

# Student Notes

## Module C (December 2012)

Session	Methodologies	Chapters covered	Students 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 – 6
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. 7 – 11
5. Audit planning	<ul style="list-style-type: none"> <li>• Case study</li> <li>• Group discussion</li> </ul>	Ch. 8, 9, 10, 11 & 12	Pg. 12 – 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>		To be released after completion of Workshop 2
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 & 15	
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	
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>		

### Discussion points

### Workshop 1 – Corporate Governance

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
<b>Shareholders: private individuals</b>	<p>Private shareholders each own a small (non-controlling) stake in BST and their individual concerns may vary significantly depending on their personal circumstances.</p> <p>Some may be holding their shares in order to benefit from a regular return on their investment through the receipt of dividends. Others may not be interested in an immediate return but could be holding the shares in order to achieve capital growth in the future. Some shareholders may also be holding the investment on a speculative basis, hoping that they will be able to make short term gains through fluctuations in the share price.</p> <p>Some, but not all, shareholders will also be interested in BST's approach to corporate and social responsibility (CSR). They will be keen to know that they are investing in a company that holds similar ethical values to themselves. This may be to the extent that they invest in a company such as BST rather than another company that has better rates of return on investment but a poorer record around CSR.</p>	<p>Despite the differing perspectives of the various private shareholders of BST shares they will all expect the board to manage the company in such a way as ensures its profitability and hence growth and increase in the company share price.</p> <p>The directors will have to carefully balance the preferences of shareholders for immediate returns (through dividends) and future capital growth (through reinvestment of profits in the company).</p> <p>In all cases the shareholders will expect the board to responsibly manage the risks associated with the business in order to assure its continued financial success. For BST, this will include responding to the risks from internet only travel websites, managing relationships with customers and suppliers and retaining BST's reputation for quality and commitment to CSR.</p> <p>Shareholders will expect BST to have published an ethical policy demonstrating its commitment to CSR; to be seen to be fulfilling that commitment and to continually update that commitment with the latest guidance and thinking on these issues.</p>
	<p>BST has opposed the move to create an independent statutory regulatory body to regulate travel operators in Hong Kong. Shareholders may be concerned that BST is not as strongly committed to</p>	<p>BST will need to fully explain to shareholders why it opposes the move to independent regulation and may need to assure them that this will not damage the reputation</p>

# Student Notes

## Module C (December 2012) Workshop 1 – Exercise 2.1 Corporate Governance

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
	CSR as it claims to be.	of the company with regards to CSR.
<b>Shareholders: Institutional investors</b>	Institutional investors can take many forms but will often consist of entities such as pension funds. As with private shareholders they may have varying objectives which will generally feature around achieving a return either through the receipt of dividends or longer term capital growth. Some institutional investors market themselves to their clients as entities that only invest in ethical and responsible businesses – therefore, like private investors, the CSR record of BST will be of importance to such shareholders.	See above
	Institutional investors are perhaps more likely to exercise their rights at company AGMs than private shareholders and will therefore be concerned with the issues that are usually raised at such meetings. They will be interested in having a say on issues such as changes to the board structure, appointment of auditors etc.	The board will be expected to run AGMs efficiently and correctly and for information regarding voting issues to be sent to shareholders at the appropriate times for their consideration.
<b>Shareholders: employees of BST, (excluding directors)</b>	Shareholders who are employees rewarded through the employee incentive programmes will have the same general concerns as private shareholders (see above). They will be particularly concerned about the strategy to move towards online sales channels as this could result in their redundancy following the closure of retail travel shops. They will also want reassurance that directors are appropriately remunerated for their roles, but that this remuneration is not excessive in relation to their own pay.	Shareholders who are employees will expect the board to adopt appropriate communications with them as set out by the corporate governance guidelines.

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
<b>Directors: Executive directors</b>	<p>The directors will (or should!) be concerned with fulfilling their fiduciary duty in their stewardship of the company. At times this will mean balancing the competing needs of all stakeholders which include themselves. They may also find that at times their own personal interests compete with those of the company around such areas as salary, bonuses, share options and the future direction and objectives of the company. In these circumstances it will be essential for the directors to apply best practice.</p> <p>As part of applying best practice, directors should adhere to recommendations and requirements for corporate governance including establishing an audit committee, including non-executive directors and implementing an independent internal audit team who report directly to the audit committee.</p>	<p>The key elements of corporate governance that the board will be expected to address are:</p> <ul style="list-style-type: none"> <li>(a) Management and mitigation of risk including the operation of an adequate and appropriate system of control. This may include appropriate internal audit functions.</li> <li>(b) Good supervision and management within set best practice guidelines so as to add to the performance of the company.</li> <li>(c) Safeguards against misuse of resources, whether human, financial, physical or intellectual.</li> <li>(d) Accountability not just to shareholders but also other stakeholders, such as employees. All shareholders should be treated equitably and the rights of stakeholders should be recognised.</li> </ul>
<b>Directors: Independent non-executive directors (INED)</b>	<p>Revised corporate governance guidance states that at least one third of the board must be independent non-executive directors on the main board for listed companies such as BST.</p> <p>As a result of their independent status, INED's should be free from conflicts of interest (unlike executive directors as noted above) and in a better position to promote the interests of shareholders and other stakeholders. Their activities are to carry out effective monitoring of the company in conjunction with equally independent external auditors on behalf of shareholders. They will be particularly interested in the results of work and investigations undertaken by the internal audit team.</p>	<p>In their role for promoting the interests of shareholders and other stakeholders, INED's will expect the members of the executive board to listen to and act upon the views expressed and recommendations made by them.</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
<b>Customers: BST retail travel shops and third party travel agents</b>	<p>Customers shopping in BST retail travel stores will have a number of concerns:</p> <ul style="list-style-type: none"> <li>• Price/value for money</li> <li>• Quality of packages or individual holiday components</li> <li>• Availability of products and flexibility in tailoring holidays to individual preferences</li> <li>• Convenience of store location</li> <li>• Shopping experience in the store</li> <li>• BST response to dealing with problems/issues (e.g. refunds policy)</li> <li>• Ethics of BST in terms of the environmental, social, human and economic impact of its activities</li> <li>• Travel safety record</li> </ul>	<p>Customers will expect the company to have systems and processes in place to assure them of both high quality products and a high quality experience when booking their holiday.</p> <p>Such processes will extend to the store design, flexibility of the in-store booking system, payment procedures, staff knowledge management with regard to holiday locations and customer service policies.</p> <p>Many customers will also expect the company to have a clear statement with respect to its corporate and social responsibility and to adhere to the guidelines it has set itself.</p>
<b>Customers: Online</b>	<p>Online customers will have similar concerns as those shopping in BST retail travel stores but in addition will be concerned with:</p> <ul style="list-style-type: none"> <li>• Ease of online shopping experience especially via a tablet computer or smartphone</li> <li>• Availability/reliability of ecommerce website</li> <li>• Security around online payments/storage of personal data</li> <li>• Cancellation policy</li> <li>• Availability of online coupons or discounts</li> </ul>	<p>Customers will expect the directors to have implemented relevant controls around the IT environment to assure them of a high quality online shopping experience.</p> <p>Customers will expect BST to have (and state) its privacy policy with respect to personal information and for the company to ensure that the website through which it sells its products has sufficient security features. Appropriate IT controls (and an appropriate control environment) will need to be in place in order to satisfy these concerns.</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
<b>Suppliers</b>	<p>Suppliers of BST include hoteliers, airlines and tour guides. They will be interested in being able to reach as wide an audience as possible so as to minimise unsold products. They will also be interested in their own profitability and so desire the best possible price for their product. They may be concerned that traditional tour operators, such as BST, cannot perform as well as internet based travel sites in relation to these criteria.</p> <p>They will also be concerned with BST's ability to pay for allotments purchased on credit as well as the company's long term viability, as this will impact on future allotments booked with them.</p> <p>Suppliers will be concerned about their own cash flow and therefore BST's policies and procedures for remitting payments due to suppliers will be of high importance.</p>	<p>Suppliers will be concerned that the directors effectively manage and govern the company in order to ensure its success and continuance.</p> <p>Suppliers will expect management to have an appropriate system of internal control in place to ensure that suppliers are paid accurately and on time.</p>
	<p>BST has a well-advertised commitment to corporate and social responsibility. Part of this includes goals relating to the environmental, social, human and economic impacts of its activities. Suppliers will therefore be concerned as to what the guidance and requirements set out by BST mean for their business and any impact on profitability.</p>	<p>Suppliers will expect to work with directors to agree on the guidance and requirements determined by BST as part of its corporate and social responsibility strategy. Terms will need to be agreed that allow BST to fulfil its commitment but that also are not overly onerous for suppliers in terms of being able to deliver the quality of holiday required by BST at the prices required.</p>

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

### References

#### Learning Pack

Chapter 1: Scope of corporate governance – section 3

Chapter 2: Corporate governance reports and practice – section 2

### BST Ltd

### Luk Brothers & Co.

### Background information and current year audit

Luk Brothers & Co. has been the external auditor of BST Ltd ('BST') for a number of years. You are an audit partner at Luk Brothers & Co. and have been the key audit partner of BST for the past seven years. During this time you have built up a strong working relationship with the directors at BST. The directors value your expertise and the professional reputation of Luk Brothers & Co. whom they regularly engage to perform non-audit work. You were therefore unsurprised to receive confirmation from BST that they would like Luk Brothers & Co. to continue as external auditor for the year ending 30 September 2012.

Shortly after this confirmation you received a call from Ms. Shanon Kei, the Chief Financial Officer at BST. Ms. Kei explained that BST was undertaking a overall review of its IT systems in order to compete better with online only travel companies. She described how this review would cover back office operations and customer relationship systems in addition to the BST customer website. Given your experience and knowledge of BST, Ms. Kei felt that Luk Brothers & Co. were best placed to perform this review. She would like you to lead the team reviewing the design and controls of the BST IT systems and present a report to the directors making recommendations for improvements.

A few days later you receive another call from Ms. Kei who is furious. Ms. Kei has been reviewing the audit engagement pack and is very angry about your proposed changes to the audit team. She is concerned that her staff will need to spend additional time on the audit in order to familiarise the new team with the business. She insists that you and the audit senior manager remain in place for the current year audit and threatens to put the audit out to tender next year if this does not happen.

### Required

Discuss whether Luk Brothers & Co. should accept the appointment to act as external auditors of BST Ltd for the year ending 30 September 2012.



### Discussion points

### Workshop 1 – Audit acceptance

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

#### Long association with audit client and familiarity threat

The key audit partner has been in place for seven years. Due to the long association, there is a significant risk to independence due to the familiarity that is likely to have built up between BST and the key audit partner over that time period. The Code of Ethics does not specify any limit on acting as engagement partner for a limited company although for a listed company such as BST (or public interest company) the limit is seven years.

The risk is further highlighted by the fact that BST wishes the key audit partner and senior audit manager to continue in those roles precisely due to the close relationships that have been built up with key members of staff.

#### Provision of non-audit services

BST regularly uses Luk Brothers & Co. to carry out non-audit work. More recently, Ms. Kei has requested that the key audit partner leads a team of Luk Brothers & Co. staff carrying out a review of the IT systems at BST.

Provision of non-audit services in addition to audit work may create a self-review, self-interest or advocacy threat. Before agreeing to provide any non-audit services, Luk Brothers & Co. must assess whether this creates a threat to independence and whether suitable safeguards can be put in place.

#### Self-review threat

In general, a self-review threat arises when a previous judgment needs to be reviewed by the auditor responsible for that judgment. The key area in which there is likely to be a self-review threat is where a firm provides additional services other than audit service to its client. In this scenario, a self-review threat may be created where BST has requested Luk Brothers & Co. to carry out a review of the IT systems and make recommendations to the directors.

As per the Code of Ethics, the following IT systems services are deemed not to create a threat to independence as long as the firm's personnel do not assume a management responsibility:

- (a) Design or implementation of IT systems that are unrelated to internal control over financial reporting;
- (b) Design or implementation of IT systems that do not generate information forming a significant part of the accounting records or financial statements;
- (c) Implementation of 'off-the-shelf' accounting or financial information reporting software that was not developed by the firm if the customization required to meet the client's needs is not significant; and
- (d) Evaluating and making recommendations with respect to a system designed, implemented or operated by another service provider or the client.

Any new overall IT system is likely to have a significant impact on the financial statements of BST. This would mean that Luk Brothers & Co. is relying on a system, as part of the audit evidence that would be gathered in future audits, which it, at least in part, has determined and made recommendations on.

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

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

### Are there any issues over management integrity?

The warning by Ms. Kei that she will put the audit out to tender unless her demands regarding the audit team are met present an intimidation threat. As Ms. Kei is the CFO of BST, this manipulative behaviour raises doubts about her integrity in this role.

If Luk Brothers & Co. concede to Ms. Kei's threats, this may suggest to Ms. Kei that she could intimidate the firm in any area of the audit which she does not agree with. Additionally, if Luk Brothers & Co. feel threatened by BST, they may be tempted to brush over any areas which they feel may be contentious.

### Are the threats or management integrity issues significant?

**Long association and familiarity threats:** This threat is significant as a reasonable and informed third party may conclude that the key audit partner's objectivity is impaired or is likely to be impaired, even if he acts with the utmost integrity.

**Provision of non-audit services:** Firms have traditionally carried out non-audit work for their clients. Provided safeguards can be applied to reduce this threat to an acceptable level, this issue is not significant.

**Self-review threat:** Moderately significant. The decision whether or not to accept the IT systems review engagement is unlikely to have any bearing on the current year external audit work and therefore does not raise an issue with respect to continuance for the year ending 30 September 2012. However, it may have a bearing on the firm's independence and objectivity for external audits undertaken in subsequent periods.

Based on the information provided it would appear there is a high likelihood that the advice provided by the firm would have a material impact on future financial statements. However, it may be possible to reduce the scope of the engagement to avoid a situation where the firm takes the final decision as to which IT system is appropriate. This along with other safeguards may mitigate the threat.

**Management integrity:** The risks arising from Ms. Kei's threats are highly significant. Ms. Kei's willingness to manipulate the firm suggest she may be willing to employ similar tactics in the event the auditor does not meet a satisfactory conclusion, in her opinion, on the financial statements of BST. In general, if management integrity issues exist, they will be highly significant and will require the firm to plan the audit to take account of the increased risk. This is likely to result in additional or extended audit procedures.

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

**Long association and familiarity threats:** This threat can be eliminated by rotating the engagement partner and also considering rotating the senior audit manager (with careful consideration as to the impact of loss of knowledge from the audit team especially as this is a concern of BST).

**Provision of non-audit services and the self-review threat:** This threat can be managed by using separate partners and engagement teams for any audit and non-audit work. Luk Brothers & Co. can also undertake an independent partner review of the audit work to ensure that the work has been performed objectively, disclose and discuss the impact on independence to those charged with governance and ensure staff are made aware of the firm's policies and procedures to prohibit them from making managerial decisions for BST.

**Management integrity:** Audit procedures can be planned and performed so as to take into account any doubts surrounding management integrity. For example, less reliance would be placed on written representations from Ms. Kei or internally generated audit evidence from her, and more reliance would be placed on externally generated evidence. However, it is doubtful that this would be enough to reduce the threat to a level that is clearly insignificant.

### Conclusion

If accepted by Ms. Kei, the rotation of the key audit partner (and possibly the audit senior manager) would appear to reduce the threats to independence and objectivity to a sufficiently low level and would not prevent Luk Brothers & Co. from accepting their continued appointment.

The provision of non-audit services and self-review threats do not pose any issues in respect of continuing with the audit engagement for the year ended 30 September 2012. However, based on the currently proposed scope it is likely that it would lead to objectivity issues for subsequent audits. The IT systems review engagement should not be accepted unless (i) the scope can be sufficiently reduced to avoid Luk Brothers & Co. making any management decisions and (ii) the suggested safeguards can be put in place.

The intimidation threat has no safeguards that can be applied to reduce the threats to an acceptable level. Even though the other threats can be managed, this alone is enough to conclude that Luk Brothers & Co. should not continue with the engagement.

### References

The above is based on the following:

#### ***HKICPA's Code of Ethics for Professional Accountants***

All members of the HKICPA are required to comply with the *Code of Ethics for Professional Accountants* which became effective as of 1 January 2011 (revised February 2012). Professional accountants are expected to demonstrate the highest standards of ethical behaviour and to act in the public interest.

A professional accountant shall comply with the following fundamental principles:

- (a) *Integrity* – to be straightforward and honest in all professional and business relationships.
- (b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

- (c) *Professional Competence and Due Care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- (d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- (e) *Professional Behaviour* – to comply with relevant laws and regulations and avoid any action that discredits the profession.

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

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

A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle.

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

Threats fall into one or more of the following categories:

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

### Reference

#### Learning Pack

Chapter 4: Code of Ethics

Chapter 7: Changes in auditor appointment

### BST Ltd

#### Board financial update

Ms. Shanon Kei, the Chief Financial Officer, is currently in the process of preparing a financial update for the board of directors, which she is required to prepare and present every month. She has provided you with some of her notes on the initial analysis to help you with your audit planning.

#### Performance

	Forecast Year to 30 Sept 2012	Interim results Six months to 30 Mar 2012	Audited financial statements Year to 30 Sept 2011
Revenue (HK\$m)	20,968	6,951	18,153
Gross profit %	7.4%	Loss	8.6%
Operating profit %	1.1%	Loss	1.1%
Profit/(loss) before tax (HK\$m)	124	(454)	163

- Continued increase in in-bound business from mainland China and outbound specialist market for Hong Kong
- Eroded margin due to difficulties in controlling costs of supply – largely hoteliers
- Increased admin spend in executing rationalisation of business processes and implementation of eCRM

#### Efficiency

	Forecast Year to 30 Sept 2012	Interim results Six months to March 2012	Audited financial statements Year to 30 Sept 2011
Average receivable collection period	20 days	29 days	23 days
Asset turnover	2.0 times	1.8 times	2.1 times

- Increased proportion of online sales has improved collection periods
- Investment in eCRM, mobile apps and other computer software offset by divestment in retail travel shop real estate

#### Liquidity

	Forecast Year to 30 Sept 2012	Interim results Six months to March 2012	Audited financial statements Year to 30 Sept 2011
Current ratio	34.8%	54.0%	30.2%
Cash and bank balances (HK\$m)	398	(186)	715

- High cash spend on investments and technology programmes

### Discussion points

### Workshop 1 – Identify inherent risks (task 1)

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
<b>At the entity level</b>		
<b>Management integrity</b>	<ul style="list-style-type: none"> <li>Possible management bias due to employee incentive scheme. Interim revenue and profit estimates seem highly optimistic.</li> <li>Integrity of management may be questioned following BST's opposition to moving away from self-regulation</li> </ul>	<ul style="list-style-type: none"> <li>The risk could potentially affect all components</li> <li>The risk arising from the employee incentive scheme is most likely to affect income statement components</li> </ul>
<b>Going concern</b>	<ul style="list-style-type: none"> <li>Possible cash flow issues as BST typically purchases allotments 12-18 months before the holiday season and customers do not generally make bookings more than 12 months in advance</li> <li>CFO financial update predicts a fall in gross profit margin from 8.6% to 7.4% in spite of significantly increased revenue</li> <li>BST is losing purchasing power with suppliers which may account for reduced gross margins. Consumer networking websites may increase pressure on BST to provide discounts and vouchers reducing margins further</li> <li>Risk of overtrading where BST is spending a significant amount of cash on IT projects – cash balances have fallen by HK\$901m in 6 months and current ratios are low (although improving) in the interim update</li> <li>BST bears all the risk of unsold allotments</li> <li>Criticism following BST's opposition to independent regulation may lead to a loss of business</li> <li>Licence withdrawal by regulators if BST does not follow regulations would mean BST can no longer operate</li> </ul>	<ul style="list-style-type: none"> <li>Would potentially affect all components and financial statement assertions if BST not considered to be a going concern</li> </ul>

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
<b>Group financial statements</b>	<ul style="list-style-type: none"> <li>Risk of error in consolidation, for example in eliminating intercompany sales, especially as Ticketmate Hong Kong Agency Ltd has a different year-end to BST</li> <li>Reliance on unknown component auditors of Ticketmate Hong Kong Agency Ltd</li> </ul>	<ul style="list-style-type: none"> <li>All components are included in the consolidation process</li> </ul>
<b>Acquisition of Ticketmate Hong Kong Agency Ltd</b>	<ul style="list-style-type: none"> <li>Accounting for the purchase of Ticketmate Hong Kong Agency Ltd in the consolidated financial statements may be inaccurate or not comply with reporting standards</li> <li>Valuation of goodwill in the financial statements</li> </ul>	<ul style="list-style-type: none"> <li>Goodwill</li> <li>Valuation</li> </ul>
<b>Foreign currency translation risk</b>	<ul style="list-style-type: none"> <li>BST usually pays for allotments in the suppliers' local currency whereas customers pay for holidays using HK\$ - large fluctuations in rates could result in BST making losses if not hedged effectively</li> <li>Errors may be made in rates used or conversion calculations - or management may be tempted to deliberately manipulate the exchange rates to increase profits</li> </ul>	<ul style="list-style-type: none"> <li>Accuracy</li> <li>Valuation</li> <li>Cost of sales</li> <li>Trade receivables</li> <li>Prepayments</li> <li>Trade and other payables</li> </ul>

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
<b>At the assertion level</b>		
<b>Revenue</b>	<ul style="list-style-type: none"> <li>Customers pay deposits at time of booking holidays and the balance 8 weeks before departure – revenue may be overstated if these are recorded in revenue at year end but the customer date of departure is not until after year end</li> <li>Cash deposits - risk of unrecorded transactions/misappropriation</li> <li>Deposit amount may be inaccurately entered into the booking system following payment</li> <li>Website bookings may not be updated onto the main booking system accurately or may lead to cut-off issues</li> <li>The forecast revenues per the CFO financial update show an increase of 15.5% on the prior year suggesting revenue may be overstated</li> <li>Errors in data entered into the booking system could lead to incorrect amounts being charged to customers</li> </ul>	<ul style="list-style-type: none"> <li>Revenue and receivables</li> <li>Trade and other payables</li> <li>Cut-off</li> <li>Occurrence</li> <li>Completeness</li> <li>Accuracy</li> </ul>
<b>Discounts and vouchers</b>	<ul style="list-style-type: none"> <li>Possibility of inappropriate accounting for new discount, voucher and bonus schemes offered by the new eCRM</li> </ul>	<ul style="list-style-type: none"> <li>Cut-off</li> <li>Revenue</li> <li>Provisions</li> <li>Occurrence</li> </ul>
<b>Commission paid to third party travel agents</b>	<ul style="list-style-type: none"> <li>Possibility of third party travel agents manipulating figures to increase commission earned</li> <li>Risk of commission not being recorded accurately, or revenue being recorded net of commission due to the fact third party travel agents remit cash to BST after deducting commissions due</li> </ul>	<ul style="list-style-type: none"> <li>Occurrence</li> <li>Completeness</li> <li>Accuracy</li> </ul>
<b>Non-current assets</b>	<ul style="list-style-type: none"> <li>Travel retail stores reclassified as assets held for sale may not be accurately valued or classified</li> <li>Disposals of properties may not be accounted for correctly, e.g. profit or</li> </ul>	<ul style="list-style-type: none"> <li>Valuation</li> </ul>



Inherent risk	Explanation/indicators	Components and assertions affected by the risk
	loss on disposals	
<b>Intangible assets</b>	<ul style="list-style-type: none"> <li>Significant expenditure on developing the new IT systems, some costs may be inappropriately capitalised</li> </ul>	<ul style="list-style-type: none"> <li>Existence</li> </ul>
<b>Trade receivables</b>	<ul style="list-style-type: none"> <li>The CFO forecast shows receivables days for 2012 anticipated to be 20 days compared with 23 days in the prior year – this suggests a potential misstatement of trade receivables or revenue</li> <li>Risk of some debts being irrecoverable from customers</li> <li>Risk of irrecoverable debts not being adequately provided for given customers only pay a deposit with the final balance not being due until 8 weeks before departure</li> <li>Errors in the booking system may lead to customers not being invoiced or being invoiced incorrectly</li> <li>Errors in recording receipts in the booking system may increase risk of irrecoverable balances, e.g. receipts allocated to incorrect customer account</li> </ul>	<ul style="list-style-type: none"> <li>Existence</li> <li>Valuation</li> <li>Cut-off</li> </ul>

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
<b>Prepayments to suppliers</b>	<ul style="list-style-type: none"> <li>Market conditions or events could mean prepayments to suppliers for allotments are not recoverable</li> <li>Risk that advanced bookings of allotments with suppliers may be recognised as cost of sales when they are made rather than being matched to the revenue streams to which they relate</li> </ul>	<ul style="list-style-type: none"> <li>Valuation</li> <li>Cut-off</li> </ul>
<b>Cash</b>	<ul style="list-style-type: none"> <li>Risk of misappropriation of cash from travel shops</li> </ul>	<ul style="list-style-type: none"> <li>Completeness</li> </ul>
<b>Provisions</b>	<ul style="list-style-type: none"> <li>Management's estimation of general provisions or the provision for closure of shops may be inappropriate or insufficiently prudent</li> </ul>	<ul style="list-style-type: none"> <li>Valuation</li> <li>Completeness</li> <li>Existence</li> </ul>

### Conclusion

BST is undergoing a period of intense change in the way it does business in order to react to market demands and preferences. The company has already started undertaking significant investment in IT projects which the company hopes will be funded by the closure of a number of its retail travel outlets.

The changes at BST have resulted in several situations where management will need to account for something new, for example the discount vouchers and bonus schemes offered by the new eCRM, shops held for sale and the purchase of Ticketmate Hong Kong Agency Ltd. With a high volume of changes in a short time, there is an increased risk that the accounting may not be in line with accounting standards. Luk Brothers & Co. will need to make sure that they examine these areas carefully.

Additionally, there are several areas of the financial statements which rely on management estimations and assumptions and these will require careful consideration by Luk Brothers & Co.. They will especially need to concentrate on the valuation of goodwill on the purchase of Ticketmate Hong Kong Agency Ltd, provisions and recoverability of prepayments to suppliers. Estimations are of particular importance as there is a possibility of management bias due to the share incentive schemes.

### References

The above is based on the following auditing standard:

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

According to **HKSA 315 (Clarified)**, inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

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

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

### **Learning Pack**

Chapter 8: Planning, materiality and risk assessment – Section 4.1.1

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

### Discussion points

### Workshop 1 – Identify controls (task 2)

(i)  Control environment

Control environment at BST	
<b>Management's integrity and ethical values</b>	<ul style="list-style-type: none"> <li>Renowned for quality products and social and corporate responsibility</li> <li>Publicised statement of goals in relation to the impact of its activities</li> <li>Management has publically stated it is not in favour of independent statutory regulation which has been criticised</li> </ul>
<b>Commitment to competence</b>	<ul style="list-style-type: none"> <li>Won awards for excellent travel safety record and 'ultimate consumer experience'</li> <li>Award winning website</li> <li>Business improvement programme has been implemented</li> <li>Engaged Andy Wah &amp; Partners Consulting Group to undertake review of key risks and market disruptors and recommend courses of action</li> </ul>
<b>Participation by those charged with governance</b>	<ul style="list-style-type: none"> <li>Seven non-executive directors and audit committee</li> </ul>
<b>Management's philosophy and operating style</b>	<ul style="list-style-type: none"> <li>Culture of employee engagement</li> <li>Clear company-wide commitment to quality and customer experience</li> </ul>
<b>Organisational structure</b>	<ul style="list-style-type: none"> <li>Clear organisational structure evidenced by board structure</li> </ul>
<b>Assignment of authority and responsibility</b>	<ul style="list-style-type: none"> <li>Clear assignment of responsibility in a number of places: legal team re contracts, regulations team, booking systems manager, travel shop managers re some authorisation procedures and manager of travel agents sales team re informing 3<sup>rd</sup> party travel agents of relevant procedures</li> </ul>
<b>Human resource policies and practices</b>	<ul style="list-style-type: none"> <li>Employee incentive schemes, e.g. share purchase scheme</li> </ul>

(ii)  **Entity's risk assessment process**

### Risk assessment process at BST

#### Evidence of risk assessment process:

- Internal audit department present
- Group risk assessment management committee in place
- Regulations team monitor the requirements of regulations impacting BST
- Review of allotment contracts for exposure to risks by BST legal team
- Engaged Andy Wah & Partners Consulting Group to undertake a review of key risks and market disruptors
- Implemented programme to reduce travel shop real estate in order to control costs and remain competitive/strategic focus moving towards online distribution in line with customer requirements
- Risk assessment procedures regarding litigation are in place as identified by Andy Wah & Partners Consulting Group (however see below)
- Presentation of a financial update to the board on a monthly basis

#### Areas of potential weakness:

- Unclear as to the scope and authority of the internal audit department
- Andy Wah & Partners Consulting Group identified that whilst a process of risk assessment in relation to litigation is in place, this had not been subject to recent scrutiny by the internal audit department

(iii)  **The information system relevant to financial reporting**

### The information system at BST

#### Evidence of strengths in information system:

- Booking system with unique user id and passwords means activity can be monitored by user
- Real time amendment to booking data and holiday availability
- Booking system automatically generates invoices and payment reminders

#### Areas of potential weakness:

- Overnight upload of online bookings means such booking activity is not shown on the system as it occurs which could result in the risk of double/over booking - particularly given the growth in the online distribution channel
- Some business processes may be out of date, or insufficiently agile, for the online focussed strategy resulting in a recommendation from Andy Wah & Partners Consulting Group to review and update these processes



### (iv) Control activities

#### Controls activities identified

- Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further
- Report of changes made to the product catalogue is printed then reviewed and approved by the booking system manager
- Adjustment to pricing and discounts can only be made by the head office team
- Completion of customer booking information form – including confirmation of travel insurance, and checking by sales representative
- 30% deposit taken at the time of booking on all holidays and holiday components
- Appropriate verification of credit/debit card and cheque payments
- Secure cash tills in travel shops
- Booking confirmation, terms and conditions and important information documents given to all customers
- Explanation of cancellation policy by sales representative at the time of booking
- A daily reconciliation between the deposits recorded on the booking system and the amount of cash, cheques and credit/debit card transactions taken is performed by a member of staff in the store and reviewed by the manager for any discrepancies
- Credit control process in place for final balances and chasing amounts overdue
- Post opened by two members of staff
- Segregation of duties between post opening/payment logging and allocation of payments to the individual customer accounts
- Weekly bank reconciliation with explanation of reconciling items
- Unique user id and access to booking system
- Process in place for monitoring payments from 3<sup>rd</sup> party travel agents and process for chasing up outstanding amounts



### (v) Monitoring of controls

#### Controls identified

- Monthly report summarising amounts due from customers reviewed by the financial controller
- Review of weekly bank reconciliation by financial controller
- Weekly report of overdue amounts, with explanations, for the travel agent sales manager

### Control environment, risk assessment process and information systems at BST

#### Perception of quality of BST's internal controls and impact on audit approach

Overall the control environment, risk assessment process and information systems in place at BST appear to be appropriate. The attitude of the directors towards internal controls appears positive with evidence that they understand the nature of the internal controls that should be in place in a business such as BST and have taken active steps to implement appropriate controls. Some potential deficiencies have been identified but these are not so significant or pervasive as to rule out a test of controls approach to the audit.

### Control activities and monitoring of controls

#### Sales and receivables cycle

A number of control activities and monitoring of controls have been identified as being in place for the sales and receivables cycle. The audit team must now consider whether any of the controls address the inherent risks identified and therefore whether the controls are relevant to the audit of BST.

### References

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

### Learning Pack

Chapter 11: Internal control and tests of controls – sections 1.1, 1.2 and 1.3

### Discussion points

### Workshop 1 – Identify controls (task 3)

Focusing on **sales and trade receivables** we can begin to consider the control activities and monitoring procedures that might address the inherent risks identified in task 1:

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from task 2)
<b>Revenue</b>	
Customers pay deposits at time of booking holidays and the balance 8 weeks before departure – revenue may be overstated if these are recorded in revenue at year end but the customer date of departure is not until after year end	Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further
Cash deposits - risk of unrecorded transactions/misappropriation	Secure cash tills in travel shops Daily reconciliation between the deposits recorded on the booking system and the amount of cash, cheques and credit/debit card transactions
Deposit amount may be inaccurately entered into the booking system following payment	A daily reconciliation between the deposits recorded on the booking system and the amount of cash, cheques and credit/debit card transactions taken is performed by a member of staff in the store and reviewed by the manager for any discrepancies
Website bookings may not be updated onto the main booking system accurately or may lead to cut-off issues	Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further
Errors in data entered into the booking system could lead to incorrect amounts being charged to customers	Report of changes made to the product catalogue is printed then reviewed and approved by the booking system manager



Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from task 2)
<b>Trade receivables</b>	
Risk of some debts being irrecoverable from customers	<p>30% deposit taken at the time of booking on all holidays and holiday components</p> <p>Explanation of cancellation policy by sales representative at the time of booking</p> <p>Credit control process in place for final balances and chasing amounts overdue</p>
Risk of irrecoverable debts not being adequately provided for given customers only pay a deposit with the final balance not being due until 8 weeks before departure	<p>Monthly report summarising amounts due from customers reviewed by the financial controller</p>
Errors in the booking system may lead to customers not being invoiced or being invoiced incorrectly	<p>Unique user id and access to booking system</p> <p>Adjustments to pricing and discounts can only be made by the head office team</p>
Errors in recording receipts in the booking system may increase risk of irrecoverable balances, e.g. receipts allocated to incorrect customer account	<p>Segregation of duties between post opening/payment logging and allocation of payments to the individual customer accounts</p>

### References

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

### Learning Pack

Chapter 11: Internal control and tests of controls; sections 1.4 and 1.5

### Discussion points

### Workshop 1 – Identify controls (task 4)

Focusing on **sales and trade receivables** we can begin to assess the effectiveness of controls identified in task 2 & 3 and identify any control risks:

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks
<b>Revenue</b>		
Customers pay deposits at time of booking holidays and the balance 8 weeks before departure – revenue may be overstated if these are recorded in revenue at year end but the customer date of departure is not until after year end	Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further	The audit team would need to ensure that the control is regularly undertaken and is effective in that any issues are highlighted and addressed/corrected
Cash deposits - risk of unrecorded transactions/misappropriation	Secure cash tills in travel shops	This control is likely to be effective but other controls (or substantive testing) would need to be considered to address the risk of misappropriation before the deposits are placed in the tills
Deposit amount may be inaccurately entered into the booking system following payment	A daily reconciliation between the deposits recorded on the booking system and the amount of cash, cheques and credit/debit card transactions taken is performed by a member of staff in the store and reviewed by the manager for any discrepancies	It appears that this control would be effective in identifying and potentially correcting errors in the recording of deposits

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks
Website bookings may not be updated onto the main booking system accurately or may lead to cut-off issues	Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further	The audit team would need to ensure that the control is regularly undertaken and is effective in that any issues are highlighted and addressed/corrected.
Errors in data entered into the booking system could lead to incorrect amounts being charged to customers	Report of changes made to the product catalogue is printed then reviewed and approved by the booking system manager	The audit team would need to be satisfied that the booking system manager's review would be able to identify any errors in data entered into the system. It is unclear how the manager would identify errors or omissions and for this reason may prove not to be a reliable control.

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Consideration of whether control activity or monitoring can be relied on
<b>Trade receivables</b>		
Risk of some debts being irrecoverable from customers	<p>30% deposit taken at the time of booking on all holidays and holiday components</p> <p>Explanation of cancellation policy by sales representative at the time of booking</p> <p>Credit control process in place for final balances and chasing amounts overdue</p>	<p>It appears that this is an effective control</p> <p>This control may reduce the likelihood of customer cancellations and therefore the non-payment of final balances. It would also increase BST chances of recovering debts if customers proved to have not complied with the terms of the policy</p> <p>The credit control procedures appear to be relevant to reducing the risk of irrecoverable receivables</p>
Risk of irrecoverable debts not being adequately provided for given customers only pay a deposit with the final balance not being due until 8 weeks before departure	Monthly report summarising amounts due from customers reviewed by the financial controller	<p>This control should inform the financial controller of the 'normal' level of irrecoverable debts and lead to an informed estimate for the year end allowance.</p> <p>However, there remains scope for management bias in the year end estimate and therefore some substantive testing is likely to be necessary</p>
Errors in the booking system may lead to customers not being invoiced or being invoiced incorrectly	<p>Unique user id and access to booking system</p> <p>Adjustments to pricing and discounts can only be made by the head office team</p>	<p>This control should reduce risk of unauthorised entries on customer accounts</p> <p>This control should reduce the risk of unauthorised amendments to pricing or unauthorised discounts</p>

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Consideration of whether control activity or monitoring can be relied on
Errors in recording receipts in the booking system may increase risk of irrecoverable balances, e.g. receipts allocated to incorrect customer account	Segregation of duties between post opening/payment logging and allocation of payments to the individual customer accounts	Segregation of duties will reduce the risk of incorrect recording to an extent but there is still scope for human error and there appear to be few procedures in place to identify errors if they occur. Therefore these controls are unlikely to be effective in isolation.

### Conclusion

There appear to be a number of potentially effective control activities and monitoring of controls that could be relied upon by the audit team in order to gain assurance as to revenue and trade receivables recorded in the financial statements. The controls will need to be tested to ensure their effectiveness and in addition some substantive audit procedures will be required either where controls are not considered sufficient in isolation or where testing shows them to be ineffective. In addition, some level of substantive testing will always be undertaken in order to address the inherent limitations present within any system of internal controls. However, overall reliance on controls as part of the audit procedures for revenue and trade receivables would seem to be appropriate.

### References

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

### Learning Pack

Chapter 11: Internal control and tests of controls; section 1

### Discussion points

### Workshop 1 – Identify controls (task 5)

Focusing on *sales and trade receivables* we can identify the further work to be performed:

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
<p><b>Revenue</b></p> <p>Customers pay deposits at time of booking holidays and the balance 8 weeks before departure – revenue may be overstated if these are recorded in revenue at year end but the customer date of departure is not until after year end</p>	<p><b>Revenue</b></p> <p>Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further</p>	<p>The audit team would need to ensure that the control is regularly undertaken and is effective in that any issues are highlighted and addressed/corrected.</p>	<p>Discuss the use and effectiveness of the reports with senior managers/directors</p> <p>Review a sample of reports to ascertain whether issues are highlighted and followed up</p> <p>For a sample of highlighted issues ascertain if/how the issue was resolved</p>	<p>Undertake analytical procedures based on the value of deposits recorded in the booking system compared to the total value of bookings with more than 8 weeks before departure.</p> <p>Select a sample of holidays with a departure date after year end and trace deposits/balances payments to the accounting records to ensure that they have not been recorded in year end revenue figures</p>

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
Cash deposits - risk of unrecorded transactions/misappropriation	Secure cash tills in travel shops	This control is likely to be effective but other controls (or substantive testing) would need to be considered to address the risk of misappropriation before the deposits are placed in the tills	A sample of travel shops could be visited to ensure the cash deposits are placed in tills through observation of the procedure  Check that the end of day reconciliations are performed effectively and competently and are authorised	Review a sample of end of day reconciliations between the cash till and the deposits recorded on the booking system for that day – ascertain the extent of any discrepancies and how these are addressed
Deposit amount may be inaccurately entered into the booking system following payment	A daily reconciliation between the deposits recorded on the booking system and the amount of cash, cheques and credit/debit card transactions taken is performed by a member of staff in the store and reviewed by the manager for any discrepancies	It appears that this control would be effective in identifying and potentially correcting errors in the recording of deposits	The audit team would need to ensure that the control is regularly undertaken and is effective in that any issues are highlighted and addressed/corrected. This would be tested through checking a sample of the reconciliations and review by the manager	Review a sample of end of day reconciliations between the cash till and the deposits recorded on the booking system for that day – ascertain the extent of any discrepancies and how these are addressed

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
Website bookings may not be updated onto the main booking system accurately or may lead to cut-off issues	Weekly report showing KPI's from booking system is produced and circulated to senior managers and directors with any anomalies being investigated further	The audit team would need to ensure that the control is regularly undertaken and is effective in that any issues are highlighted and addressed/corrected	Discuss the use and effectiveness of the reports with senior managers/directors  Review a sample of reports to ascertain whether issues are highlighted and followed up  For a sample of highlighted issues ascertain if/how the issue was resolved	Select a sample of bookings taken on the website and trace to the booking system, checking for accuracy and completeness.  Select a sample of 'online bookings' from the booking system and trace to the website, checking for accuracy and existence
Errors in data entered into the booking system could lead to incorrect amounts being charged to customers	Report of changes made to the product catalogue is printed then reviewed and approved by the booking system manager	The audit team would need to be satisfied that the booking system manager's review would be able to identify any errors in data entered into the system. It is unclear how the manager would identify errors or omissions and for this reason may prove not to be a reliable control.	Discuss the review process with the manager in order to ascertain whether the review is likely to be effective. If so, test the procedures undertaken by the manager to ascertain whether they are carried out sufficiently frequently and that any issues identified are addressed/corrected	Select a sample of changes made to the booking system (e.g. changes in prices) and trace to supporting documentation/authority.  Select a sample of documents which require a change on the booking system (e.g. price reductions in sales promotions) and trace to the booking system for accuracy.



Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
<b>Trade receivables</b>				
Risk of some debts being irrecoverable from customers	30% deposit taken at the time of booking on all holidays and holiday components	Would anticipate this is an effective control	Sample of bookings tested in the system to check the deposit was taken. Also tested through observation at travel shops and test data on the online booking system.	For a sample of holidays in the booking system, check to ascertain if a deposit was recorded. Trace receipt of cash to the bank statement.
	Explanation of cancellation policy by sales representative at the time of booking	This control may reduce the likelihood of customer cancellations and the non-payment of final balances. It increases BST chances of recovering debts if customers fail to comply with the terms of the policy	This control could be tested through observation at travel shops	For a sample of attempted cancellations by customers ascertain whether the cancellation policy is capable of being enforced

# Student Notes

## Module C (December 2012) Workshop 1 – Identify controls risks (task 5) (Session 5)

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
	Credit control process in place for final balances and chasing amounts overdue	The credit control procedures appear to be relevant to reducing the risk of irrecoverable receivables	Testing on a sample of overdue balances could be undertaken to ascertain whether these controls are rigorously applied	Perform a receivables circularisation on a number of balances due at year end  Perform 'cash after date' testing to ascertain the amount of receivables received post year end

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
Risk of irrecoverable debts not being adequately provided for given customers only pay a deposit with the final balance not being due until 8 weeks before departure	Monthly report summarising amounts due from customers reviewed by the financial controller	This control should inform the financial controller of the 'normal' level of irrecoverable debts and lead to an informed estimate for the year end allowance, However, there remains scope for management bias in the year end estimate and therefore some substantive testing is likely to be necessary	Discuss with the financial controller the extent to which his review of the monthly reports is used to inform the calculation of the year end allowance.  Review the monthly reports and consider whether the provision takes into account the information contained in them.	Perform a receivables circularisation on a number of balances due at year end  Perform 'cash after date' testing to ascertain the amount of receivables received post year end  Identify any amounts in dispute at year end, through review of correspondence files for example, and trace to year end allowance.  Where amounts are not included in the year end provision ascertain from the management its basis for not providing against the disputed amount.

Inherent risk identified (from task 1)	Control activities and monitoring of controls that address the inherent risk (from tasks 2 & 3)	Effectiveness of controls and control risks (from task 4)	Work to perform on the controls	Substantive procedures
Errors in the booking system may lead to customers not being invoiced or being invoiced incorrectly	<p>Unique user id and access to booking system</p> <p>Adjustments to pricing and discounts can only be made by the head office team</p>	<p>This control should reduce risk of unauthorised entries on customer accounts</p> <p>This control should reduce the risk of unauthorised amendments to pricing or unauthorised discounts</p>	<p>Test system using test data</p> <p>Test system using test data – e.g. check system blocks unauthorised changes</p>	Select a sample of amendments made to the system in the year and check they were made by authorised personnel
Errors in recording receipts in the booking system may increase risk of irrecoverable balances, e.g. receipts allocated to incorrect customer account	Segregation of duties between post opening/payment logging and allocation of payments to the individual customer accounts	Segregation of duties will reduce the risk of incorrect recording to an extent but there is still scope for human error and there appear to be few procedures in place to identify errors if they occur. Therefore these controls are unlikely to be effective in isolation.	Check presence of controls through observation of post opening, payment logging and allocation of payments	Select a sample of receipts from source documentation and trace to booking system for accuracy of recording

### References

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

### Learning Pack

Chapter 11: Internal control and tests of controls; section 3

Chapter 13: Specific audit procedures; sections 4 and 12