** states that the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

## Learning Pack

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

Chapter 13: Specific audit procedures – section 4: Receivables

## HKSEC

### Audit area: Accounts payable

#### (i) Post year-end payments

As part of your firm's audit of Accounts payable you have examined cash payments shown on the bank statement after the year end in order to establish whether any unrecorded liabilities exist. Your testing traced each payment selected to supporting documentation, such as supplier invoices and delivery notes, and to the accounts payable listing provided to you by the accounts payable supervisor at HKSEC. Your testing covered payments shown on the bank statement in the period 1 – 30 April 2013. You were also provided with the following extract from the draft financial statements for the year ended 31 March 2013:

	2013 HK\$'000	2012 HK\$'000
Trade payables	7,010	10,909

A summary of the results of your testing is shown below:

- 48 payments tested, with a total value of HK\$1,827,910
- 43 payments satisfactorily tested:
  - Agreed to correct amounts on invoice and dates on delivery notes
  - Date of supply of goods/services agreed as occurring on or before 31 March 2013
  - Agreed to cash book
  - Traced to list of accounts payable at 31 March 2013 and amount correctly included
- 5 payments were found to have errors when testing, as follows:

Supplier	Date paid on bank statement	Amount HK\$	Description of error
Wing Hong Engineering Co	5/4/13	7,615	Not included in accounts payable at 31 March 2013, services received 4 March 2013
Lee Wah Parts & Services Co	12/4/13	10,109	Not included in accounts payable at 31 March 2013, services received 1 Feb 2013
Kowloon Kitchen Co	22/4/13	200,716	Not included in accounts payable at 31 March 2013, services received 27 March 2013
Hong Kong Digital Logistics Co	22/4/12	87,417	Delivery note dated 1 April 2013
Steady Security Management Co	22/4/12	18,918	Amount shown on invoice is HK\$81,918

You have discussed these errors with the accounts payable supervisor at HKSEC who provided you with the following explanations:

- Wing Hong Engineering, Lee Wah Parts & Services, and Kowloon Kitchen: the accounts payable clerk, responsible for recording invoices received, was unwell from Friday 29<sup>th</sup> March to Thursday 4<sup>th</sup> April. These invoices were received by HKSEC on Wednesday 3<sup>rd</sup> April and left on the desk of the accounts payable clerk for when she returned to work. On her return she discovered that the accounts payable ledger for the year ending 31 March 2013 had been closed in order to allow the preparation of the year-end financial statements to begin and therefore posted the amounts to the accounts payable ledger for the year ending 31 March 2014. The accounts payable supervisor was not aware this occurred until you raised these errors.
- Hong Kong Digital Logistics: this supplier sends an invoice with each delivery and the amount was added to the accounts payable ledger for the year ended 31 March 2013 in error.
- Steady Security Management: an error had been made when setting up the online payment to this supplier on 18 April, the remaining balance due of HK\$63,000 was paid on 29 April after the supplier alerted the accounts payable clerk to the error that had occurred.

(ii) **Supplier statement reconciliations**

As part of your firm's testing of accounts payable you had planned to inspect the reconciliations, performed by the accounts payable clerk, between supplier statements sent to HKSEC by its suppliers and the amounts recorded on the HKSEC accounts payable ledger. After you had selected your sample of suppliers for testing you requested the reconciliations for those suppliers from accounts payable supervisor. AT this point he told you that the accounts payable team had been under a lot of pressure and so the reconciliations had not been performed for any suppliers since January 2013. However, the supplier statements have been retained and filed by the accounts payable clerk.

## Discussion points

### Audit area – Accounts payable

(i) **Post year-end payments**

**What is the issue?**

- Three invoices totalling HK\$218,440 were not included in the accounts payable ledger for the year indicating potential issues with cut-off
- The accounts payable clerk was away and no invoices were recorded in the payables ledger after March 29<sup>th</sup> 2013 and so there is a potential that further liabilities are unrecorded
- An invoice for Hong Kong Digital Logistics Co totalling HK\$87,417 was incorrectly included in the accounts payable ledger since the item was not received until the following period
- An invoice from Steady Security Management Co was underpaid by HK\$63k due to an error recording the invoice in the payables ledger this occurred after the period end

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

- The net effect of the cut-off errors is an understatement of HK\$131,023, a figure which is not material to revenue or total assets, but is borderline material at 6.7% of PBT
- Additionally trade payables days looks very low in the information provided from the draft financial statements at 15.4 days in 2013 compared to 27.56 days in 2012 indicating further potential for understatement of trade payables
- Further alternative audit procedures will be necessary to obtain evidence as to the completeness of year end trade payables or to ascertain the extent of any error
- The invoice from Steady Security does not relate to the period in question but the recording error needs to be noted for the following year audit in case this was not an isolated incident

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

- Ascertain from discussion with the accounts payable supervisor & clerk whether any other invoices were left on the desk of the clerk whilst she was unwell
- Agree a sample of supplier statements to the accounts payable ledger
- Review a sample of invoices entered onto the trade payables ledger just after the period end to ensure they have all been recorded in the correct period
- Review a sample of invoices entered onto the trade payables ledger near the period end to ascertain whether they have been recorded in the correct period
- Inspect correspondence to ascertain whether suppliers have chased non-payment by HKSEC and whether payments were subsequently made

- Ascertain and review the procedures in place in the accounts payable team to ensure that all invoices are recorded, especially since the accounts payable ledger is closed so soon after the period end
- Select a sample of goods received notes from the weeks before the period end and trace to invoices and amounts included on the purchase ledger to identify any errors in invoicing or incomplete recording of invoices on the purchase ledger

(ii) **Supplier statement reconciliations**

**What is the issue?**

- HKSEC has not carried out supplier statement reconciliations for the last three months of the current period end
- This increases the risk of unrecorded liabilities and the risk of individual invoice values being accounted for incorrectly
- Additionally, there is the potential for HKSEC to overpay suppliers or even make duplicate payments for the same invoice. If large amounts are overpaid this could negatively impact on cash flows

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

- Accounts payable may be misstated in the statement of financial position

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

- Ascertain and review the procedures within the accounts payable team at HKSEC to ensure that all invoices received are recorded correctly
- For a sample of suppliers, SMP can reconcile the period end supplier statements to the accounts payable ledger
- Analyse the amounts owed to a sample of individual suppliers in the trade payables listing to amounts owed to these suppliers in the previous year for reasonableness
- If necessary, SMP can carry out a confirmation of trade payables for a sample, focussing on regular suppliers who have small or zero balances on their accounts and a sample of other accounts in addition to any large balances
- For a sample of accounts payable either side of the period end, compare the actual dates of individual transactions with the dates they were recorded in the ledger to check cut-off has been applied correctly

## References

The above is based specifically 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 modify the auditor's report.

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

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

## **Learning Pack**

Chapter 13: Specific audit procedures – section 6 Trade payables and accruals

## HKSEC

### Audit area: Going concern

- (i) Letter from bank regarding overdraft and commercial loan application

#### EASTERN HONG KONG BANKING GROUP LIMITED

Mr. Phillip Chan  
Managing Director  
Hong Kong Show and Exhibition Colosseum Limited  
West Kowloon Golden Strip  
West Kowloon  
Hong Kong  
4<sup>th</sup> April 2013



Dear Mr. Chan

#### Request for overdraft facility and commercial loan

I am writing to confirm Eastern Hong Kong Banking Group's decision regarding HKSEC's recent applications to extend the company's overdraft facility and to request further finance through the provision of a commercial loan.

At present HKSEC has an overdraft facility available to it of HK\$50 million and in addition the company has a commercial loan with Eastern Hong Kong Banking Group of HK\$894,308 million which was provided in respect of the development of a hotel complex and acquisition of the Tai O Country Golf Club.

The terms of commercial loan state that HKSEC must retain a gearing ratio (debt/equity) of no more than 35%. Based on HKSEC's recent financial submissions to this bank, the gearing ratio is approximately 30%. We therefore consider that any further advance of funds or an extension in the overdraft facility would expose Eastern Hong Kong Banking Group to unnecessary risk.

It is with regret, therefore, that we cannot meet your request at this time.

*Jane Choo*

Jane Choo  
Commercial Applications Manager  
Eastern Hong Kong Banking Group

(ii) **Cancellation of events by Concert Factory Inc.**

Ms Choi, Commercial Director has provided you with a copy of a letter from its legal advisers regarding a series of events which have been cancelled by Concert Factory Inc., the promoter of “Hong Kong Gala Ball and Theatre Show Extravaganza”, due to be held at HKSEC venue throughout the month of June 2013.

**KL Legal**



Ms. Marsha Choi  
Commercial Director  
Hong Kong Show and Exhibition Colosseum Limited  
West Kowloon Golden Strip  
West Kowloon  
Hong Kong  
28 March 2013

Dear Ms. Choi

**Concert Factory Inc. event cancellation**

Thank you for our recent meeting regarding the actions available to the board of HKSEC following the cancellation of the June 2013 event schedule promoted by Concert Factory Inc. As we discussed, the reason for the cancellation was due to the forced liquidation of Concert Factory Inc. by a number of its creditors earlier this month. In brief, our main findings, having reviewed the circumstances, contract between HKSEC and Concert Factory Inc. and relevant precedents, is as follows:

1. The contract does not provide any protection to HKSEC resulting from cancellation of part or all of the events booked by Concert Factory Inc.
2. The financial circumstances of Concert Factory Inc. mean it is unlikely to have any cash to pay costs incurred by HKSEC for the event. There are a number of preferential creditors seeking to recoup monies from Concert Factory Inc.
3. HKSEC will be liable to pay refunds on tickets purchased through the HKSEC box office by individuals.

*David Brown*

David Brown  
Partner, KL Legal



Ms. Choi has also provided you with a financial summary for this event:

<b>Concert Factory Inc – Gala and theatre extravaganza</b>							
				<b>HK\$'000</b>			
<b>Contract price and payment schedule:</b>							
Contract price agreed based on Concert Factory Inc agreed specification:				<u>5,198</u>			
Payment schedule:	25% on booking	billed 8th June 2012	1,300	received 18th July 2012			
	25% 6 months before event	billed 30th Nov 2012	1,300	not received			
	50% after settlement meeting	not billed	<u>2,598</u>				
			<u>5,198</u>				
<b>External service partner contract costs to deliver contract specification:</b>							
	Security staff*		300				
	Lighting and Rigging*		498				
			<u>798</u>				
<b>Contract specification variations requested by Concert Factory Inc</b>							
	Additional security staff on specified dates*		180				
	Gala ball menu changes (HKSEC catering)		810				
	Additional staging, lighting and sound requests*		193				
			<u>1,183</u>				
*contract agreed between HKSEC and relevant service partners in October 2012, amount not yet invoice by supplier							
<b>Event ticket sales at 31 January 2013:</b>							
	Total ticket value		82,547				
	Total booking fees		4,867				
			<u>87,414</u>				

On discussion with Ms. Choi, she told you that the directors intend to include a provision of HK\$82,547,000 in the financial statements for the year ending 31 March 2013 to cover the cost of refunding event ticket sales. No refunds have yet been made.

## Discussion points

### Audit area – Going concern

(i) **Letter from bank regarding overdraft and commercial loan application**

**What is the issue?**

- The application to extend HKSEC's overdraft facility and provide a further commercial loan has been rejected as this would make HKSEC very highly geared and too risky for the bank
- The purchase of non-current and intangible assets in the year has been mainly funded via an existing loan but there has been a cash shortfall and HKSEC are exhibiting a large negative cash outflow in the 2013 statement of cash flows
- Since cash reserves have been depleted in investment projects, there may not be enough cash for the daily running of the business raising the concern that HKSEC is no longer a going concern

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

- The use of the going concern assumption in the 2013 HKSEC financial statements may not be appropriate
- SMP will need to ensure that they obtain sufficient appropriate audit evidence about the appropriateness of the use of the going concern assumption in the financial statements

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

- SMP will need to perform additional audit procedures to obtain sufficient appropriate audit evidence about the appropriateness of the use of the going concern assumption in the financial statements
- If HKSEC have not yet made a formal assessment of going concern, SMP must request they do so
- SMP must evaluate any plans relating to this assessment and assess whether they are feasible and are likely to improve the cash flow issues at HKSEC
- A review and analysis of HKSEC's cash flow forecast, if this exists, needs to be undertaken in order to assess HKSEC's plans
- SMP will need to request written representations from management regarding their plans for future action and the feasibility of these plans
- The worry over going concern means that SMP will need to revise their risk assessment and may then need to revise the timing, nature and extent of planned audit procedures accordingly

(ii) **Cancellation of events by Concert Factory Inc.**

**What is the issue?**

- A promoter has cancelled an event leaving HKSEC liable for paying contracted costs to suppliers and refunds to customers
- A provision has been made in the financial statements but this seems to be calculated incorrectly
- The ticket value due for refund is HK\$82,547k but cash balances at HKSEC only total HK\$1,908k at 31 March 2013
- Internal controls seem to have failed as monies due to promoters should have been kept untouched in a separate bank account
- If HKSEC is unable to pay customer refunds, the company may no longer be a going concern

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

- The proposed provision is 43% of revenue and so is material to the financial statements
- The provision does not include amounts contracted to be paid to suppliers totalling HK\$1,171k which seem to be an unavoidable obligation
- The internal catering cost of HK\$810k has been correctly excluded from the provision as there is no present obligation to provide this service
- The booking fees of HK\$4,867k will need to be refunded to customers and should have been included in the provision
- The total ticket value of HK\$82,547k will need to be refunded to customers but cash from ticket sales should have been kept separately enabling HKSEC to do this
- If HKSEC cannot obtain sufficient cash to pay the refund to customers and the other related costs to suppliers it may not be a going concern and this will either mean doubts over going concern will need to be disclosed in the financial statements or the financial statements will need to be prepared 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 HKSEC?**

- SMP will need to discuss with directors the likelihood of having to pay the contracted amounts to the external service partners in order to assess whether there will be a probable transfer of economic benefits
- They can then check post period end bank statements for any evidence of these contracted amounts being paid and review correspondence with the external service partners to assess the likelihood of payment being made
- SMP should check that a specific bank account exists for the 'New Year event extravaganza'
- If so, SMP could trace a sample of ticket sales for the 'New Year event extravaganza' to the event specific bank account

- SMP could also check that no monies have been paid out of the event specific bank account to Concert Factory Inc in line with HKSEC control procedures
- If monies have been paid out of the bank account, SMP will need to enquire of management where these have been paid to and why
- If HKSEC have not kept cash from ticket sales due to Concert Factory Inc separate as per their internal controls, SMP should evaluate whether their assessment of the risks of material misstatement at the assertion level remain appropriate and modify audit procedures accordingly
- They will also need to perform additional audit procedures to obtain sufficient appropriate audit evidence about the appropriateness of the use of the going concern assumption in the financial statements given that HKSEC may not have enough cash to pay the customer refunds
- The adequacy of the disclosure of the provision will need to be checked once SMP are satisfied with its amount

## References

The above is based on the following auditing standards:

**HKSA 570 (Clarified) *Going Concern*** states that the objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
- (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (c) To determine the implications for the auditor's report.

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

- (a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- (b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:
  - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

- (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the above procedures, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks.

### **Learning Pack**

Chapter 13: Specific audit procedures – section 9 Audit of provisions

Chapter 16: Overall audit review and finalisation – section 2 Going concern

## HKSEC

### Draft financial statements

You have been provided with a copy of the draft financial statements for HKSEC for the year ending 31 March 2013.

#### Required

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

#### Key questions/approach for analytical procedures at the review stage

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

DRAFT

#### STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 2013

	Note	2013 HK\$'000	2012 HK\$'000
Revenue	1	191,976	189,225
Cost of sales		(165,997)	(144,456)
Gross profit		25,979	44,769
Administrative expenses		(19,318)	(22,352)
Operating profit		6,661	22,417
Finance costs	1	(4,713)	(1,789)
Profit before taxation		1,948	20,628
Taxation		(300)	(3,167)
Profit for the year		1,648	17,461

DRAFT STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2013

	<i>Note</i>	<i>2013</i>		<i>2012</i>	
		HK\$'000	HK\$'000	HK\$'000	HK\$'000
<b>ASSETS</b>					
<i>Non-current assets</i>					
Intangible assets	2	219,541		-	
Property, plant and equipment	3	<u>4,654,500</u>		<u>1,782,062</u>	
			4,874,041		1,782,062
 <i>Current assets</i>					
Inventories		19,219		16,147	
Prepayments		7,879		21,717	
Trade receivables	4	15,987		19,309	
Cash and bank balances		<u>1,908</u>		<u>286,485</u>	
			44,993		343,658
<b>Total Assets</b>			<u><u>4,919,034</u></u>		<u><u>2,125,720</u></u>
 <b>EQUITY AND LIABILITIES</b>					
<i>Equity</i>					
Issued share capital		2,000,000		2,000,000	
Revaluation reserve		1,854,532		-	
Accumulated profit		<u>37,313</u>		<u>68,410</u>	
			3,891,845		2,068,410
 <i>Non-current liabilities</i>					
Long term borrowings			930,975		36,667
 <i>Current liabilities</i>					
Trade and other payables	5	10,119		14,543	
Taxation payable		3,548		6,100	
Provisions	6	<u>82,547</u>		-	
			96,214		20,643
<b>Total equity and liabilities</b>			<u><u>4,919,034</u></u>		<u><u>2,125,720</u></u>

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 2013

	<i>Issued share capital</i>	<i>Revaluation reserve</i>	<i>Accumulated profit</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Balance as at 1 April 2012	2,000,000	-	68,410	2,068,410
Profit for the year	-	-	1,648	1,648
Revaluation in year	-	1,854,532	-	1,854,532
Distributions to owners - dividends			<u>(32,745)</u>	<u>(32,745)</u>
Balance as at 31 March 2013	<u><u>2,000,000</u></u>	<u><u>1,854,532</u></u>	<u><u>37,313</u></u>	<u><u>3,891,845</u></u>

## STATEMENT OF CASH FLOWS AS AT 31 MARCH 2013

	2013		2012	
	HK\$'000	HK\$'000	HK\$'000	HK\$'000
<i>Profit before taxation</i>		1,948		20,628
Adjustments for:				
Depreciation	127,239		94,917	
Interest expense	<u>4,713</u>		<u>1,789</u>	
		131,952		96,706
Increase in inventory	(3,072)		(363)	
Decrease/(Increase) in trade receivables	3,322		(2,086)	
Decrease/(Increase) in prepayments	13,838		(256)	
(Decrease)Increase in trade and other payables	(4,424)		2,236	
Increase in provisions	<u>82,547</u>		<u>-</u>	
		<u>92,211</u>		<u>(469)</u>
<i>Cash generated from operations</i>		226,111		116,865
Interest paid	(4,713)		(1,789)	
Income taxes paid	<u>(2,852)</u>		<u>(4,191)</u>	
		<u>(7,565)</u>		<u>(5,980)</u>
<i>Net cash from operating activities</i>		218,546		110,885
<i>Cash flows from investing activities</i>				
Purchase of goodwill, patents, property, plant & equipment	(1,366,420)		(49,887)	
Proceeds from disposal of property, plant and equipment	<u>1,734</u>		<u>18,200</u>	
<i>Net cash used in investing activities</i>		(1,364,686)		(31,687)
<i>Cash flows from financing activities</i>				
Increase in long term borrowings	894,308		-	
Distributions to owners	<u>(32,745)</u>		<u>(34,253)</u>	
<i>Net cash from financing activities</i>		<u>861,563</u>		<u>(34,253)</u>
<i>Net (Decrease)/Increase in cash</i>		<u>(284,577)</u>		<u>44,945</u>



## Notes to financial statements for the year ended 31 March 2013

### 1 ACCOUNTING POLICIES

#### 1.1 Basis of preparation

The financial statements for the year ended 31 March 2013 are prepared on the historical cost basis.

#### 1.2 Revenue

Revenue comprises the amounts earned from rental of exhibition, conference, meeting and concert spaces and associated services supplied to customers in the ordinary course of business. Income is also earned from the leasing of restaurant premises inside HKSEC's venue to third parties.

Revenue is recognised on the date on which a conference, exhibition, show or other event is held. Any deposits received from customers at the year end date relating to events due to be held after the year end are deferred and included within trade and other payables.

Annual membership revenues generated from the Tai O Country Golf Club are recognised in the periods to which they relate.

#### 1.3 Finance costs

Finance costs comprise interest expense on borrowings.

#### 1.4 Intangible assets

##### (i) Goodwill

Goodwill represents amounts arising on acquisition of subsidiaries and is the difference between the fair value of consideration paid and the net fair value of identifiable assets and liabilities. Goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but tested annually for impairment.

##### (ii) Patents

Patents are initially recognised at cost and are then revalued to the present value of the future income streams expected to be derived over the life of the patent. Amortisation is charged on a straight line basis over the life of the patent.

#### 1.5 Property, plant and equipment

Properties are stated at their revalued amount less accumulated depreciation. Items of plant and equipment are stated at cost less accumulated depreciation. Depreciation is provided at rates calculated to write off the cost of non-current assets, less their estimated residual value, over their expected useful lives on the following bases:

Land and buildings	– 50 years
Leasehold improvements	– 15% or over the remaining term of the lease, whichever is shorter
Plant and machinery	– 12% straight line
Motor vehicles	– 20% straight line
Fixtures, fittings, computer and office equipment	– 20% straight line

## 1.6 Inventories

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

## 1.7 Trade receivables

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

## 1.8 Prepayments

Prepayments represent deposits and advance payments to suppliers for future supply of contracted event services. The credit-worthiness of suppliers is monitored in order to assess the recoverable amounts of prepayments and amounts are written down when evidence is obtained of future services not being received according to the original terms.

## 1.9 Trade and other payables

Trade and other payables include amounts owed to suppliers, accruals and deferred income representing monies received from customers in advance of the date of their event.

## 1.10 Provisions

A provision against potential future refunds relating to a series of gala balls and theatre shows has been made. HKSEC board of directors believe a present obligation has arisen as a result of the cancellation of the events by HKSEC's customer when the customer was forced into liquidation in January 2013 and cancelled the events due to take place during June 2013. It is probable that ticket holders will claim refunds for the amount of their tickets directly from HKSEC.

## 2 INTANGIBLE ASSETS

	<i>Goodwill</i> HK\$'000	<i>Patents</i> HK\$'000	<i>Total</i> HK\$'000
<i>Cost/Revalued amount</i>			
At 1 April 2012	-	-	-
Additions	67,290	1	67,291
Revaluation	<u>-</u>	<u>174,000</u>	<u>174,000</u>
At 31 March 2013	<u>67,290</u>	<u>174,001</u>	<u>241,291</u>
<i>Amortisation and impairment losses</i>			
At 1 April 2012	-	-	-
Amortisation for year	<u>-</u>	<u>21,750</u>	<u>21,750</u>
At 31 March 2013	<u>-</u>	<u>21,750</u>	<u>21,750</u>
<i>Carrying amount</i>			
At 31 March 2013	<u>67,290</u>	<u>152,251</u>	<u>219,541</u>
At 31 March 2012	<u>-</u>	<u>-</u>	<u>-</u>

### 3 PROPERTY, PLANT AND EQUIPMENT

	<i>Land and buildings</i> HK\$'000	<i>Computer equipment</i> HK\$000	<i>Fixtures, fittings and equipment</i> HK\$'000	<i>Assets under construction</i> HK\$'000	<i>Total</i> HK\$'000
<i>Cost</i>					
At 1 April 2012	1,978,442	117,187	172,210	-	2,267,839
Additions	236,544	17,781	28,686	1,016,118	1,299,129
Disposals	-	(10,141)	(10,917)	-	(21,058)
Revaluation	<u>1,365,532</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,365,532</u>
At 31 March 2013	<u><u>3,580,518</u></u>	<u><u>124,827</u></u>	<u><u>189,979</u></u>	<u><u>1,016,118</u></u>	<u><u>4,911,442</u></u>
<i>Depreciation &amp; impairment</i>					
At 1 April 2012	399,220	53,420	33,137	-	485,777
Charge for the year	40,497	27,242	37,750	-	105,489
Disposals	-	(9,105)	(10,219)	-	(19,324)
Revaluation	<u>(315,000)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(315,000)</u>
At 31 March 2013	<u><u>124,717</u></u>	<u><u>71,557</u></u>	<u><u>60,668</u></u>	<u><u>-</u></u>	<u><u>256,942</u></u>
<i>Carrying Amount</i>					
At 31 March 2013	<u><u>3,455,801</u></u>	<u><u>53,270</u></u>	<u><u>129,311</u></u>	<u><u>1,016,118</u></u>	<u><u>4,654,500</u></u>
At 31 March 2012	<u><u>1,579,222</u></u>	<u><u>63,767</u></u>	<u><u>139,073</u></u>	<u><u>-</u></u>	<u><u>1,782,062</u></u>

### 4 TRADE RECEIVABLES

	2013 HK\$'000	2012 HK\$'000
Gross trade receivables	15,472	21,939
Less: Allowance for receivables	<u>(572)</u>	<u>(4,827)</u>
	14,900	17,112
Accrued revenue	<u>1,087</u>	<u>2,197</u>
Trade receivables	<u><u>15,987</u></u>	<u><u>19,309</u></u>

### 5 TRADE AND OTHER PAYABLES

	2013 HK\$'000	2012 HK\$'000
Trade payables	7,010	10,909
Accruals, deferred income and customer deposits received in advance	<u>3,109</u>	<u>3,634</u>
	<u><u>10,119</u></u>	<u><u>14,543</u></u>

## 6 PROVISIONS

	2013	2012
	HK\$'000	HK\$'000
Provision for customer refunds of New Year gala balls and theatre shows	<u>82,547</u>	<u>-</u>

The amount provided has been based on the value of tickets sold by HKSEC to customers for the 'Gala Ball and Theatre Show Extravaganza' cancelled by a HKSEC customer.

# Student Notes

## Module C (June 2013) Workshop 2 – Exercise 11.1 Audit Completion

### Discussion points

### Analytical procedures at the completion stage

Observation	Potential issues	Further investigations/actions
Revenue has increased by 1.5% from 2012 to 2013 even though external economic factors have resulted in increased cancellations, a reduction in repeat business and increased pressure on HKSEC to lower event charges	Revenue may be overstated Cut-off of revenue was identified as an issue during the audit execution phase	Discuss the reasons for the increase with management Consider further extending cut off testing to ensure no revenue has been recognised from events taking place in the period ended 31 March 2014
Administrative expenses have fallen by 13.6% and represent 10.1% of revenue in 2013 compared to 11.8% in 2012	Administrative expenses may be understated and this may also indicate the inappropriate capitalisation of some costs (e.g. director's salary)	HKSEC need to investigate the reason for the fall, especially since there is potential for management bias due to HKSEC using the financial statements when applying for another new loan If not already carried out at the execution stage, consider performing cut-off testing over administrative expenses
Finance costs were 4.9% of long term borrowings in 2012 but have fallen to 0.5% of long term borrowings in 2013	Finance costs may be understated	Review loan agreements for the new loan taken out in the period and identify the relevant interest rate and timing of loan Discuss with management the finance costs in the statement of comprehensive income compared to those in the loan statement if inconsistencies are found

# Student Notes

## Module C (June 2013) Workshop 2 – Exercise 11.1 Audit Completion

Observation	Potential issues	Further investigations/actions
The average depreciation rate for land and buildings during the year is 1.1% but this seems low as the rate is 2%	Depreciation of land and buildings may be understated resulting in an overstatement of non-current assets in the statement of financial position	Reperform calculation of depreciation of land and buildings to ensure it is correct For revalued assets check that the depreciation has been calculated using the revalued amount
Gross trade receivables have fallen by 29.5% from 2012 to 2013. Trade receivables days have fallen from 33 days to 28.3 days. Accrued revenue has fallen by 50% over the same period	Possible errors in recording of trade receivables and accrued revenue, especially as cut-off has been an issue in the audit execution phase Errors in the recording of receivables were also found by internal audit at HKSEC earlier in the period It may also be an indication of the cash flow issues experienced by HKSEC leading them to collect receivables more quickly	Carry out increased testing on completeness of receivables For a sample of events, agree the contracted amounts to invoices and check the invoices have been recorded in the correct period in ledger Ascertain from the sales ledger department whether there has been a drive to collect receivables balances more quickly
The allowance for receivables was 22% of gross trade receivables in 2012 but this has fallen to 3.7% of gross trade receivables in 2013	The trade receivables allowance may be understated resulting in an overstated trade receivables balance on the statement of financial position. Profit may also be overstated as a result	Investigate and compare the calculations of both years allowances for reasonableness Review the aged receivables listing and for a sample of old receivables, obtain further information regarding their recoverability by discussions with management and review of customer correspondence
Prepayments, which represent deposits and advanced payments to suppliers, have fallen by 64% from 2012 to 2013 and Cost of sales has increased by 15% from 2012 to 2013	Prepayments may be understated with a corresponding overstatement of cost of sales Audit execution work identified an issue with cut-off in several areas and this may be a potential issue for prepayments	Obtain a breakdown of prepayments and agree a sample of prepayments to supporting documentation, ensuring the prepayment has been calculated correctly For a sample of invoices paid before the

# Student Notes

## Module C (June 2013) Workshop 2 – Exercise 11.1 Audit Completion

Observation	Potential issues	Further investigations/actions
Trade payables days has decreased from 27.6 days in 2012 to 15.4 days in 2013	<p>This may indicate an understatement of trade payables</p> <p>Trade payables were identified as an issue during audit execution work which found issues with cut-off of trade payables and also that supplier statements were not reconciled for the last three months of the year</p> <p>It is unlikely HKSEC is paying its suppliers more quickly given the cash flow difficulties at the company unless suppliers are concerned about HKSEC's ability to pay and are therefore not extending the same amount of credit to them as previously</p>	<p>period end, agree to invoices to check the invoices have been expensed in the correct period</p> <p>Discuss with accounts payable whether the speed with which suppliers are paid has changed. If there is no evidence to support this change discuss the reason for the fall in the ratio with management</p> <p>Consider carrying out further audit procedures or extending samples over trade payables (in addition to additional procedures carried out at the audit execution phase) focussing on cut-off testing</p>



## Audit completion

### Management forecasts

You have just received the following email from the engagement manager in charge of the HKSEC audit during the completion phase of the audit:

#### HKSEC going concern issues

**From:** HKSEC Engagement Manager

**To:** HKSEC audit team

**Attached:** HKSEC cash flow forecast to 31 March 2014.xls

Dear team,

We are finalising our audit work and yet continue to have some doubts over the viability of HKSEC as a business and whether the going concern presumption is appropriate. As part of our completion considerations I have requested that the directors of HKSEC provide us with a cash flow forecast for the 12 months to 31 March 2014. I am attaching this for you. Please can you review the forecast prepared by the directors, in particular considering:

- Whether HKSEC can meet its debts as they fall due
- Whether HKSEC is likely to breach any of its banking covenants
- The appropriateness of the assumptions used by management in preparing the forecast

Using your review of the cash flow forecast and other audit evidence we have obtained, please conclude as to what you consider to be the most appropriate basis for preparation of the financial statements for HKSEC for the year ended 31 March 2013 and whether you consider that any additional disclosures are required.

Thank you

### Required

Prepare a response to the manager's email.

# Student Notes

## Module C (June 2013) Workshop 2 – Handout 11.2 Audit Completion

### HKSEC

#### Cash Flow Forecast - 12 Months to 31 March 2014

Month:	2013					2014					Totals		
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan		Feb	Mar
<b>Receipts</b>													
Cash receipts from box office	25,678	28,667	34,978	31,989	28,901	35,209	41,987	42,718	44,017	21,900	18,019	27,081	<b>381,144</b>
Cash receipts from sale of FlexPod services	0	2,300	2,500	2,700	2,700	2,800	2,800	2,800	2,800	2,800	2,800	2,800	<b>29,800</b>
Cash receipts from hotel						50,625	50,625	50,625	50,625	50,625	50,625	50,625	<b>354,375</b>
Collection from venue credit sales	11,987	16,917	18,616	19,091	16,920	18,101	19,715	19,816	18,616	19,017	19,614	19,861	<b>218,271</b>
Collection of annual golf club membership fees	1,200	1,754	2,109	2,754	3,125	3,125	3,125	3,125	3,125	3,125	3,125	3,125	<b>32,817</b>
Loans received				900,000									<b>900,000</b>
<b>Total Receipts</b>	<b>38,865</b>	<b>49,638</b>	<b>58,203</b>	<b>956,534</b>	<b>51,646</b>	<b>109,860</b>	<b>118,252</b>	<b>119,084</b>	<b>119,183</b>	<b>97,467</b>	<b>94,183</b>	<b>103,492</b>	<b>1,916,407</b>
<b>Payments</b>													
Payments to suppliers													<b>0</b>
Settlements with promoters	10,817	0	0	20,191	27,819	23,019.00	21,871	29,161	35,161	32,910	37,181	12,717	<b>250,847</b>
Refunds Concert Factory tickets	32,983	21,989	16,491										<b>71,463</b>
Staff costs	4,635	4,635	4,635	4,635	4,635	4,635	4,635	4,635	4,635	4,635	4,635	4,635	<b>55,620</b>
Utilities & maintenance	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	<b>60,000</b>
Administration and marketing costs	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	<b>14,400</b>
Bank interest and charges	46,548	46,548	46,548	70,000	70,000	70,000	70,000	70,000	70,000	70,000	70,000	70,000	<b>769,644</b>
Dividends													<b>0</b>
Capital purchases - hotel construction				337,500			337,500						<b>675,000</b>
<b>Total Payments</b>	<b>101,183</b>	<b>79,372</b>	<b>73,874</b>	<b>438,526</b>	<b>108,654</b>	<b>103,854</b>	<b>440,206</b>	<b>109,996</b>	<b>115,996</b>	<b>113,745</b>	<b>118,016</b>	<b>93,552</b>	<b>1,896,974</b>
<b>Cashflow Surplus/Deficit (-)</b>	<b>-62,318</b>	<b>-29,734</b>	<b>-15,671</b>	<b>518,008</b>	<b>-57,008</b>	<b>6,006</b>	<b>-321,954</b>	<b>9,088</b>	<b>3,187</b>	<b>-16,278</b>	<b>-23,833</b>	<b>9,940</b>	<b>19,433</b>
<b>Opening Cash Balance</b>	<b>1,908</b>	<b>-60,410</b>	<b>-90,144</b>	<b>-105,815</b>	<b>412,193</b>	<b>355,185</b>	<b>361,191</b>	<b>39,237</b>	<b>48,325</b>	<b>51,512</b>	<b>35,234</b>	<b>11,401</b>	
<b>Closing Cash Balance</b>	<b>-60,410</b>	<b>-90,144</b>	<b>-105,815</b>	<b>412,193</b>	<b>355,185</b>	<b>361,191</b>	<b>39,237</b>	<b>48,325</b>	<b>51,512</b>	<b>35,234</b>	<b>11,401</b>	<b>21,341</b>	

#### Assumptions:

FlexPod sales commence in April 2013  
 Concert Factory cancelled event is replaced through aggressive marketing  
 Hotel occupancy at 90%  
 Return golf club membership to maximum by August 2013  
 New loan approved in July  
 Growth in venue business of 15%

## Discussion points

### Audit completion

#### Management forecasts

**From:** HKSEC audit team

**To:** HKSEC Engagement Manager

**Re:** HKSEC going concern issues

Dear Engagement Manager

I have reviewed the HKSEC cash flow forecast as requested in your previous email. Please find here the results of the review.

#### 1. Appropriateness of assumptions used by management

##### New loan approval

- HKSEC has included the approval of a HK\$900m loan in the cash flow forecast but audit work found that a recent loan application was refused and unlikely to be granted under the current circumstances
- The forecast loan accounts for 47% of the total forecast cash receipts for the 12 months to 31 March 2014. Of all the assumptions made, the loan assumption seems to have the largest impact on forecast cash balances. Without the loan, HKSEC will have a net cash flow deficit of HK\$880,567k <sup>Note</sup> for the year ended 31 March 2014  
*(Note: This deficit included the bank interest and charges related to the loan for easy demonstration. The net cash flow deficit status would not change significantly without it.)*
- Additionally the forecast bank interest charge does not seem to increase significantly enough given the size of the loan

##### FlexPod

- The patent for FlexPod was awarded in March 2013. In the cash flow forecast, HKSEC have assumed that by May 2013, the company will have been able to manufacture 4 FlexPod units and bring these to market. This seems unfeasibly quick
- This cash flow forecast does not reconcile to one we were given by management earlier in the audit. In the discounted cash flow we were given for the FlexPod patent valuation, management claimed that FlexPod would generate cash flows of HK\$28,800k in year 1, yet in this cash flow forecast, cash receipts are HK\$1m higher at HK\$29,800k for the year
- Information given to us by management during the audit, claims that each FlexPod unit will be used for 120 events per annum, generating cash inflows of HK\$60k per event. Under this cash flow forecast, each FlexPod would need to be used 124 times in the year to generate the proposed cash inflows of HK\$29,800k  $((29,800/60)/4 = 124)$ . This seems even more unrealistic as management forecast FlexPod will only generate cash receipts for 11 months of the first year

## Concert Factory event being replaced by aggressive marketing

- HKSEC have assumed that the cancelled Concert Factory Event will be replaced through aggressive marketing. However, marketing costs do not reflect this and are static throughout the twelve months of the cash flow forecast
- It seems unlikely that HSKEC will be able to find a promoter willing to schedule an event for the entire month of June at such late notice. Should such a promoter be found, the promoter's buying power will be able to drive down the price making it unlikely that HKSEC replace all income lost from the cancellation

## Cash receipts from hotel

- HKSEC have forecast the hotel to open as originally planned in September 2013, even though audit work has found that construction is running late
- HKSEC have assumed the hotel will have 90% occupancy rates from opening but we have no information backing this. The assumption also does not seem to take into account that occupancy rates will fluctuate throughout the year and will be affected by scheduled events, national holidays etc. The occupancy rate seems high but may be realistic if it is based on bookings already taken.

## Golf club membership

- Golf club membership has been forecast to return to maximum by August 2013 but management have not yet provided any evidence to base this upon
- Audit procedures uncovered that the golf course was not being maintained to the previous high standards and has been damaged in part by building works. We will need to see evidence that the course is being repaired and members are returning before agreeing this assumption is appropriate

## Growth in venue business of 15%

- Work carried out when identifying inherent risks found that market conditions are deteriorating in the venue business. There are less events at HKSEC as customers are scaling back spending and an increase in competitive tendering has driven down prices
- This assumption seems particularly unrealistic and it is unlikely management will be able to support the assumption with adequate evidence

## Payments to suppliers

- No payments to suppliers have been included in the cash flow forecast which is clearly an omission

## Dividends

- HKSEC have forecast that the company will not be paying dividends in the year even though dividends have been paid to shareholders for the last two years. Steady dividends are of importance to New Hung Kee Property Investment who own one third of the shares in HKSEC
- Further evidence will be required before a conclusion on the reasonableness of this assumption is reached

## Settlements with promoters

- No settlements are forecast to be paid in May or June which seems unrealistic looking at the actual and forecast cash receipts from the box office for the preceding months

**Conclusion:** Overall, the assumptions seem unrealistic given the information we currently have. In some cases, we may be able to find evidence to support the assumptions before concluding. However, unless management are able to provide adequate support for **all** the unrealistic assumptions underlying the forecast, I would conclude they are **not reliable**.

## 2. Is HKSEC likely to breach any of its banking covenants?

To date we have only be made aware of one banking covenant - that HKSEC does not exceed a 30% gearing ratio. HKSEC has a gearing ratio of 24% (debt/equity) as per the draft financial statements for the period ending 31 March 2013. If in the unlikely circumstance the company is granted a loan application in July as forecast, then the banking covenant will be broken. If the loan is not granted, the cash flow deficit in the year will have to be financed via an overdraft and again the covenant will be broken.

For completeness, SMP will need to examine loan agreement documentation to ascertain whether there are any other covenants which HKSEC are forecast to break.

**Conclusion:** HKSEC will be breaking its loan covenant agreement in the period following that currently being audited.

## 3. Will HKSEC be able to meet debts as they fall due?

SMP will need written confirmation from the bank as to whether a loan application has been successful since the period end, however unlikely this seems. If, as suspected, the loan application has been refused, it seems highly unlikely that HKSEC will be able to meet debts as they fall due.

In addition the refunds due on the ticket purchases of the cancelled Concert Factory event are likely to fall due before the receipt of the loan (if it is forthcoming), as well as before large interest payments in April, May and June 2013. It is not clear how HKSEC plan to fund these amounts falling due.

**Conclusion:** HKSEC seem unlikely to be able to meet debts as they fall due. A material uncertainty exists that casts significant doubt on the entity's ability to continue as a going concern and therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business.

## 4. Appropriate basis for the preparation of financial statements

The use of the going concern assumption is not appropriate in the financial statements of HKSEC as conditions cast significant doubt upon the entity's ability to continue as a going concern.

HKSEC will therefore need to prepare financial statements on an alternative basis. The alternative basis chosen must be acceptable under Hong Kong Financial Reporting Standards.

## 5. Additional disclosures

HKSEC must disclose the fact that it has not prepared financial statements on a going concern basis, together with the basis on which it prepared the financial statements and the reason why HKSEC is not regarded as a going concern

SMP will be able to express an unmodified opinion on financial statements prepared on an alternative basis, provided there is adequate disclosure but may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report to:

- (a) the alternative basis of preparation used; and to
- (b) draw attention to the note in the financial statements that discloses the matter

Kind regards

HKSEC audit team

## References

**HKAS 570 (Clarified) *Going Concern*** provides guidance to auditors in this area. The objectives of the auditors are:

- (a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
- (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (c) To determine the implications for the auditor's report.

Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action the auditor must:

- (i) Evaluate the reliability of the underlying data generated to prepare the forecast; and
- (ii) Determine whether there is adequate support for the assumptions underlying the forecast.

Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

If the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (for example, liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use

It is also worth reviewing the requirements of **HKAS 1, *Presentation of Financial Statements***, which states that when preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of

material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

## **Learning Pack**

Chapter 16: Overall audit review and finalisation

## Dragon Tattoo Co Limited

Dragon Tattoo Co Limited (Dragon) is a Hong Kong based producer of water sports equipment including surfboards, water-skis, windsurfing boards and kayaks. Products are sold under the company name locally and Dragon also holds licences with overseas companies to produce branded sports equipment.

You are the external auditor for Dragon for the year ended 31 March 2013.

During the audit, you learnt that there were issues with unexpected staff absences in the accounting department prior to the period end. In December 2012, the accounts assistant was involved in a water-ski accident and was unable to work for 12 weeks. Unfortunately, this coincided with the financial controller being hospitalised for 8 weeks following a gas explosion at an off-site training course.

The finance director described to you how he had hired and trusted temporary workers from a reputable agency in their absence. He was therefore shocked to discover the temporary accounts assistant had accidentally deleted the entire non-current asset register master files two weeks before the period end but failed to tell anyone until queried on 1 April 2013. The accounting system at Dragon automatically backs up daily and retains seven days of backups before these are overwritten by the next daily back up.

Despite several attempts it had not been possible to reconstruct or recover the non-current asset register master files. Tests of controls over non-current assets were not carried out during the interim audit work this year.

At 31 March 2013, the carrying amount of non-current assets on the statement of financial position was HK\$87m.

Total assets of Dragon at 31 March 2013 are HK\$425m and the profit before tax for the period ended 31 March 2013 is HK\$186m.

### Required

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



## **Hornet Tattoo Co Limited**

Hornet Tattoo Co Limited (Hornet) is a manufacturer of home healthcare equipment based in Hong Kong. Products include pill boxes, canes, shower chairs and commodes and these are sold directly to retailers in Hong Kong and mainland China. As the population has aged, demand for Hornet's products has increased.

In previous years, Hornet was limited to selling locally due to stringent regulation covering healthcare equipment. However, in January 2012 the European Union (EU) agreed that ten of Hornet's products complied with EU directives for medical devices allowing Hornet to sell those products in all EU countries. Hornet expanded quickly following the agreement and revenues from EU sales have been rapidly growing each month.

You are the external auditor of Hornet for the year ended 31 March 2013.

Audit work has shown the company is highly geared. The company took out a bank loan in January 2012 to aid with the expansion but an application to extend the loan was rejected twice in 2013. You have noticed that salaries have not been paid post period end, and the statement of financial position shows net current liabilities of HK\$25m at 31 March 2013.

After additional audit procedures were carried out, you concluded that Hornet is overtrading and that there is significant doubt about Hornet's ability to continue as a going concern. The directors at Hornet strongly deny any problems and cite the company's growing revenues as an indicator of its success.

They have refused to include a statement highlighting the significant doubt over Hornet's ability to continue as a going concern and have dismissed the auditor's concerns as ludicrous.

### **Required**

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

## Discussion points

### Audit reporting

#### Dragon Tattoo Co Limited

##### Impact on auditor's report

- Tests of controls were not carried out during this period and so the audit firm needed to carry out substantive testing of non-current assets in order to obtain sufficient and appropriate audit evidence
- However, the audit firm was unable to carry out any substantive testing on non-current assets as the non-current asset register was destroyed and it was too late to retrieve a backup
- Non-currents assets are a material figure on the statement of financial position being 20% of total assets and 47% of profit before tax
- Since the audit firm has been unable to substantiate the non-current asset figure, this represents a material inability to obtain sufficient appropriate audit evidence
- The auditor's report needs to be qualified on the basis that this is material but not pervasive
- As the report has been qualified, the auditors must use the heading "Qualified Opinion" for the opinion paragraph
- The auditors shall also include a paragraph providing a description of the matter giving rise to the qualification and a quantification of the financial effects
- This shall be inserted immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion"

##### Reference

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.

HKSA 705 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

## Hornet Tattoo Co Limited

### Impact on auditor's report

- Hornet is experiencing severe cash flow difficulties which have been exacerbated by the refusal of the bank to extend the loan
- The company is overtrading and is currently exhibiting a net current liability position
- These conditions collectively cast significant doubt as to the going concern status of the company
- The directors at Hornet have dismissed the concerns of the auditors and have refused to amend the financial statements to disclose the significant doubt as to the going concern status of the company
- The auditors have obtained sufficient, appropriate audit evidence regarding the appropriateness of the director's use of the going concern assumption in the financial statements through the performance of additional audit procedures
- In the auditor's judgement, the use of the going concern assumption in the financial statements of Hornet is inappropriate, and so the auditor must express an adverse opinion in the auditor's report
- The auditors must include a paragraph in the auditor's report which describes the basis for the adverse opinion and states that the financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework

### Reference

The above is based on the following auditing standards:

#### HKSA 570 (Clarified) *Going Concern*

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

According to HKSA 570 (Clarified), if the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion.

As per HKSA 705 (Clarified), the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

The standard 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