

Student Notes

Module C (Jun 2012)

Session	Methodologies	Chapters covered	Students
Workshop 1			
1. Introduction	<ul style="list-style-type: none"> • Presentation • Group discussion 		
2. Corporate governance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 1 & 2	Pg. 1 – 7
3. Overview of an audit	<ul style="list-style-type: none"> • Card game 		
4. Audit acceptance / continuance	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 4 & 7	Pg. 8 – 13
5. Audit planning	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 8, 10, 11 & 12	Pg. 14 - 48
6. Project management in audit planning stage	<ul style="list-style-type: none"> • Group discussion 	Ch. 8	
7. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		
Workshop 2			
8. Reboot	<ul style="list-style-type: none"> • Presentation • Group discussion 		To be released after completion of Workshop 2
9. Audit execution	<ul style="list-style-type: none"> • Individual work • Progress meeting and reporting • Group discussion 	Ch. 9, 10, 12, 13 & 15	
10. Project management in audit execution stage	<ul style="list-style-type: none"> • Presentation • Group discussion 		
11. Audit completion	<ul style="list-style-type: none"> • Group sharing • Group discussion 	Ch. 9, 15, 16 & 17	
12. Group audit	<ul style="list-style-type: none"> • Group discussion 	Ch. 18	
13. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 		

Discussion points

Workshop 1 – Corporate Governance

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
Audit Committee	<p>The members of the newly formed audit committee should be interested in making sure it observes the rules of the <i>Code on Corporate Governance Practices in Hong Kong</i> (HK Code). The HK Code sets out the minimum duties for audit committees and its rules will affect the role, function and composition of the audit committee.</p> <p>The audit committee will be concerned the board allows it authority to carry out its responsibilities independently, including the following.</p> <ul style="list-style-type: none"> • Maintaining an appropriate relationship with Yin Yang & Co, or any other appointed auditor • Monitoring and reviewing the effectiveness of the internal control function at Golden Panda • Monitoring the integrity of the financial statements of the company <p>The audit committee should supervise the internal audit function and they will be concerned that the current reporting line (to the FD) is transferred to the audit committee.</p> <p>As Auric Kim has been appointed as a member of the audit committee, the other members may be concerned that the executive directors do not understand the purpose of an audit committee and feel that they detract from their authority or deliberately try to influence the audit committee.</p>	<p>The audit committee will expect the board to adhere to requirements of the HK Code. This stipulates that the board should establish formal and transparent arrangements for considering how it will apply the financial reporting and internal control procedures and for maintaining an appropriate relationship with the company's auditors.</p> <p>The HK Code states that the audit committee should consist entirely of non-executive directors. The members of the audit committee will expect the board to consider any concerns over Auric Kim being appointed a member of the committee.</p> <p>The audit committee will expect to be provided with written terms of reference which include its role and the authority delegated to it by the board. It will also expect the company to provide it with sufficient resources to discharge its duties and ensure that at least one member of the audit committee has appropriate professional qualifications, or accounting or related financial management expertise.</p> <p>Reference</p> <p>See Learning Pack Chapter 2: Corporate governance reports and practice Part A Corporate governance, Section 4 Board committees</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
<p>Current shareholders: Auric and Cammi</p>	<p>Auric and Cammi Kim are currently majority shareholders with equal voting rights meaning that together they can make decisions without gaining approval from other shareholders. They have expressed a preference for a “hands on” management style and may be concerned that the public listing may result in a dilution of their control due to them no longer being the majority shareholders.</p> <p>Auric and Cammi are interested in rapidly expanding the business but will want to ensure that this is not at the expense of the reputation for high quality at Golden Panda.</p> <p>As the original founder members of the company, Auric and Cammi Kim will be interested in both a dividend income and longer term growth of their investment.</p>	<p>As directors, the founder family members are in a unique position to influence the future direction of the company and will have to be careful to balance their own preferences against the demands of the other shareholders in the business.</p>
<p>Current shareholders: Other Kim family members</p>	<p>The other members of the Kim family are minority shareholders. They do not seem to hold any seats on the board and as minority shareholders will have no control over decision making. They may be concerned that a listing will further dilute their control and shareholding.</p> <p>The other Kim family members may be disappointed that no dividends have been paid by the company for two years. They may have been reliant on dividends as a source of income and so be interested in how the proposed listing could affect dividends and the return on their investment.</p> <p>The other Kim family members will</p>	<p>The board has a responsibility to ensure that the corporate governance of the company includes the equitable treatment of all shareholders, including minority shareholders. Even though the other Kim family members are minority shareholders, the board still has a responsibility to respect their rights and views.</p> <p>The other members of the Kim family will expect the board to take appropriate actions with regard to their responsibility for risk management and internal controls, and to see that there are adequate reporting systems in place to allow the directors to manage these issues appropriately. Some of their concerns may be addressed by the existence of the internal audit function which will highlight the business risks and internal control issues to the board so they can</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
	want reassurance that directors are appropriately remunerated for their roles, but that this remuneration is not excessive, as this will reduce profitability.	take action. The other Kim family members will expect the board to determine directors' salaries transparently with no individual director being able to determine their own remuneration package.
Current shareholders: venture capitalist	<p>The venture capitalist is looking for an exit strategy through the proposed listing and so will be concerned that this goes ahead.</p> <p>The venture capitalist will be concerned with maximising the return on its investment and receiving the highest possible valuation for the shareholding. The venture capitalist will therefore be very interested in the figures given in the audited financial statements.</p>	<p>The venture capitalist will expect the board to assist with the exit. If the listing cannot go ahead, the investor may expect the board to come up with an alternate exit strategy.</p> <p>The venture capitalist will expect the board to provide the necessary financial information required for valuing its investment. The board will be expected to cooperate in any assurance work carried out on the valuation.</p>
Shareholders post-listing: private shareholders	<p>Private shareholders each own a small (non-controlling) stake in Golden Panda 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>Despite the differing perspectives of the various private shareholders of Golden Panda 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.</p>

In the jewellery business this will

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
	<p>Some, but not all, shareholders will also be interested in Golden Panda'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 them. This may be to the extent that they invest in a company such as Golden Panda rather than another company that has better rates of return on investment but a poorer record around CSR.</p> <p>Like other Hong Kong jewellery producers, Golden Panda has taken advantage of cheaper skilled labour in mainland China. Shareholders may be interested in whether workers outside Hong Kong receive a fair compensation for their efforts.</p>	<p>include the processes by which the directors ensure the reputation for innovation and quality are retained.</p> <p>Shareholders will expect Golden Panda 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>Shareholders post-listing: institutional investors</p>	<p>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 Golden Panda will be of importance to such shareholders.</p>	<p>See above</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
	<p>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.</p>	<p>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.</p>
Customers: wholesale	<p>Wholesale customers purchasing an exclusive commission to sell under their own brand name will be concerned that these products are not sold elsewhere. They will also want to ensure that the commission products are of decent quality and will not damage the reputation of their own brands.</p> <p>Wholesale customers purchasing jewellery to sell under the Golden Panda brand will want to know that the wholesale catalogue is reliable and up-to-date with the latest designs.</p> <p>Both types of wholesale customer will be concerned with the following:</p> <ul style="list-style-type: none"> • Sustainable, reliable and consistent quality of ordered jewellery • Reliable distribution networks • Fair and competitive pricing • Products available when ordered • Good customer service and availability of credit • Golden Panda is an ethical supplier and will not damage their brand reputation 	<p>Wholesale customers will expect the board to have purchasing, design and production systems in place to maintain the quality and innovation in design that their customers require.</p> <p>They will expect Golden Panda to safely and efficiently deliver any orders they may place.</p> <p>They will expect contracts drawn up for commissions to be fair and adhered to.</p> <p>Wholesale customers may expect the board to have clear policies with regards to CSR which are aligned with their own.</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
Customers: retail	<p>Golden Panda retail customers will have a variety of concerns:</p> <ul style="list-style-type: none">• Jewellery is competitively priced• Contemporary and innovative designs• Jewellery is made from high quality gold and gemstones• Ongoing association of Golden Panda brand name with quality and style• Durability of products• Availability of products• Convenience of store locations• Reliability of estore, safety of information and delivery costs• Shopping experience in stores, boutiques and concessions• Golden Panda response to dealing with problems/issues (e.g. refunds policy)• Ethics of Golden Panda in terms of treatment of suppliers and staff	<p>Customers will expect Golden Panda to have systems and processes in place to assure them of both high quality jewellery and a high quality shopping experience.</p> <p>Such processes will extend to the sourcing of raw materials and finished jewellery, design and production processes, store and estore layout, payment procedures and policies around customer service.</p> <p>Many customers will also expect the company to have a clear statement with respect to its CSR and to adhere to the guidelines it has set itself.</p>

Stakeholder	Concerns of stakeholder	Expectations on board to address concerns
Executive Directors	<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 and bonuses for example and, in the case of the original founder members, the future direction and objectives of the company. Other directors may be concerned with a concentration of power in Auric and Cammi Kim. In all 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 function who report directly to the audit committee. These will be especially important if the listing goes ahead.</p>	<p>The key elements of corporate governance that the board will be expected to address are:</p> <ul style="list-style-type: none">(a) Management and mitigation of risk including the operation of an adequate and appropriate system of control. This may include appropriate internal audit functions.(b) Good supervision and management within set best practice guidelines so as to add to the performance of the company.(c) Safeguards against misuse of resources, whether human, financial, physical or intellectual.(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.

References

Learning Pack

Chapter 1: Scope of corporate governance – section 3

Chapter 2: Corporate governance reports and practice – section 4

Golden Panda Jewellery Co

Yin Yang & Co Background information and audit of Golden Panda Jewellery Co

You are the audit senior at Yin Yang and Co. Your firm has recently been approached by the board of Golden Panda Jewellery Co ('Golden Panda') to accept appointment as external auditors of the company for the year ending 31 March 2012. Golden Panda is preparing to list on the Hong Kong Stock Exchange and believes that Yin Yang & Co is better placed to support and advise Golden Panda with the listing process and its plans for expansion than its current auditor.

Yin Yang & Co specialises in the provision of audit, assurance and business advisory services in a wide range of industry sectors within Hong Kong. The firm is the auditor for another major jewellery retailer based in Hong Kong and the directors of Golden Panda have expressed that the firm's expertise in the jewellery sector was a key factor in their selection as proposed auditor. Yin Yang & Co does not have any offices outside Hong Kong.

You have recently met with the board of Golden Panda to discuss the proposed engagement. At the meeting, the finance director, John Tse, explained how the inventory control and management system has resulted in the company being able to dispense with full year end inventory counts in their retail stores. He hopes to apply the system to the production units in mainland China in the future, but until then full year end inventory counts will be taking place in those units.

During the meeting, John also mentioned that he was looking for a company secretary to help manage the extra work associated with the proposed listing. He has been struggling to recruit a suitable candidate for what he believes is a part-time role and would like a member of the audit team to temporarily act as company secretary until the right person is appointed.

Following the meeting, a colleague presented you with a clipping from a press report which she felt might be relevant.

Clarity needed over Golden Panda payments

Hong Kong authorities are investigating payments made by Golden Panda Jewellery Co as part of the acquisition of a jewellery retailer in June 2010. George Yun-Wing claims he was forced to resign from his position as financial controller when he questioned a large payment to an unknown advisory firm in the Cayman Islands. A spokesman from Golden Panda Jewellery Co has stated:

'Regretfully Mr Yun-Wing was asked to leave Golden Panda after a personal issue with a co-worker. There is no substance to his claims and all payments made to advisory firms are of a proper nature. The company are fully and openly cooperating with the authorities on the matter which we expect to be dismissed very soon.'

When asked whether any payments had in fact taken place the Golden Panda spokesman refused to comment.

Hong Kong Times, 19 March 2012

Required

Discuss whether Yin Yang & Co should accept the appointment to act as external auditors of Golden Panda Jewellery Co for the year ending 31 March 2012.

Discussion points

Workshop 1 – Audit acceptance

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

Threats: Conflict of interest and independence issues

A conflict of interest is a situation that may undermine the judgment of a professional accountant. In these situations principles of independence, integrity and objectivity are not satisfied and promoting personal interest may result in adverse consequences to stakeholders.

Firms should take reasonable steps to identify circumstances that could pose a conflict of interest before they happen. A conflict of interest may result in the Code being breached (often conflicts of interest give rise to self-interest threats). The key principle for the firm is that it should not accept an engagement in which there is likely to be a significant conflict of interest.

Member of audit team to act as company secretary

A conflict of interest has arisen from the request for a member of the audit team to act as company secretary on a temporary loan basis. A company secretary under the Companies Ordinance is an officer of the company and is not a clerical function which could be regarded as insignificant. This creates a self-review threat from the possibility that the member of the audit team in this role could audit their own work. The audit team member acting in this role may also become too sympathetic towards the employees at Golden Panda thus impairing their independence and objectivity and creating a familiarity threat. If the threat is considered too great, as is likely, the request should be declined.

Assistance with listing

Additionally, the board at Golden Panda has indicated that if appointed as auditor, they would expect Yin Yang & Co to advise and support them in the listing process. This could also give rise to a self-review threat and the firm will need to clarify the level of support and advice expected.

Acting for a competitor

Finally, as Yin Yang & Co already acts as auditor for another major jewellery retailer in Hong Kong, a conflict of interest may arise between the interests of Golden Panda and the other jewellery retailer. This could occur if a takeover situation develops, for example.

Competence to perform audit work

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

Specific consideration would need to be given to the following issues before Yin Yang & Co could accept appointment as Golden Panda's auditors:

- As Golden Panda is a new client inherent risk is increased
- Yin Yang & Co has no offices in mainland China to carry out the audit of inventory counts at the production units. Yin Yang & Co will need to consider whether it has the resources to send part of the audit team to the production unit locations or whether it needs to rely on the work of other auditors
- The valuation of manufactured inventory may require the use of an auditor's expert especially as the valuation includes the degree of complexity in design which would be difficult for a non-specialist to ascertain

- Any valuation of the inventory of gold to be used in manufacture may also require an auditor's expert to confirm quality and market price

Are there any issues over management integrity?

Before accepting a new engagement, the professional accountant shall consider whether there is any threat to compliance with the fundamental principles, that is any potential threats to integrity or professional behaviour, for example, entity involvement in illegal activities.

The press clipping implies two issues which cast doubt on the integrity of Golden Panda. These are the suspicious payments made to the advisory firm in the Cayman Islands and the circumstances surrounding the resignation of the financial controller. Both these issues will require further investigation before an acceptance decision can be made.

Yin Yang & Co should consider whether Golden Panda is changing auditor due to these issues, rather than anything to do with the listing. This also casts doubt on the integrity of the company.

Are the threats or management integrity issues significant?

Conflict of interest and independence issues: Overall, these issues are moderately significant and can be reduced to an acceptable level with application of appropriate safeguards.

The loan of a member of Yin Yang & Co staff and the provision of advice to Golden Panda does not pose a significant threat as safeguards should be relatively simple to apply. If safeguards are not deemed to be adequate, the firm can always accept the audit appointment and refuse the non-audit assignment.

Before any loan staff assignment commences, Yin Yang & Co would also need to investigate and confirm whether the assignment would be permissible under the rules of the HKICPA Code. According to the HKICPA Code, an employee of the firm should not serve on the board of an entity, although in some circumstances it is permissible for a partner or employee of an assurance firm to serve as company secretary.

The conflict of interest between the interests of Golden Panda and the other jewellery retailer would only be significant if the work carried out is a source of conflict. In this case, there does not appear to be any reason why the engagement should materially prejudice either entity. Yin Yang & Co will need to manage its work so that the interests of Golden Panda do not adversely affect the other jewellery retailer and vice versa.

Competence to perform audit work: As inventory is such a material figure (70% of total assets and 52% of revenue in March 2011) and its valuation requires specialist skill and knowledge lack of competence will be a significant risk. However, given Golden Panda's current experience in this sector this is likely to be an issue which can be overcome.

Management integrity: Yin Yang & Co will need to carry out further investigation before making a final conclusion on the significance of the risks arising from the alleged lack of management integrity. Initially it appears there is no truth to the claims of the disgruntled finance director, but Yin Yang & Co will need to check this.

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. If Yin Yang & Co discovers the claims of the former employee have substance, the firm may decide no safeguards are adequate for it to accept the position of auditor.

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

Conflict of interest and independence issues: The loan of a member of Yin Yang & Co staff to perform the Company Secretary role is allowed on a temporary basis provided that the staff on the loan assignment shall not be involved in providing assurance services that would not be permitted under the Code or assuming management responsibilities. Yin Yang & Co must make sure that different staff are used on the loan assignment and audit work and that loan staff are clearly briefed on what they can and cannot do for Golden Panda. As a last resort, if Yin Yang & Co felt that this did not reduce the threats to an acceptable level, they should refuse the loan staff assignment.

When being asked to advise on the listing, Yin Yang & Co will need to ensure it does not:

- Authorise, execute or consummate a transaction
- Sanction a particular course of action for the entity to pursue
- Report in a management capacity to those charged with governance

Yin Yang & Co should make sure that it has clear quality control policies establishing what staff are and are not allowed to do on behalf of entities. Procedures should be established to make sure staff at the firm do not make decisions on behalf of Golden Panda. Once again, different staff should be providing advice to those working on the audit so that duties are segregated.

Safeguards which Yin Yang & Co can apply to manage the conflicting interests of Golden Panda and their other audit client in the jewellery sector are:

- Disclosing that they are the auditor of a competitor to both parties and obtaining written permission from them both to act (key safeguard)
- Using separate engagement teams
- Procedures to prevent access of information (such as secure passwords and firewalls)
- Clear procedures for the respective teams on issues of security and confidentiality
- The use of confidentiality agreements signed by the partners and staff
- Regular review of the safeguards by an independent partner
- Advising one or both of the entities to obtain third party independent advice

As Golden Panda is planning on listing, Yin Yang & Co should be aware that for listed entities the rules of the HKICPA Code are more stringent and further safeguards may need to be applied.

Competence to perform audit work: Yin Yang & Co will need to use a competent, capable and objective auditor's expert to value the gold and finished goods which are beyond their area of expertise. For such a material area, the firm may decide it is less risky to send part of the audit team to the production units rather than rely on the work of other auditors. These safeguards will reduce the threat to an acceptable level.

Management integrity: The press clipping indicates that the matter is being investigated and the case will shortly be dropped. Until this happens, Yin Yang & Co will need to carry out further investigation before deciding whether the threat can be reduced to an acceptable level. The firm should make inquiries of legal counsel, internal audit and the board with regards to the suspicious payments and the circumstances surrounding the financial controller's resignation. Yin Yang & Co also needs to consult with the predecessor auditors to ensure there are no reasons behind the change in auditor which they ought to be made aware of.

In the event that the allegations are found to have substance, audit procedures will need to be planned and performed to take this into account. For example, less reliance would be placed on written representations from management or internally generated audit evidence, and more reliance placed on externally generated audit evidence.

Conclusion

If the claims of the financial controller are proved to have no substance, Yin Yang and Co can accept the audit of Golden Panda, providing that the necessary safeguards, discussed above, are put in place.

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. 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

Golden Panda prior year report to management

The engagement partner responsible for Golden Panda, Jane Wang, has sent you the following email to assist you with the risk assessment and planning work you are carrying out in respect of the audit of the financial statements of Golden Panda for the year ending 31 March 2012.

Golden Panda – prior year report to management

To: Audit senior

From: Jane Wang

Received: 14 April 2012

Attached: Golden Panda Jewellery Company Lee Sun & Co Report to Management following external audit for the year ending 31 March 2011

William Chang from the newly formed Audit Committee at Golden Panda has just passed me this Report to Management prepared by the previous auditors at the end of last year's audit. He has investigated management's response to the report and is concerned that not all recommendations have been put into place. He has ticked off those recommendations which have been actioned, and put a cross next to those which have not been actioned. He has also made some handwritten notes on the report.

Please can you review the report (which I have scanned and attached for you), along with William's highlighting and notes, and consider whether there are any implications for our risk assessment and audit planning this year.

In particular, you should consider whether this helps us to determine our audit approach on specific areas.

Thanks

Jane

Golden Panda Jewellery Company

Lee Sun & Co

**Report to Management following external audit
for the year ending 31 March 2011**

June 2011

Jane, here is the report I mentioned to you, I have investigated what has been implemented and noted on the attached.
Thanks, William Chang

Contents

- 1 Basis and purpose of report
- 2 High priority recommendations

Appendix: details of high priority recommendations

1 Basis and purpose of report

The report summarises the significant internal control deficiencies identified during our external audit procedures on the financial statements of Golden Panda for the year ending 31 March 2011. Specific procedures to identify significant internal control deficiencies were not carried out except where they were necessary for our audit of the financial statements. Consequently, this report does not represent a comprehensive statement of all internal control deficiencies that may exist and does not attempt to quantify the effect of any significant control deficiencies identified.

The report describes each significant internal control deficiency identified, explains the possible consequences of the deficiency and makes recommendations as to how Golden Panda might remedy the deficiency.

The contents of the report have been discussed with members of the board and senior management and their responses to the internal control deficiencies identified have been recorded in the appendix. Lee Sun & Co has undertaken no work to verify whether any actions proposed by the board or senior management, in respect of the significant internal control deficiencies identified, have been actioned since our report.

This report has been prepared for the sole use of the board of directors at Golden Panda. It must not be distributed to any other party without the prior written consent of Lee Sun & Co. No liability is accepted by Lee Sun & Co to any third party who may choose to rely on this report.

2 High priority recommendations

Six high priority recommendations were identified. The issues are noted below in summary and are documented in detail, with a recommendation and management response, in the appendix to this report.

- 1 Failure to observe internal control procedures – receipt of goods – should be addressed
- 2 Failure to observe internal control procedures – cashing up – should be addressed
- 3 Overriding of store security systems should be addressed with store managers. The reasons for such activity should be identified.
- 4/5 Company policies regarding credit limits for wholesale customers should be reviewed and simplified
- 6 Production units should not commence work on customer commissions until a signed contract has been received by the legal team.

Appendix: Details of high priority recommendations

Ref	Issue/risk	Recommendations	Management response
	Retail sales		
1	<p>It was observed at a number of retail stores that staff, when taking receipt of items of inventory from Golden Panda production units, did not agree the items received to:</p> <ul style="list-style-type: none"> (i) The delivery note included with the delivery; or (ii) The original order placed by the manager with the production unit <p>Failure to carry out checks required by company internal control procedures increases the risk of misappropriation of assets and reduces the effectiveness of controls around inventory, potentially leading to losses for the company.</p>	<p>All staff involved in receiving items of inventory in stores should be regularly reminded, in writing, of their responsibilities to perform the control procedures required.</p> <p>Staff should acknowledge their understanding of such procedures in writing.</p> <p>The internal control procedures manual should be updated to include documenting that the control has been performed and the internal audit team should consider auditing this control during its store visits.</p>	<p>A review is planned by the internal audit team and is scheduled for September 2011.</p> <p>✓</p>
2	<p>It was observed at a number of retail stores that cashing up procedures, per Golden Panda internal control procedures manual, were not always adhered to. These included:</p> <ul style="list-style-type: none"> (i) Cashing up being undertaken by only one person and the same person performing the z-read (ii) Discrepancies between cash takings and z-read that are above the store threshold are not always notified to head office. <p>Failure to observe these control procedures increase the risk of misstatement of takings each day and increase the risk of misappropriation of cash. Head office will be unaware if there are persistent errors or discrepancies for specific stores and will therefore be unable to take remedial action.</p>	<p>Again, all staff involved in cashing up procedures should be regularly reminded, in writing, of their responsibilities to perform the control procedures required.</p> <p>Staff should acknowledge their understanding of such procedures in writing.</p> <p>Consideration should be given to implementing IT controls which require managers to enter the results of cashing up procedures each day, even where a discrepancy has not arisen.</p>	<p>A review is planned by the internal audit team and is scheduled for September 2011.</p> <p>✓</p>

Ref	Issue/risk	Recommendations	Management response
3	<p>It was observed in a number of stores that the store manager was able to override the alert mechanisms of the radio frequency identification systems (RFIS) employed in the stores. On five separate occasions override was performed in order to fulfil an online e-store sale which could not be fulfilled by the relevant production unit. There is no mechanism built into the RFIS to allow for such sales. In three of these occasions the store manager provided another employee with the security code required to override the system.</p> <p>Allowing the overriding of such security measures will undermine the benefits that the RFIS system has afforded Golden Panda and could see an increase in internal thefts and loss of control over inventory. Inventory records may not be an accurate reflection of the inventory on hand in each store.</p>	<p>Store managers should be reminded that they should not override the security mechanisms in place nor allow their staff to do so. Disciplinary action for managers failing to comply should be considered.</p> <p>A review of the circumstances when overriding the system is required should be undertaken and where these are for legitimate business reasons consideration should be given to developing the system to allow for such circumstances.</p>	<p>A communication has been sent to all store managers that this is a breach of company policy and that disciplinary action will be taken in future cases.</p> <p>✓</p> <p>The internal audit team will review the circumstances where overrides are necessary to ascertain where there are legitimate business cases.</p> <p>X</p>
	Wholesale sales		
4	<p>Credit limits for wholesale customers are determined on an ad hoc basis leading to an inconsistency between the levels of credit extended to each customer.</p> <p>The lack of formal procedures in determining credit limits for wholesale customers may lead to inappropriate levels of credit being granted and confusion as to which credit limits apply to which customers. This may increase the risk of credit limits being exceeded and bad debts arising, leading to losses for the company.</p>	<p>A company policy and process for determining the level of credit to extend to new wholesale customers should be documented and communicated to sales managers.</p> <p>A review of all existing credit limits should be undertaken and, where possible and appropriate, these limits should be revised in order to bring them into line with company policy</p>	<p>A review of company policy will be conducted for all new wholesale customers going forward.</p> <p>✓</p> <p>WC: as far as I know a review for existing customers has not been undertaken .</p>

Ref	Issue/risk	Recommendations	Management response
5	<p>Approximately 30% of the wholesale accounts examined during our audit procedures had balances outstanding at the year-end which were in excess of the authorised credit limit for that customer.</p> <p>Failure to observe credit limits when making sales to wholesale customers will increase the risk of bad debts and lead to losses for the company.</p>	<p>A simplification of the credit limit process described above will reduce the risk of customers being extended credit beyond their credit limits.</p> <p>An automatic check of credit limits in the sales ledger system should also be considered.</p>	<p>A review of company policy will be conducted for all new wholesale customers going forward.</p> <p>✓</p> <p>As far as I know, automatic checks of credit limits have not been investigated .</p>
6	<p>In respect of items specifically commissioned by wholesale customers, the design is passed to the production unit who commence work on production before the contract for the commission was drawn up by the legal team and signed by the customer.</p> <p>Where production work begins before the customer has signed the contract there is a risk that the customer may change their mind or wish to amend the commission in some way. This could result in any work that is in progress on the commission being wasted and could result in some materials being no longer usable or of reduced value.</p>	<p>The production unit responsible for the work should not commence work until it has received authority from the legal team that the contract with the customer has been signed.</p>	<p>This process will be implemented at the earliest opportunity.</p> <p>✓</p>

Discussion points

Workshop 1 – Identify inherent risks (task 1)

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
At the entity level		
Going concern	<ul style="list-style-type: none"> • Rapid growth of business may result in overtrading • Increased reliance on funding – funding has increased by 17% on prior year • Venture capitalist seeking exit strategy • Over reliance on the Hong Kong and mainland China markets • High degree of competition in home market • Risk that the planned listing fails 	<p>Inherent risks at the entity level are characterised by:</p> <ul style="list-style-type: none"> • applying to the financial statements as a whole • being more pervasive to the financial statements as a whole • affecting many assertions
Management integrity	<ul style="list-style-type: none"> • Possible management bias due to preparation for listing • Possible management bias if there are covenants attached to the loans from the bank • Question over unusual payments 	<p>(See learning pack, chapter 8 Planning, materiality and risk assessment, section 5 Risk assessment)</p>
Opening balances	<ul style="list-style-type: none"> • This is a new audit client and it may therefore be difficult to obtain assurance over opening balances 	

Student Notes

Module C (Jun 2012) Workshop 1 – Identify inherent risks (task 1) (Session 5)

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
At the assertion level		
Revenue	<ul style="list-style-type: none"> Cash sales may not be complete or accurately recorded Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers Some sales made online through estore – may not be recorded by systems accurately 	<ul style="list-style-type: none"> Completeness Occurrence Cut-off Accuracy
Purchases	<ul style="list-style-type: none"> Some purchases, including gold and watches, supplied by overseas suppliers and invoiced in foreign currency which may lead to translation errors 	<ul style="list-style-type: none"> Accuracy
Distribution costs, selling expenses and administrative expenses	<ul style="list-style-type: none"> Costs recorded in the trial balance have not increased at the same rate as the increase in revenue – distribution and selling costs have increased by 22% and administrative costs have fallen by 4% – this may be due to some accruals not yet being accounted for, but may also indicate understatement of these costs In particular, we might have expected to see selling costs increase more significantly as these would be associated with an increase in staff numbers given the rate of expansion 	<ul style="list-style-type: none"> Completeness Accuracy

Student Notes

Module C (Jun 2012) Workshop 1 – Identify inherent risks (task 1) (Session 5)

Inherent risk	Explanation/indicators	Components and assertions affected by the risk
Non-current assets	<ul style="list-style-type: none"> • Significant expenditure on buildings and leasehold improvements – useful lives may not have been determined appropriately • Some expenditure may be inappropriately capitalised as leasehold improvements, e.g. expenditure on maintenance of retail stores • If development costs of the online estore have been capitalised these may now be overvalued given its pending decommissioning and the poor results in delivering sales revenue 	<ul style="list-style-type: none"> • Existence • Valuation
Inventory	<ul style="list-style-type: none"> • Nature of inventory (valuable/portable) makes it susceptible to misappropriation • Valuation of manufactured items is complex • May be difficult to identify the quality/grade (e.g. 12kt vs 24kt) of gold items from physical inspection 	<ul style="list-style-type: none"> • Existence • Valuation
Trade receivables	<ul style="list-style-type: none"> • Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods • Trade receivables days have risen from 41 days in 2011 to 52 days in the trial balance – this suggests either issues over the recoverability of some receivables or errors in recording 	<ul style="list-style-type: none"> • Existence • Valuation
Trade payables	<ul style="list-style-type: none"> • Trade payables have risen from 44 days in the prior year financial statement to 50 days in the trial balance. This may indicate issues over cash flow (i.e. company is withholding payments) or errors in recording 	<ul style="list-style-type: none"> • Cut-off
Deposits received	<ul style="list-style-type: none"> • Risk that deposits received are recognised as sales revenue before goods are supplied to customers 	<ul style="list-style-type: none"> • Cut-off • Completeness

Conclusion

Golden Panda has grown rapidly over the past two years with no signs of this growth slowing. The business appears to remain profitable however, such rapid growth can lead to going concern issues in a business where expansion is too fast. Golden Panda has invested heavily in new buildings and making leasehold improvements and will also have incurred significant increases in costs associated with staffing and production. This will all potentially put a strain on cash flows and the company has had to increase its borrowings from the bank. The future of the business may also be heavily dependent on the success of the planned listing. The auditors will therefore need to carefully consider management's assessment of the going concern presumption in spite of the strength of growth.

The risks associated with management bias means that the auditors 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. Areas of the financial statements that are subjective and open to judgment will require particularly careful attention – for example, allowance against receivables and accounting estimates around depreciation.

The risks associated with a business making cash sales are significant and the auditor will specifically need to design procedures around the completeness of recording of sales that are appropriate within the context of the control environment (more of this next session).

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 200 (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)


Introduction


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


Internal control has five elements:


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

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

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

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

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

 **Monitoring of controls** is part of the process of ensuring that control activities are carried out as required and remain effective over time.

In order for management to ensure that control activities continue to be effective in managing the entity's risks identified in the risk assessment process, the entity should also implement a system of monitoring controls.

(i)  **Control environment**

Control environment at Golden Panda

Management's integrity and ethical values	<p>Management appear to have a commitment to quality evidenced by their hands on approach to management and control, for example approving some of the major designs for jewellery and regularly communicating the company's ethical standards policy. In addition, the company adheres to criteria for the purchase of gold set out by the Fairtrade Foundation and the Alliance for Responsible Mining.</p> <p>However, the issue over payments made to an unknown advisory firm in the Cayman Islands may prove to raise some doubts over management integrity.</p>
Commitment to competence	<p>Controls are clearly established and documented and the directors have made use of technology to support staff in performing their work competently – e.g. the learning management system and the radio frequency technology used in stores. Where production has been transferred to mainland China production and quality control managers employed in Hong Kong continue to oversee the production units.</p> <p>However, some issues were identified by the previous auditors in their report to management in the previous year and it appears that management has not sought to address all of these expediently.</p>
Participation by those charged with governance	<p>Given that it has only just been formed, the degree of participation by the audit committee appears to be minimal. However, there is evidence that they are beginning to participate (i.e. communication between William Chang and Jane Wang). The INED's appointed also appear to have relevant experience to support Golden Panda in its listing and strategy.</p>
Management's philosophy and operating style	<p>Systems of controls are in place and documented, as is an internal audit team and there is a clear commitment to control through the introduction of the radio frequency technology in stores. Senior managers and the board meet regularly and there appears to be an 'inclusive' style of management. However, the management style of Auric and Cammi Kim is quite 'hands on' which may be difficult to sustain as the company experiences such rapid growth. There also appears to be some weaknesses in terms of how management has responded to feedback from the company's previous auditors.</p>
Organisational structure	<p>There is evidence of appropriate organisational structure both at head office/board level and on a store level – e.g. store managers responsible for each location.</p>
Assignment of authority and responsibility	<p>Authority and responsibility for controls within the stores is communicated through the controls procedures manuals but this communication appears to have failed in relation to some of the stores or is not sufficiently enforced in order to ensure compliance.</p>

Control environment at Golden Panda

Human resource policies and practices

Golden Panda appears to ensure that staff are appropriately supervised and their work monitored and that they are regularly reminded of the company's code of conduct. The Golden Panda academy is set up to impart the organisational values and staff are given access to a company-wide learning system to develop their skills on-the-job. Senior managers are incentivised through a bonus compensation scheme.

(ii) Entity's risk assessment process

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

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

Risk assessment process at Golden Panda

Evidence of risk assessment process:

- Internal audit department in place
- 'Hands on' management style
- Non-executive directors have been appointed with relevant experience
- Regular meetings between board, senior management and operational staff
- Regular review of performance compared to budget
- Involvement of legal team in contract negotiations and drafting
- Introduction of radio frequency technology in stores
- Learning system put into place

Areas of potential weakness:

- Auric and Cammi Kim travel to stores and production units frequently which may mean risks and issues at head office are less well managed – in addition, risk assessment through this means will become less effective as the business expands.
- Internal audit team reports into finance director which may reduce their independence and create bias in their work.

- (iii)  The information system relevant to financial reporting

The information system at Golden Panda

Evidence of strengths in information system:

- Radio frequency technology in stores which is integrated with the in-store sales and inventory systems
- Budgeting process with review of deviations from budget along with reporting to board from managers
- Daily cash till reconciliations
- Control procedures manual for stores

Areas of potential weakness:

- Apparent reluctance of staff to communicate issues to head office (e.g. failure to report discrepancies above threshold during cashing up procedures)
- Systems employed in stores cannot address issues such as stores needing to fulfil internet orders from estore
- Systems/controls around estore sales appear to be unclear

Conclusion on control environment, risk assessment process and information systems at Golden Panda

Perception of quality of Golden Panda's internal controls and impact on audit approach

Overall the control environment, risk assessment process and information systems in place at golden Panda 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 Golden Panda and have taken active steps to implement appropriate controls.

However, the weaknesses identified in each of control environment, risk assessment process and information systems suggest that quality of internal controls may only be medium as opposed to strong. Consequently, for some areas of the audit it may not be possible to rely fully on the internal controls in place.



(iv) Control activities

Controls activities identified

Contracts for purchases and sales to wholesale customers approved by legal team

Designs for major collections are approved by the board

Use of specialist security firm to distribute products and collect cash from stores

Radio frequency identification technology used in stores

Integration of radio frequency identification technology with sales and inventory records

Cashing up procedures

- Two members of staff counting cash
- Store manager performing z-read and reconciling to cash counted

Controls over sales to wholesale customers are recorded in a checklist by sales managers:

- Credit checks on new customers
- Orders in writing and signed by customer
- Designs for bespoke commissions approved by customers
- Legal contract drawn up and signed by customer for bespoke commissions
- Production on bespoke commissions now starts after contract is signed
- Despatch notes signed by customer and copy retained and sent to accounts for invoicing
- Customer accounts monitored and overdue amounts chased by sales managers in writing
- Cases referred to legal team where payment is not forthcoming

Formal checks on quality of production by management

System of annual budgetary control is in place

Preparation of monthly management accounts and preparation of monthly board reports by senior managers

Communication of code of conduct and ethical standards policy



Monitoring of controls

Controls identified

Cashing up procedures:

- Store managers must notify head office of discrepancies over a set threshold

Controls over sales to wholesale customers are recorded in a checklist by sales managers which are periodically reviewed by senior management

Regular review of overdue accounts by head of wholesales with sales managers

Internal audit department in place

References

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

Learning Pack

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

Discussion points

Workshop 1 – Identify controls (task 3)

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



Control activities

Controls activities identified	Relevant to sales/receivables and cash?	Inherent risk addressed (from task 1)
Contracts for purchases and sales to wholesale customers approved by legal team	yes re wholesale sales	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods
Designs for major collections are approved by the board	No	
Radio frequency identification technology used in stores	Yes	Cash sales may not be complete or accurately recorded
Integration of radio frequency identification technology with sales and inventory records	Yes	Cash sales may not be complete or accurately recorded
Cashing up procedures	Yes	Cash sales may not be complete or accurately recorded
– Two members of staff counting cash		
– Store manager performing z-read and reconciling to cash counted		

Controls activities identified	Relevant to sales/receivables and cash?	Inherent risk addressed (from task 1)
Controls over sales to wholesale customers are recorded in a checklist by sales managers:	Yes	
– Credit checks on new customers	Yes	
– Orders in writing and signed by customer	Yes	
– Designs for bespoke commissions approved by customers	Yes	
– Legal contract drawn up and signed by customer for bespoke commissions	Yes	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods
– Production on bespoke commissions now starts after contract is signed	Yes	
– Despatch notes signed by customer and copy retained and sent to accounts for invoicing	Yes	
– Customer accounts monitored and overdue amounts chased by sales managers in writing	Yes	
– Cases referred to legal team where payment is not forthcoming	Yes	
Formal checks on quality of production by management	No	
System of annual budgetary control is in place	Yes	Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers Some sales made online through estore – may not be recorded by systems accurately

Controls activities identified	Relevant to sales/receivables and cash?	Inherent risk addressed (from task 1)
Preparation of monthly management accounts and preparation of monthly board reports by senior managers	Yes	Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers Cash sales may not be complete or accurately recorded Some sales made online through estore – may not be recorded by systems accurately
Communication of code of conduct and ethical standards policy	Yes	Addresses inherent risks at entity level



Monitoring of controls

Controls identified	Relevant to sales/receivables and cash?	Inherent risk addressed (from task 1)
Cashing up procedures: <ul style="list-style-type: none">– Store managers must notify head office of discrepancies over a set threshold	Yes	Cash sales may not be complete or accurately recorded
Controls over sales to wholesale customers are recorded in a checklist by sales managers which are periodically reviewed by senior management	Yes	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods
Regular review of overdue accounts by head of wholesales with sales managers	Yes	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods
Internal audit department in place	Yes	All where a particular area is investigated by the internal audit team

References

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

Learning Pack

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

Discussion points

Workshop 1 – Identify controls (task 4)

We can now consider how we might evaluate the effectiveness of the internal controls that we have identified as relevant to inherent risks associated with **sales/receivables and cash** and think about whether we might want to rely on them.



Control activities

Controls activities identified	Inherent risk addressed (from task 1)	How to evaluate effectiveness	Rely?
Contracts for purchases and sales to wholesale customers approved by legal team	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	For a sample of bespoke commissions trace to contract and ascertain whether approved by legal team Discuss with legal team the extent to which the contracts have proved enforceable	Yes, providing no evidence of contracts not being in place or being unenforceable
Radio frequency identification technology used in stores	Cash sales may not be complete or accurately recorded	Test the performance of the radio frequency identification technology in a number of stores to ascertain whether the system accurately records sales	Yes, although the instances of overriding would need to be taken into account and if significant may mean reliance cannot be placed on the system
Integration of radio frequency identification technology with sales and inventory records	Cash sales may not be complete or accurately recorded	Test the performance of the radio frequency identification technology in a number of stores to ascertain whether the system accurately records sales	Yes, although the instances of overriding would need to be taken into account and if significant may mean reliance cannot be placed on the system
Cashing up procedures <ul style="list-style-type: none"> – Two members of staff counting cash – Store manager performing z-read and reconciling to cash counted 	Cash sales may not be complete or accurately recorded	Observe cashing up procedures in a sample of stores Review documentation of cashing up procedures and ascertain whether discrepancies are appropriately reported	Yes, providing evidence that cashing up procedures are correctly followed by staff and reporting to head office is appropriately carried out – need to check recommendations from prior year management report have been implemented

Controls activities identified	Inherent risk addressed (from task 1)	How to evaluate effectiveness	Rely?
<p>Controls over sales to wholesale customers are recorded in a checklist by sales managers:</p> <ul style="list-style-type: none"> – Credit checks on new customers – Orders in writing and signed by customer – Designs for bespoke commissions approved by customers – Legal contract drawn up and signed by customer for bespoke commissions – Production on bespoke commissions now starts after contract is signed – Despatch notes signed by customer and copy retained and sent to accounts for invoicing – Customer accounts monitored and overdue amounts chased by sales managers in writing 	<p>Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods</p>	<p>For a sample of wholesale customers, test each of the controls in place to ascertain whether the appropriate controls were applied to each customer</p> <p>E.g. new customers should have credit check, bespoke commissions should have a contract in place before production started, all customers should have signed a despatch note etc.</p> <p>Review the sales managers' checklists for a sample of wholesale customers to ascertain whether control procedures are carried out</p> <p>Select a sample of overdue accounts and confirm referral to legal team</p>	<p>Yes, providing evidence obtained suggests procedures are appropriately carried out</p> <p>If credit limits have not been reviewed and processes reconsidered for existing customers then this may reduce ability to rely on these controls</p>

Controls activities identified	Inherent risk addressed (from task 1)	How to evaluate effectiveness	Rely?
<ul style="list-style-type: none"> – Cases referred to legal team where payment is not forthcoming 			
System of annual budgetary control is in place	<p>Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers</p> <p>Some sales made online through estore – may not be recorded by systems accurately</p>	Ascertain the procedures used around annual budgets and monthly management accounts and consider whether such procedures would be capable of identifying errors or misstatements in categories of revenue such as online sales, deposits etc	Yes, where budgetary processes and management accounting are found to be effective and identify issues in the recording of transactions
Preparation of monthly management accounts and preparation of monthly board reports by senior managers	<p>Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers</p> <p>Cash sales may not be complete or accurately recorded</p> <p>Some sales made online through estore – may not be recorded by systems accurately</p>		



Monitoring of controls

Controls identified	Inherent risk addressed (from task 1)	How to evaluate effectiveness	Rely?
<p>Cashing up procedures:</p> <ul style="list-style-type: none"> – Store managers must notify head office of discrepancies over a set threshold 	Cash sales may not be complete or accurately recorded	For a sample of stores identify days where cashing up procedures resulted in discrepancies above the threshold for that store. Obtain evidence that the discrepancy was notified to head office	Yes, providing instances of non-reporting are isolated
Controls over sales to wholesale customers are recorded in a checklist by sales managers which are periodically reviewed by senior management	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	<p>Inspect checklists for evidence of review by senior managers.</p> <p>Discuss with senior managers and sales managers what the outcomes of such reviews are</p>	Yes
Regular review of overdue accounts by head of wholesales with sales managers	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	<p>Identify documentation which is evidence that such reviews have taken place, e.g, notes from meetings or action lists</p> <p>Ascertain from management whether the actions from the meeting were undertaken</p> <p>For a sample of such actions, review the current status of the customer account to see whether they have resulted in payment</p>	Yes

Controls identified	Inherent risk addressed (from task 1)	How to evaluate effectiveness	Rely?
Internal audit department in place	All where a particular area is investigated by the internal audit team	Review the effectiveness of the internal audit department through consideration of their experience, qualifications etc Consider whether there is any work on which the external auditors may wish to rely and inspect such work for evidence that it has been properly undertaken and appropriate conclusions reached	The biggest issue with relying on internal audit relates to their lack of independence from the accounting function

References

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

Learning Pack

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

Discussion points

Workshop 1 – Identify controls (task 5)

Introduction


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

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

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




Substantive procedures – based on control activities identified

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
Contracts for purchases and sales to wholesale customers approved by legal team	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	Yes, providing no evidence of contracts not being in place or being unenforceable	<ul style="list-style-type: none"> Select a sample of balances due from wholesale customers at year end and trace to post year end payments Ascertain reasons from management for any balances due that fall outside the period agreed within the contract 	<ul style="list-style-type: none"> Existence Valuation

Student Notes


Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
Use of specialist security firm to distribute products and collect cash from stores	Cash sales may not be complete or accurately recorded	Yes	<ul style="list-style-type: none"> Perform analytical procedures comparing levels of monthly sales by store to budgeted levels and prior year 	<ul style="list-style-type: none"> Completeness Accuracy
Radio frequency identification technology used in stores	Cash sales may not be complete or accurately recorded	Yes, although the instances of overriding would need to be taken into account and if significant may mean reliance cannot be placed on the system	<ul style="list-style-type: none"> Ascertain from management reasons for any unexpected variations across stores or within particular months Inspect a sample of reconciliations of the cash takings for a sample of stores (per documentation completed during cashing up) with the amount of cash deposited with the specialist security firm Compare takings to till rolls for a sample of stores and investigate any differences 	

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
Integration of radio frequency identification technology with sales and inventory records	Cash sales may not be complete or accurately recorded			
Cashing up procedures <ul style="list-style-type: none"> – Two members of staff counting cash – Store manager performing z-read and reconciling to cash counted 	Cash sales may not be complete or accurately recorded	Yes, providing evidence that cashing up procedures are correctly followed by staff and reporting to head office is appropriately carried out	See above	
Controls over sales to wholesale customers are recorded in a checklist by sales managers: <ul style="list-style-type: none"> – Credit checks on new customers – Orders in writing and signed by customer – Designs for bespoke commissions approved by customers – Legal contract drawn up and signed by customer for bespoke commissions – Production on bespoke commissions now starts after contract is signed 	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	Yes, providing evidence obtained suggests procedures are appropriately carried out If credit limits have not been reviewed and processes reconsidered for existing customers then this may reduce our ability to rely on these controls	<ul style="list-style-type: none"> • Perform an accounts receivable circularisation at year end and ascertain reasons for any differences between the amount due per the sales ledger and the amount reported as due by the customer • For a sample of accounts receivable at year end, trace amounts to payments received after the year end. Investigate any reasons for non- payment of amounts due 	<ul style="list-style-type: none"> • Existence • Valuation


Student Notes

Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
<ul style="list-style-type: none">– Despatch notes signed by customer and copy retained and sent to accounts for invoicing– Customer accounts monitored and overdue amounts chased by sales managers in writing– Cases referred to legal team where payment is not forthcoming			<ul style="list-style-type: none">• Ascertain from management the basis of the calculation of the year-end allowance against receivables, consider reasonableness compared to amount of receivables written off in prior year and reperform calculation• Review the aged-receivables analysis and identify any overdue amounts, ascertain whether such amounts are included in the year-end allowance against receivables and ascertain from management reasons for not including overdue amounts where this is the case	

Student Notes

Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)


Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
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- Inspect correspondence files to identify any disputes over amounts due from customers and ascertain whether such amounts are included in the year-end allowance against receivables

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
System of annual budgetary control is in place	Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers		<ul style="list-style-type: none"> Compare the level of deposits in relation to prior year Select a sample of sales made after the year end and where a deposit was paid by the customer ascertain whether the deposit was paid pre-year end, if so, trace deposit to deferred income balance. 	<ul style="list-style-type: none"> Cut-off Completeness Accuracy
Preparation of monthly management accounts and preparation of monthly board reports by senior managers	Some sales made online through estore – may not be recorded by systems accurately	Yes, where budgetary processes and management accounting are found to be effective and identifying issues in the recording of transactions	<ul style="list-style-type: none"> Compare the level of sales made online with prior year on a monthly and product line/type basis; ascertain reasons for any unexpected variations 	
	Some customers pay deposits for goods – revenue may be overstated if these are recorded in revenue at year end but goods have not been despatched to customers			


Student Notes

Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)

Controls identified	Inherent risk addressed/ effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
	<p>Cash sales may not be complete or accurately recorded</p> <p>Some sales made online through estore – may not be recorded by systems accurately</p>			




Substantive procedures – based on monitoring of controls identified

Controls identified	Inherent risk/effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
<p>Cashing up procedures:</p> <ul style="list-style-type: none"> – Store managers must notify head office of discrepancies over a set threshold 	Cash sales may not be complete or accurately recorded	Yes providing instances of non-reporting are isolated	See above	
<p>Controls over sales to wholesale customers are recorded in a checklist by sales managers which are periodically reviewed by senior management</p>	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	Yes	See above	


Student Notes

Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)

Controls identified	Inherent risk/effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
Regular review of overdue accounts by head of wholesales with sales managers	Risk of bad debts or insufficient allowance against receivables as a number of wholesale customers are extended credit of varying periods	Yes		

Student Notes

Module C (Jun 2012) Workshop 1 – Identify controls (task 5) (Session 5)

Controls identified	Inherent risk/effectiveness	Rely?	Substantive procedures 	Area/FS assertion tested
Internal audit department in place	All where a particular area is investigated by the internal audit team	The biggest issue with relying on internal audit relates to their lack of independence from the accounting function	Ascertain whether there is any work undertaken by the internal audit team that is relevant to the external audit. Where such work exists the external audit team must establish whether the specific piece of work can be relied upon by assessing, for example, the experience and qualifications of the staff performing the work and the appropriateness of the conclusions reached	Potentially all depending on nature of the work undertaken by internal audit

Conclusions and overall audit approach



Overall the control environment, risk assessment process and information systems in place at Golden Panda appear, in theory, to be appropriate. However, the failure to implement some of the internal controls suggested by the prior year auditors does raise questions as to whether management do always take action with respect to controls when necessary. Further investigation may indicate that in some areas of internal controls are not adequate and that a substantive audit approach will be required.



In principle, the overall inherent risks associated with sales, receivables and cash appear to be well addressed by control activities and monitoring of controls. However, there is a question as to whether these control activities and monitoring of controls are always being operated effectively, e.g. cashing up procedures and issues associated with accounts receivable that were raised by the previous auditor.



Some level of substantive testing will always be required due to the inherent limitations of internal control procedures. The extent of substantive procedures however will depend on the outcome of controls testing and may be reduced where controls are found to operate effectively and are relevant to addressing the inherent risks identified.

References

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

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*

Learning Pack

Chapter 11: Internal controls and tests of control, Sections 1, 2, 3 and 4

Chapter 12: Substantive procedures including analytical procedures, Sections 1.4 and 1.5 and diagram in section 1.7.2