

**Section 1 – Identifying and assessing RoMM at assertion level (“RoMM assessment”)****Concept check:**

- What is the objective of an audit?
- How does the RoMM assessment help achieve that objective?
- What is the relationship between RoMM assessment and other audit concepts?

The concept of audit risk is set out in HKSA 200 (Clarified).

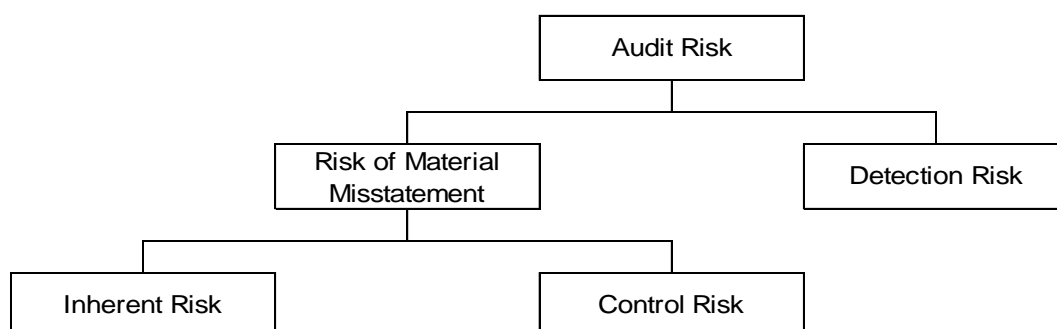
**Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the F/S are materially misstated. Audit risk is a function of detection risk and RoMM.

**Detection Risk** is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. However, detection risk can never be zero due to limitations of an audit.

**RoMM** is the risk that the F/S are materially misstated prior to audit. This consists of two components:

Component of RoMM	Remark
Inherent risk	This refers to 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.  They are beyond the control of auditors. However, the auditors can address detection risk by designing audit procedures to <u>reduce RoMM to an acceptably low level</u> and thus minimise audit risk.
Control risk	This refers to the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.  Control risk can never be zero due to limitations of internal control.

The relationship between the above components can be summarised in the below diagram:

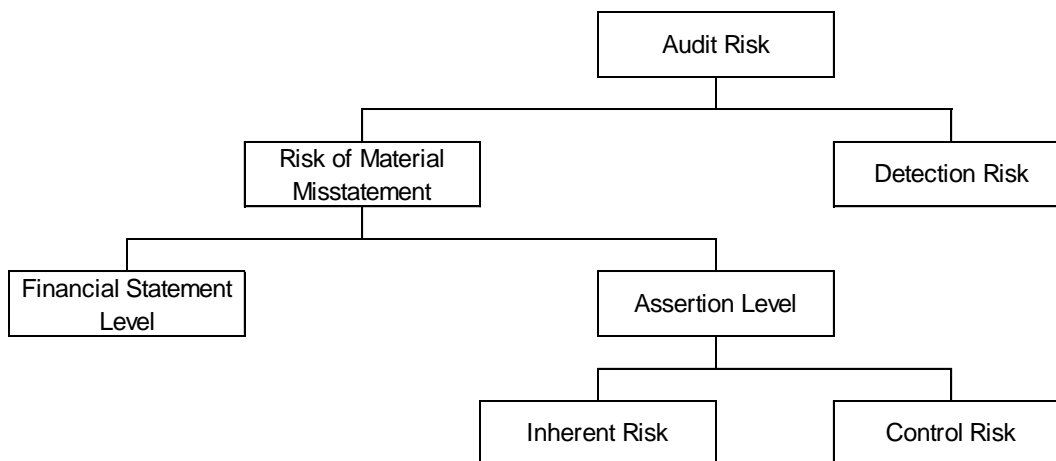


HKSA 200 (Clarified) further states that the RoMM exists at two levels:

- **RoMM at the Financial Statement Level.** It refers to RoMM that relate pervasively to the F/S as a whole and potentially affect many assertions.
- **RoMM at the Assertion Level.** It refers to RoMM for specific classes of transactions, account balances and disclosures.

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Thus, the above diagram can be further expanded as follows:



**In a nutshell:**

1. Audit Risk = RoMM x Detection Risk
2. Audit Risk = (Inherent Risk x Control Risk) x Detection Risk
3. Inverse relationship between RoMM and Detection Risk: At a given level of audit risk, the greater the RoMM, the less the detection risk that can be accepted and thus the more persuasive audit evidence is required.

**Assertions for Statement of Financial Position:**

Assertion	Definition
Existence	Assets, liabilities and equity exist
Completeness	All assets, liabilities and equity that should have been recorded have been recorded
Rights and Obligations	The entity holds/controls the rights to assets. Liabilities are obligation of the entity
Valuation and Allocation	Assets, liabilities and equity are recorded at appropriate amounts

**Assertions for Statement of Profit or Loss and Other Comprehensive Income:**

Assertion	Definition
Occurrence	Transactions and events recorded have occurred and pertain to the entity
Completeness	All transactions and events that should have been recorded have been recorded
Accuracy	Amounts and data relating to recorded transactions and events have been recorded appropriately
Cut-Off	Transactions and events recorded have been recorded in the correct accounting period
Classification	Transactions and events have been recorded in the proper F/S

**Assertions for Presentation and Disclosure:**

Assertion	Definition
Occurrence and rights and obligations	Disclosed events, transactions, and other matters have occurred and pertain to the entity.
Completeness	All disclosures that should have been included in the F/S have been included.
Classification and Understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed.
Accuracy and Valuation	Financial and other information are disclosed fairly and at appropriate amounts.

In assessing RoMM at the assertion level, generally the auditor may consider the following factors:

<b>Factors</b>	<b>Circumstances that may increase RoMM at Assertion Level</b>
Nature of item	When the item is more susceptible to misappropriation or manipulations.
Degree of judgement involved	When the item is more susceptible to judgement (e.g. outcome of a court case).
Complexity	When the item is complex and may involve the use of expert (e.g. actuarial).
Non-routine or one-off	When the item is non-routine or one-off, the entity may be less experienced in dealing with this item.
Volume of transaction	When there is a high volume of transactions (especially near the year-end).
Previous misstatements	When the item has been misstated in prior years.

**Practice Question 1 (extracted from MC Jun 14)**
**CASE**

High-Resolution International Holdings Limited (“High-Re”) or “the Group” is a listed company in Hong Kong and a manufacturer and distributor of television and related products. The Group develops and produces different ranges of television of their own brands and OEM products. High-Re has three main manufacturing plants in Shenzhen, Mexico and Poland. As at 31 December 2013, High-Re has about 80 trading subsidiaries serving their customers in over 30 countries.

In a 2013 High-Re press release, Chairman Szeto forecasts that the world demand for television and related products will triple in the next two years in view of the coming sport events such as the World Cup and Olympics. In order to capture the market and meet the increase in demand, High-Re has put additional effort into developing a wider range of new models to meet different customers’ needs. High-Re has also acquired a few smaller scale production plants in different locations both inside and outside mainland China to enhance the Group’s production capacity. Specifically, High-Re plans to further expand its business to South America and has set up two trading offices in Sao Paulo and Mexico City.

As at 31 May 2014, High-Re’s inventory balance increased by 35% comparing to 31 December 2013. Research and development expenses increased by 70% for the first five months of 2014 compared to the same period in the previous year.

**Extract of the financial information of High-Re for the five-month period ended 31 May:**

US\$’million	2014	2013
Revenue	1,400	1,350
Cost of sales	1,323	1,280
Gross profit or GP%	5.5%	5.2%
Net (loss) / profit margin	(15)	30

**Key statement of financial position items as at 31 May:**

US\$’million	2014	2013
Property, plant and equipment	167	155
Inventory	488	363
Trade receivables	500	580
Trade payables	583	593
Cash and bank balances	54	124

Apart from business expansion, the Group has set clear business objectives to raise overall efficiency, not just focusing on utilising the Group’s production capacity. The Group’s utilisation of production capacity is approximately 65% which is an all time low in recent years and relatively low compared to other industry players.

In order to gradually improve the Group's overall efficiency, High-Re has outsourced its payroll function to a third party service provider during the year. High-Re maintains only minimal resources in the payroll function to oversee the work performed by the third party service provider.

You are Andy Chan, the lead partner of the High-Re audit engagement. You will have a planning meeting with your team soon to prepare for the upcoming High-Re annual audit. Nancy Yu is the new audit manager assisting you in this audit.

### **Question 2**

Assume you are Nancy and you are now performing the preliminary analytical review based on the financial information of the Group up to May 2014 provided by management. Andy has asked you to pay particular attention to the asset quality and to discuss with him any risk of material misstatements identified.

You arranged a meeting with High-Re's Chief Financial Officer ("CFO") and discussed with him the increase in the inventory balance. The CFO explained to you that historically the electronic market performs better in the second half of the year than the first half. They have experienced sales teams and a detailed sales strategy to promote the new models. However, when you reviewed the inventory aging, the aging profile has significantly deteriorated compared to December 2013.

### **Required:**

- (a) In light of the results of the preliminary analytical review performed and your discussion with the Group's CFO, suggest the risk of material misstatements identified relating to inventory and property, plant and equipment. Elaborate your answers.

(6 marks)

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**Answer 2(a)**

The risks of material misstatements identified include:

The inventory balance may potentially be overstated and that may impact the valuation assertion of the inventory balance. As the television industry is highly affected by technology advancement, obsolete inventory is a relatively more serious problem than in other industries.

Though management are optimistic about market demand and confident in their marketing strategy, the deterioration in inventory ageing and the disproportionate increase in inventory compared to increases in sales are indicators that there may be increasing risk of slow moving and obsolescence inventory.

In addition, since the gross profit margin percentage for television products is relatively low (i.e. 5%), any subsequent fluctuation in the selling price may impact the net realisable value of the Group's inventory.

There may be potential impairment of the group's property, plant and equipment that may impact the valuation assertion of the Group's property, plant and equipment.

The under-utilisation of the group's production facilities, the fact that the Group has turned from profit-making to loss-making during the year, and the continuous expansion of the Group's production facilities may imply that the Group will not be able to realise the economic benefits of the property, plant and equipment through operational use.

**Practice Question 2 (extracted from MC Jun 14)****Question 6**

You are the auditor of Think Limited which is a furniture manufacturer with a factory in Dongguan, China. During the planning of the audit for the year ended 31 March 2014, you obtained the following financial information:

	2014 HK\$'million	2013 HK\$'million
Revenue	525	285
Cost of goods sold	350	242
Gross Profit	175	43
Property, plant and equipment	425	495
Accounts receivable	232	75
Accounts payable	155	105

**Required:**

- (a) **Assess and explain the risk of material misstatement relating to the occurrence assertion of revenue for the year ended 31 March 2014.**

**(4 marks)****Answer 6(a)**

The risk of material misstatement relating to the occurrence assertion of Think Limited's revenue for the year ended 31 March 2014 is high as:

- The revenue significantly increased 84% from the prior year and there was no significant capital investment in Think Limited's property, plant and equipment to increase its production capacity.
- The gross profit margin increased from 15% to 33%. For manufacturing company, revenue should change in line with the cost of goods sold.
- The accounts receivable balances increased to 3 times of the same in the last year and the debtor turnover period (accounts receivable / revenue x 365 days) increased from 96 days to 161 days. It indicated that the revenue may be overstated by including non-existent debtors.



**Practice Question 3 (extracted from MC Dec 13)**

**CASE**

Superior Electronic Limited (“Superior”) is a company listed on The Hong Kong Stock Exchange and is engaged in the manufacturing and trading of electronic products with production facilities in mainland China, Vietnam and Africa. ABC & Co. (“ABC”) is the auditor of Superior and you are the partner in charge of the audit.

During the financial year ending 31 December 2013, Superior announced the following significant events:

- (1) In February 2013, Superior’s factory in Africa was flooded because of the intermittent rainfall since January 2013. Due to difficulties in accessing the facility because of the evacuation order issued by the local government, Superior has suspended production in Africa since 15 February 2013. The factory building was flooded and it was difficult to predict when production could be resumed.

The financial information related to the factory in Africa extracted from its audited financial statements for the year ended 31 December 2012 was as follows:

	HK\$'000
Property, plant and equipment	75,228
Inventories	23,410
Trade and other receivables	12,450
Bank balances and cash	5,211
Trade and other payables	11,524

- (2) In March 2013, Superior was informed that some bank balances of a subsidiary company in Africa were queried by the branch manager of the company’s local bank because a large quantity of bank notes were deposited into the company’s bank account instead of a cheque receipt. With concern about involvement in money laundering activities, an independent non-executive director of Superior voiced out in a monthly board meeting that Superior’s internal audit function should be strengthened, in particular to monitor the risk assessment process of the company.
- (3) In May 2013, Superior entered into an agreement to subcontract the manufacturing process to a company which is owned by a director of Superior with an annual consideration not exceeding HK\$200 million.

In the course of planning for the audit of Superior for the year ending 31 December 2013, ABC obtained the management accounts from Superior. The financial information extracted from the management accounts is as follows:

	Nine months ended 30 September 2013 (unaudited) HK\$'000	Year ended 31 December 2012 (audited) HK\$'000
Revenue	1,134,617	1,814,896
Cost of sales	(1,185,084)	(1,652,456)
Operating expenses	(45,928)	(99,820)
Impairment of property, plant and equipment	(62,000)	0
	(158,395)	62,620
	=====	=====

	30 September 2013 (unaudited) HK\$'000	31 December 2012 (audited) HK\$'000
Property, plant and equipment	480,228	612,334
Inventories	76,523	120,221
Trade and other receivables	250,895	321,852
Bank balances and cash	240,111	245,223
Trade and other payables	128,552	249,541
Bank and other borrowings	13,456	18,478

### Question 1

- (a) In respect of the flood damage to Superior's factory in Africa, identify and explain the risks of material misstatements at assertion level.

(10 marks)

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**Answer 1(a)**

The following are the risks of material misstatements identified at assertion level:

- (i) Existence and valuation of property, plant and equipment
- The amount of property, plant and equipment is material to financial statements, it represents 12% of the total property, plant and equipment of Superior as at 31 December 2012.
  - The flood damage may affect the usability of these assets and their recoverable or realisable value.
  - The assets may be overstated because the register includes assets that have been sold or scrapped and are not removed from the register.
- (ii) Existence and valuation of inventories
- The amount of inventories is material to financial statements, it represents 19% of the total inventories of Superior as at 31 December 2012.
  - The inventories may not be valued at the lower of cost or net realisable value.
  - The inventories may be overstated if those scrapped during the flood are not removed from the inventory listing.
- (iii) Valuation of insurance claim
- With reference to the value of property, plant and equipment of the factory, the amount of the insurance claim should be material to the financial statements.
  - The amount of insurance claim recognised depends on the assessment of the damage by the insurance company.
- (iv) Completeness of the compensation loss to employees
- The operation of the factory was suspended after the flooding and the entity may need to lay off the excessive workers so as to reduce the operating costs.
  - The amount of compensation may be understated if the entity has not fully accrued for compensation according to the statutory requirements.
- (v) Completeness of potential liability
- The possible claims from customers in respect of the late delivery of goods or default in delivery of goods may be understated.

**Practice Question 4 (extracted from MC Jun 13)****CASE**

You are an audit partner of ABC & Co. One day in July 2012, your old friend, Thomas, called you and told you that Happy Toy Ltd. (“Happy Toy”) was looking for a new auditor and would like to check if you are interested in taking up the audit engagement.

After performing some background search of Happy Toy, you arranged a meeting with the management of Happy Toy to understand more about the entity and its business.

Here are the notes that you have written down during the meeting with Happy Toy’s management:

- Happy Toy listed on The Hong Kong Stock Exchange in 2001. Its principal business is toy manufacturing and trading.
- It has a manufacturing plant in Panyu, China, and two trading companies in Hong Kong and Macau respectively.
- It mainly produces soft toys for overseas customers in the US and Europe. Only approximately 10% of sales are transacted with local customers in mainland China.
- Its toy business has been shrinking after the Financial Tsunami in 2008. Competition is getting fierce. Customer orders from the US and Europe dropped significantly while there is the continuous increase in material and labour costs in the Mainland. Management has been struggling in this business environment.
- In 2010, Happy Toy started to diversify its business portfolio and acquired a shopping arcade in the west of Guangzhou. The shopping arcade brings a stable income to the group and has been profit-making.
- In 2012, Happy Toy further diversified its business portfolio by investing in property development. It acquired a property development company in Henan focusing on developing high-end residential housing.
- The acquisition of the Henan property project was completed in February 2012. Happy Toy paid a total consideration of HK\$200 million. The asset acquired mainly represented a piece of land located in Henan. The management has engaged an external independent valuer to assess the fair value of the land. The valuation of the land as at the acquisition date was approximately HK\$180 million. A goodwill of HK\$40 million was recognized in relation to this acquisition after considering the liabilities of HK\$20 million.
- Management is confident of their property project in Henan in view of the high growth of the property market in the Mainland. They also explained that their piece of land is located in a very good location because a highway and a train station will be built nearby.
- As at 30 June 2012, Happy Toy has HK\$300 million bank borrowings with the maturity date due in September 2013.

Subsequent to the meeting, management has sent you their interim report. Here is an extract of Happy Toy's financial information as at 30 June 2012 and for the six months ended 30 June 2012:

### Segment disclosures

For the six months ended 30 June 2012:

	Toy Manufacturing Business (HK\$'000)	Property Rental Business (HK\$'000)	Property Development Business (HK\$'000)	Total (HK\$'000)
Revenue	680,000	12,000	-	692,000
Operating Profit / (loss)	(5,000)	9,000	(1,000)	3,000

For the six months ended 30 June 2011:

	Toy Manufacturing Business (HK\$'000)	Property Rental Business (HK\$'000)	Property Development Business (HK\$'000)	Total (HK\$'000)
Revenue	850,000	11,600	-	861,600
Operating Profit / (loss)	(4,000)	8,500	-	4,500

### Extract from financial statements:

	30 June 2012 (HK\$'000)	31 December 2011 (HK\$'000)
Goodwill	40,000	-
Investment property	200,000	200,000
Property, plant and equipment	160,000	162,000
Property under development	180,000	-
Inventories	6,500	8,000
Trade receivables	27,000	30,000
Cash and bank	27,000	280,000
Other current assets	5,000	4,800
<b>Total assets</b>	<b>645,500</b>	<b>684,800</b>
Trade payables	53,000	57,000
Other payables and accruals	23,000	2,000
Bank borrowings	300,000	300,000
<b>Total liabilities</b>	<b>376,000</b>	<b>359,000</b>

In early August 2012, Happy Toy would like to nominate ABC & Co. as their coming auditor for the financial year ended 31 December 2012.

**Question 2**

You have accepted Happy Toy's appointment as their auditor for the 2012 financial year audit. You are now working on the audit planning and risk assessment.

**Required:**

- (a) In respect to the property project in Henan, identify and explain the risks of material misstatements at the assertion level.

[Note: Marks will only be given if you can provide specific answers to particular account balance(s) and related assertion(s).]

(7 marks)

**Answer 2(a)**

The following are the risks of material misstatements identified:

- (i) Existence, valuation and right and obligation of the piece of land acquired
- The amount of the land acquired is material to financial statements and its valuation is highly dependent on the valuation results of the external independent valuer.
- (ii) Valuation of the goodwill arising from the acquisition of the property development company
- The amount of goodwill recognized is individually material to the financial statements and highly dependent on the valuation results of the asset and liabilities acquired.
  - Potential goodwill impairment depends on the future development of the property market in the Mainland and the timing of completion of the highway and train station.

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**Practice Question 5 (extracted from MC Jun 12)****CASE**

Super Energy Limited (“Super Energy”) is a global oil company listed in Hong Kong. It has operations in over 50 countries and is one of the largest energy companies in the world. It produces around the equivalent of 2 million barrels of oil per day and has over 10,000 petrol service stations worldwide.

Super Energy’s headquarters are in Hong Kong. It is vertically integrated from exploration and production, refining, distribution and marketing to petrol station retailing. Its largest oil production plant is in America.

Super Energy’s track record of corporate social responsibility has been mixed. The company has been involved in a number of major environmental and safety incidents and received criticism for its political influence. However, it is also the first major oil company to publicly acknowledge the need to take steps against climate change and take actions to reduce emissions. Super Energy currently invests over HK\$10 billion per year in the development of renewable energy sources and environmental protection.

In June 2011, because of a gas release, Super Energy’s oil rig working on the Bargara exploration well in the Gulf of Sankala exploded. The fire burned for 48 hours before the rig sank and the oil leaked into the Gulf of Sankala for 85 days before the well was closed and sealed. Ten people died in the accident and others were injured. The accident also caused significant damage to the environment and the livelihoods of those in the communities nearby. The accident was widely reported by the media. Super Energy was requested by the US government to investigate and explain the causes of the accident to the public.

The company has committed to take responsibility for the clean-up and compensate victims of the accident. As of 31 December 2011, the company reported that they have spent HK\$20 billion on the response activities.

ABC & Co. is the auditor of Super Energy. ABC & Co. and Super Energy’s board of directors meet with the Audit Committee quarterly. ABC & Co. also holds regular meetings with the Internal Audit and reviews the Internal Audit investigation reports.

There were two Internal Audit investigation reports issued in December 2011 which caused particular concern to ABC & Co. In these reports by the Internal Audit, they found a significant access control deficiency over the Flex Accounts which are the general ledger used by Super Energy worldwide, and some exploration and production facilities were potentially overstated due to certain significant controls over fixed asset registration and valuation were not properly exercised by the operation team.

Here is an extract of the financial data of Super Energy:

	<b>Year ended 31 December 2011</b> (Unaudited) HK\$ billion	<b>Year ended 31 December 2010</b> (Audited) HK\$ billion
Revenue	250	220
Profit / loss before tax	(50)	30
Total assets	3,790	3,856
Total liabilities	2,823	2,998

### **Question 1**

- (a) Assuming you are ABC & Co., after reading the Internal Audit report about the potential overstatement of certain exploration and production facilities, evaluate and explain the financial statement assertions that concern you most relating to fixed assets.

(3 marks)

### **Question 2**

- (a) Assuming you are ABC & Co., in response to the accident in the Gulf of Sankala, identify three risks of material misstatements of Super Energy's financial statement as at 31 December 2011.

(3 marks)

### **Answer 1(a)**

Existence and completeness due to certain significant controls over fixed asset registration were not properly implemented by the operation team;

Valuations due to certain significant control over fixed asset valuation were not properly implemented by the operation team.

### **Answer 2(a)**

In response to the accident, assessing the risk of material misstatements relating to Super Energy's financial statements as a whole, ABC & Co. should consider the following:

- The occurrence and completeness of the expenses incurred and paid relating to the accident.
- The adequacy of the provision for claim and litigation provided against the parties affected by the accident.
- The adequacy of the disclosure made in the financial statements in response to the accident e.g. provision and contingency made.
- The potential asset impairment loss after the accident.

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**Practice Question 6 (extracted from MC Dec 11)****Question 7**

You are the auditor of CC Limited (CC). CC acquired DD Limited during the year and recorded goodwill of HK\$300 million and intangible assets such as trade mark, patent and customers relationship of HK\$500 million. Management of CC engaged X Limited to value the intangible assets and advise on the business valuation of the transaction. Based on the business valuation performed by X Limited, CC developed its goodwill impairment assessment and concluded that no goodwill impairment is necessary.

**Required:**

- (a) Evaluate and explain the risk of material misstatement relating to the valuation assertion of CC Limited's goodwill and intangible assets as at 31 December 2011.

(4 marks)

**Answer 7(a)**

The risk of material misstatement relating to valuation of goodwill and intangible assets is high.

The valuation of goodwill and intangible assets may be materially misstated if:

- Improper business and intangible asset valuation prepared by X Limited due to wrong assumptions, business data and valuation methodology used;
- Certain intangible assets are not identified from the acquisition;
- Useful life of the intangible assets are over-estimated; and
- Goodwill impairment assessment was not properly prepared by management with reference to inappropriate business data and assumptions.

**Section 2 – Group Audit**

Concept check:

- What is the setting of group audit?
- What are the specific audit issues in a group audit setting?

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

Below are the basic definitions in a group audit:

**Group financial statements** are financial statements that include the financial information of more than one component.

**Component** is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

**Component auditor** is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

**Group-wide controls** are controls designed, implemented and maintained by group management over group financial reporting.

### Nature of Group Audit

The audit process in a group audit is in principle the same in a non-group audit. However, the fact the F/S is consolidated brings up additional audit considerations which are addressed by HKSA 600 (Clarified).

The objectives of the group auditor are:

- (a) To determine whether to act as the auditor of the group F/S; and
- (b) If acting as the auditor of the group F/S:
  - (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
  - (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group F/S are prepared, in all material respects, in accordance with HKFRS.

### Overview of Group Audit Process

Following on the previous section, the specific considerations required by HKSA 600 (Clarified) in the audit process are set out in the below table:

Stage	Responsibility of Group Auditor
Acceptance and Continuance	<ul style="list-style-type: none"> <li>• Obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components</li> </ul> <p>Obtaining such understanding enable the group auditor to fulfil the requirements of HKSQC 1(Clarified) and whether sufficient appropriate audit evidence can be obtained on the group F/S.</p>
Overall Group Audit Strategy and Audit Plan	<ul style="list-style-type: none"> <li>• Review the overall group audit strategy and group audit plan</li> </ul> <p>Typically, the overall audit strategy and audit plan for a group is more excessive.</p>
Understanding the Group, Its Components, and Their Environments	<ul style="list-style-type: none"> <li>• Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage</li> <li>• Obtain an understanding of the consolidation process, including the instructions issued by group management to components</li> </ul> <p>The understanding should be sufficient to:</p> <ul style="list-style-type: none"> <li>• Confirm or revise its initial identification of components that are likely to be significant</li> <li>• Assess the RoMM of the group F/S whether due to fraud or error</li> </ul>

Determine significant components and work thereon	Please below for further discussion.
Assess Component Auditors	Please below for further discussion.
Testing Group-Wide Controls	<p>Test (or request a component auditor to test) the operating effectiveness of group-wide controls if:</p> <ul style="list-style-type: none"> <li>• NET of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively; or</li> <li>• Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level</li> </ul>
Determine Component Materiality	Please below for further discussion.
Issue Group Audit Instructions to Component Auditors	Please below for further discussion.
Involvement with Component Auditors' Work	Please below for further discussion.
Test Consolidation Process	This involves the testing of consolidation adjustments and making sure the consolidation F/S is complete.
Subsequent Events	<p>Where component auditors perform work other than audits of the financial information of components:</p> <ul style="list-style-type: none"> <li>• request the component auditors to notify the group auditor if they become aware of subsequent events that may require an adjustment to or disclosure in the group F/S</li> </ul>
Communication with Group Management and Those Charged with Governance	This includes key group audit issue.
Basis of Group Audit Opinion	<p>This is based on evaluation of whether sufficient appropriate audit evidence has been obtained from:</p> <ul style="list-style-type: none"> <li>• the work performed by the group auditor;</li> <li>• the work performed by the component auditors on the financial information of the components; and</li> <li>• the audit procedures performed on the consolidation process</li> </ul>
Forming Group Audit Opinion	<p>The auditor's report on the group F/S shall not refer to a component auditor (even in the case of modification of opinion), unless required by law or regulation to include such reference.</p> <p>If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group auditor's responsibility for the group audit opinion.</p>

### **Determine Significant Components**

Significant component is a component that is:

- of individual financial significance to the group; or
- due to its specific nature or circumstances (likely to include significant RoMM of the group F/S).

A percentage to a chosen benchmark (group assets, liabilities, cash flows, profit or turnover) may be applied as an aid to identify components that are of individual financial significance.

Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgement.

HKSA 600 (Clarified) does not set out a specific threshold. Nevertheless, HKSA 600 (Clarified) includes an example that components exceeding 15% of the chosen benchmark may be considered significant components. However, a higher or lower percentage may also be deemed appropriate depending on the circumstances.

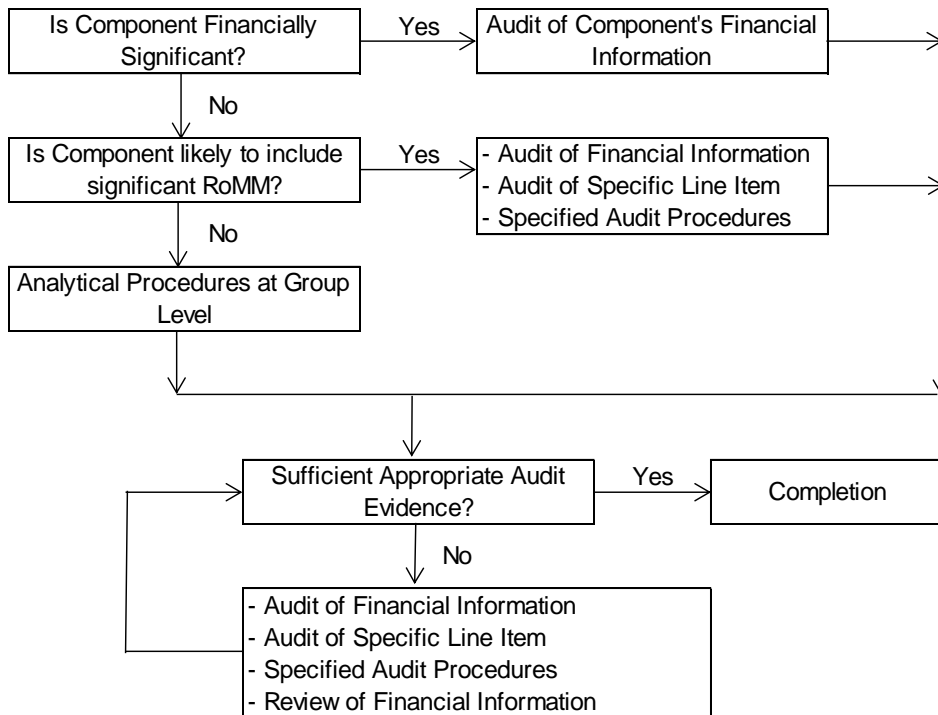
### **Determine the Type of Work to be performed on Components**

HKSA 600 (Clarified) sets out clear guidance as follows:

<b>Circumstance</b>	<b>Type of Work</b>
Significant component due to its individual financial significance	Perform an audit of the financial information of the component using component materiality
Significant component due to its specific nature or circumstances and may pose significant RoMM	Perform one or more of the following: <ul style="list-style-type: none"> <li>• An audit of the financial information of the component using component materiality</li> <li>• An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant RoMM</li> <li>• Specified audit procedures relating to the likely significant RoMM</li> </ul>
Components that are not significant components	Perform analytical procedures at group level  If the group engagement team does not consider that sufficient appropriate audit evidence will be obtained, then perform one or more of the following: <ul style="list-style-type: none"> <li>• An audit of the financial information of the component using component materiality</li> <li>• An audit of one or more account balances, classes of transactions or disclosures</li> <li>• A review of the financial information of the component using component materiality</li> <li>• Specified procedures</li> </ul>

The determination of type of work can be summarised by the following flowchart:

**Type of Work to Perform on Components**



**Assessing Component Auditors**

The findings of component auditors will be used by group auditor as basis to form the group audit opinion. Therefore, it is crucial for the group auditor to ensure the creditability of the component auditors.

In particular, the group auditor should assess the following areas in respect of the component auditors:

Areas to assess	Group Auditor's Procedures
Compliance with ethical requirements, in particular, independence (independent from the parent company and its related parties)	<ul style="list-style-type: none"> <li>Seek confirmation from the component auditor regarding their independence, objectivity and professional competence</li> <li>Visit the component auditor to discuss about their independence, objectivity and professional competence</li> <li>Request the component auditor to complete questionnaires about their independence, objectivity and professional competence</li> </ul>
Objectivity, including any bias or conflict of interest	<ul style="list-style-type: none"> <li>Obtain confirmations from the professional bodies whether the components are professional qualified and licensed with those professional bodies</li> </ul>
Professional competence, including: <ul style="list-style-type: none"> <li>Understanding of HKFRS and HKSA</li> <li>Sufficient expertise and experience in the component's industry audit</li> </ul>	<ul style="list-style-type: none"> <li>Ascertain the quality control policies and procedures used by the component auditors, both firm-wide and those applied to individual engagements</li> <li>Obtain and review the ethical codes followed by component audit firms and compare them to Code of Ethics for Professional Accountants issued by HKICPA</li> </ul>

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If there are any issues, the group auditor should increase the NET of involvement in the component auditors' work, including:

- Supervise the component auditor directly and review their working papers
- Review in details the component auditors' findings and evaluate the appropriateness of their conclusion

The group auditor should also consider to perform the audit work themselves instead of using the component auditors.

### **Group and Component Materiality**

The group auditor shall determine the following:

<b>Types of Materiality</b>	<b>Remark</b>
Materiality for the group financial statements as a whole	The principle is the same as normal audit.
Materiality level(s) to be applied to particular classes of transactions, account balances or disclosures (also known as Specific Materiality)	The principle is the same as normal audit.
Component materiality	<p>Component materiality is for those components where component auditors will perform an audit or a review for purposes of the group audit.</p> <p>Component materiality shall be lower than materiality for the group F/S as a whole.</p> <p>Where component auditors will perform an audit for purposes of the group audit, the group auditor shall evaluate the appropriateness of performance materiality determined at the component level.</p>
The threshold above which misstatements cannot be regarded as clearly trivial to the group F/S	The principle is the same as normal audit.

### **Group Instructions and Reporting Package**

After the group auditor determined the type of work in respect of each component, he should send a group instruction to each component auditor.

The group instruction typically includes the following:

- the work to be performed by the component auditor
- the use to be made of that work
- the form and content of reporting to the group auditor
- Reporting timetable
- Accounting policies to be applied at the component level
- A request that the component auditor returns an acknowledgement of receipt
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements
- Component materiality, specific materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the group F/S (in the case of an audit or review of the financial information of the component)
- Identified significant RoMM of the group F/S due to fraud or error that are relevant to the work of the component auditor
- A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware

Following the completion of work, the component auditors would report their findings to the group auditor.

The group reporting package typically includes the following:

- Whether the component auditor has complied with ethical requirements including independence and professional competence
- Whether the component auditor has complied with the group instruction;
- Identification of the financial information of the component on which the component auditor is reporting
- Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group F/S
- A list of uncorrected misstatements of the financial information of the component
- Indicators of possible management bias
- Description of any identified significant deficiencies in internal control at the component level
- Other significant matters that the component auditor communicated or expects to communicate to TCWG
- Any other matters that may be relevant to the group audit
- The component auditor's overall findings, conclusions or opinion

### **Involvement with Component Auditors**

The group auditor is ultimately responsible for the group audit opinion which encompasses the work performed by the component auditors. Therefore, the group auditor should:

- Determine whether he will be able to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence
- Involve with the work performed by the component auditors, especially when the component auditors identify audit issues that are relevant to the group F/S

The group auditor can get involved with component auditor's working by:

- Discuss with the component auditor or component management of the component's business activities and environment
- Discuss with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error
- Review the component auditor's documentation of identified significant RoMM of the group F/S
- Review the component auditors' overall audit strategy and audit plan
- Discuss significant matters with the component auditor, component management or group management, as appropriate
- Understand any audit issues (e.g. limitation of scopes, misstatements) identified by the component auditors and assess their impact on group F/S based on group materiality
- Determine whether it is necessary to review component auditor's audit documentation

The involvement by the group auditors should be conducted on a timely basis.

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**Practice Question 6 (extracted from MC Dec 12)****Question 7 (17 marks – approximately 31 minutes)**

Your team has just won a global audit proposal and is now engaged by Solid Inc. as their group auditor for the year ended 31 December 2011 audit. Solid Inc. is a multinational company with annual turnover and total net assets exceeding US\$1,000 million and US\$30,000 million respectively, and has business worldwide in different industries. In two weeks' time you will be proposing your group audit plan to the senior management of Solid Inc.

**Required:**

Through your discussion with the CEO and CFO, together with the other information gathered for your audit scoping and planning, what would be your audit response to the information gathered below, as a group auditor, to ensure the quality of the group audit?

- (a) Solid Inc. has a retail business in Asia Pacific which contributed to the group's 20% revenue and 10% net profit. The retail business is audited by another reputable well-known audit firm that you have confidence in the competence of that audit firm. (7 marks)
- (b) Solid Inc. has a real estate project in Brazil with investments of over US\$300 million. This is the first time that Solid Inc. has entered into the real estate industry. The project is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity. (7 marks)

**Answer 7(a)**

HKSA 600 (Clarified) requires the group auditor to determine the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor.

In view of the significance of the retail business in Asia Pacific (i.e. contributing 20% of revenue and 10% of net profit to the group), the group auditor should classify the retail business in Asia Pacific as a significant component as it is individually financially significant.

The group auditor should request the component auditor to perform an audit of the financial information of this significant component using component materiality. In addition, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- meet with the retail business' management or the component auditor to obtain an understanding of the retail business and its environment;
- review the component auditor's overall audit strategy and audit plan;
- perform risk assessment procedures to identify and assess risk of material misstatement of the retail business. This may be performed together with the component auditor or by the group engagement team;
- discuss with the component auditor or the retail business' management regarding the components' business activities that are significant due to fraud or error, by considering fraud risk factors;
- review the component auditor's documentation of identified significant risks of material misstatements;
- consider significant findings of the component auditor; and
- discuss with the component auditor or the retail business' management if there is disagreement on the accounting treatment or other matters among the group auditor, the component auditor and the retail business' management.

**Answer 7(b)**

Given the component is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- assess the competency, independence and objectivity of the component auditor, in particular,
  - competency: whether the local auditor has sufficient expertise and experience in the real estate industry audit;
  - objectivity: whether the local auditor is biased or has conflicts of interest or undue influence to override professional and business judgement; and
  - independence: whether the local auditor is independent from Solid Inc and its related companies;
- seek confirmation from the local auditor regarding their competence, independence and objectivity;
- visit the component auditor to discuss about its competence, independence and objectivity;
- request the component auditor to complete questionnaires about its competence, independence and objectivity;
- discuss the component auditor with colleagues in the group auditor's firm, or with a reputable third party that has knowledge of the component auditor;
- obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties;
- if the group auditor considers that there is an issue regarding the local auditor's competence, independence and objectivity, the group auditor cannot overcome the fact that the local auditor is not independent by being involved in the work of the local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component;
- the group auditor should consider performing the following further audit procedures, such as:
  - perform the audit work themselves instead of relying on the local auditor's findings;
  - supervise the component auditor directly and review their work papers; and
  - review in detail the local auditor's audit findings and evaluate the appropriateness of their audit conclusion; and
- however, the group auditor may be able to overcome less than serious concerns about the local auditor's competency by being involved in the work of local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

**Practice Question 7 (extracted and modified from ACCA P7 Jun 11 Q5)**

You are the audit manager responsible for the audit of the Pineapple Group, which comprises a parent company and six subsidiaries. One of the subsidiaries, Lemon Limited, is audited by another firm, Chan & Co. Your firm has fulfilled the necessary requirements of HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* and is satisfied as to the competence and independence of Chan & Co.

Figures extracted from the draft financial statements for the year ending 31 December 2014 are as follows:

	Pineapple Group	Lemon Limited
	HK\$ million	HK\$ million
Profit before tax	40	8
Total assets	170	40

According to the reporting pack from Chan & Co, you noted that Chan & Co is to issue a qualified opinion on Lemon Limited's financial information. Below is the extract of the reporting pack from Chan & Co:

“Lemon Limited is the subject of a court case concerning an alleged breach of planning regulations. The plaintiff is claiming compensation of HK\$4 million. The management of Lemon Limited, after seeking legal advice, believe that there is only a 20% chance of a successful claim being made against the company. As a result, the management has not recognised a provision but has disclosed the situation as a contingent liability.

Our audit evidence concludes that the recognition criteria of a provision have been met, and it is our opinion that a provision of HK\$4 million should be recognised.”

**Required:**

**Identify and explain the matters that should be considered, and actions that should be taken by your firm, in forming an opinion on the consolidated financial statements of the Pineapple Group.**

**(13 marks)**

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**Answer**

As the group auditor, of Pineapple Group, our firm as the group auditor should consider the following matters:

**Significant component**

A significant component is defined in HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* as a component identified by the group auditor that is of individual significance to the group. Lemon Limited meets the definition of a significant component because it contributes 20% of group profit before tax, and 23.5% of group total assets. Lemon Limited is therefore material to Pineapple Group's consolidated financial statements.

**2 marks****Materiality of accounting issue**

The legal case against Lemon Limited involves a claim against the company of HK\$4 million. This is material to the individual financial information of Lemon Limited as it represents 50% of profit before tax, and 10% of total assets. The matter is also material to the group financial statements, representing 10% of group profit before tax, and 2.4% of group total assets.

**1 mark****Qualified Opinion – Lemon Limited financial information**

Chan & Co has expressed a qualified opinion due to a material misstatement regarding the accounting treatment of the court case. Management has treated the matter as a contingent liability, as they believe that it is possible, but not probable, that the court case will go against the company, but the component auditor believes that it should have been recognised as a provision according to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Given the materiality of the matter to the individual financial statements, this opinion seems appropriate (rather than an adverse opinion), as long as audit evidence concludes that a provision is necessary. In other words, the audit evidence should indicate that it is probable that the legal claim will give rise to an outflow of cash.

**2 marks****Audit procedures relating to the court case**

Due to the significance of this matter, the group auditor should perform the following procedures:

- Review the audit work performed by Chan & Co
- Discuss the matter with the responsible partner of Chan & Co to understand how the conclusion that a probable outflow of cash will occur was made
- Review copies of legal correspondence and a copy of the actual claim showing the HK\$4 million claimed against the company
- Consider engaging an external expert to provide an opinion as to the probability of the court case going against Lemon Limited
- Obtain a written representation from Lemon Limited's management detailing management's reason for believing that there is no probable cash outflow

**1 mark per procedure; Maximum 3 marks**

The group auditor should also discuss the matter with the management and those charged with governance of Lemon Limited regarding the potential impact of the matter on the group audit opinion. The impact depends on whether an adjustment is made in the individual accounts of Lemon Limited, on consolidation, or not made at all, as explained below:

**1 mark****Adjustment to Lemon Limited financial statements**

Lemon Limited is a subsidiary of Pineapple, and by definition is under the control of the parent company. Therefore, management of Lemon Limited can be asked to adjust the financial information to recognise a provision. If this happens, the group audit opinion will be unqualified.

**1 mark**

**Adjustment on consolidation**

Even if Lemon Limited's financial information are not amended, an adjustment could be made on consolidation of the group financial statements to include the provision. In this case, the opinion on the group audit opinion would not be qualified as the matter causing the material misstatement has been rectified at the consolidated level.

**1 mark****No adjustment made**

If no adjustment is made, either to Lemon Limited's individual financial information, or as a consolidation adjustment in the group financial statements, the group audit opinion should be qualified due to a material misstatement. In this case, a paragraph entitled Basis for Qualified Opinion should explain the reason for the qualification, i.e. non-compliance with HKAS 37, and should also quantify the financial effect on the consolidated financial statements. Reference to the work performed by a component auditor should not be made.

**2 marks**

### Section 3 – Internal Audit

#### Internal Audit Function

**Reference:** HKSA 610 (Revised 2013) *Using the Work of Internal Auditors*

*Definition:*

**Internal Audit Function** is a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The following table summarises key differences between internal audit and external audit:

Area	Internal Audit	External Audit
Scope	<ul style="list-style-type: none"> <li>Determined by management</li> </ul>	<ul style="list-style-type: none"> <li>Determined by HKSA and relevant laws and regulations such as Hong Kong Companies Ordinance</li> </ul>
Appointment	Management	Shareholders (typically)
Focus	<ul style="list-style-type: none"> <li>Effectiveness, Efficiency and Economy ('3Es') of Operations</li> <li>Information Technology Audit including audit of general IT controls and application controls</li> <li>Internal Control Effectiveness and Recommendations</li> <li>Reporting Unidentified Risks and Internal Control Weaknesses</li> <li>Detection of Fraud</li> <li>Safeguard of Assets</li> <li>Compliance with Laws and Regulations</li> <li>Compliance with Internal Controls Policies and Procedures</li> </ul>	<ul style="list-style-type: none"> <li>True and Fair View of F/S (i.e. whether the F/S taken as a whole are free from MM whether due to fraud or error)</li> <li>Assess RoMM due to error or fraud</li> <li>Understand and evaluate internal control as part of risk assessment but not a must to test internal controls if substantive approach is adopted</li> </ul>
Prevention and Detection of Fraud	<ul style="list-style-type: none"> <li>Primary responsibility rests with management</li> <li>Internal Audit may contribute by dealing with risk assessment, internal control and providing recommendations</li> </ul>	Not directly responsible but should maintain professional skepticism
Materiality	Usually lower	Comparatively higher
Timing of Work	Continuous or Periodic	Annual, but may do interim audit
Qualification	May or may not be professionally qualified (not a must)	Professionally qualified
Status	Cannot be totally independent but objectivity is important	Must be independent
Line of Reporting	Board of directors, audit committee (at best)	To shareholders (typically)
Reporting Format	More flexible in tailor	Standard reporting as governed by HKSA
Area of Reporting	Can be Financial and/or Non-Financial	Predominantly Financial

Depending on the scope of internal audit, there could be some areas of work overlap which may be relevant to external audit including:

- Examination of internal control system, including information systems
- Examination of accounting records
- Verification of assets and liabilities

Below sets out the best practice of a sound Internal Audit Function:

- **Independent Structure.** The internal audit function should report directly to Board of Directors and Audit Committee.
- **Qualified Personnel.** Members of the internal audit function (especially the chief internal auditor) should be professionally qualified, for example, members of HKICPA.
- **Sufficient Personnel.** The internal audit function should have sufficient manpower such that it can carry out its functions adequately.
- **Quality.** The work performed by internal audit function should be documented and governed by in-house audit manuals.
- **Regular Review and Reporting.** The work of the internal audit function should be performed and reported on a periodic basis.

### **Using the work of Internal Audit**

Objectives of the external auditors are:

- (a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:
- (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- (c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

In respect of internal audit, the external auditors may:

- use the work performed by the internal audit function; or
- obtain direct assistance from the internal auditors (i.e. the internal auditors perform audit procedures under the direction, supervision and review of the external auditor).

However, direct assistance should not include:

- Discussion of fraud risks and determination of unpredictability
- Circularisation of external confirmations

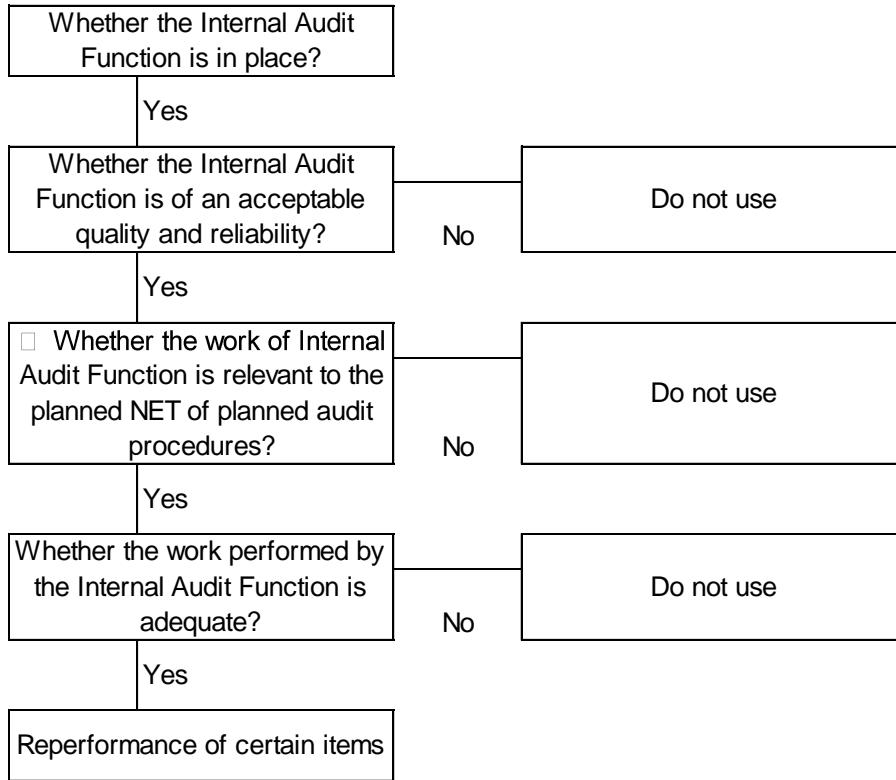
Obviously, the external auditors will use the work of internal audit only if the following conditions are met:

- The quality of internal audit function is acceptable such that its work can be used;
- The scope of work of internal audit function is relevant to the planned NET of planned audit procedures; AND
- The work performed by internal audit function is adequate.

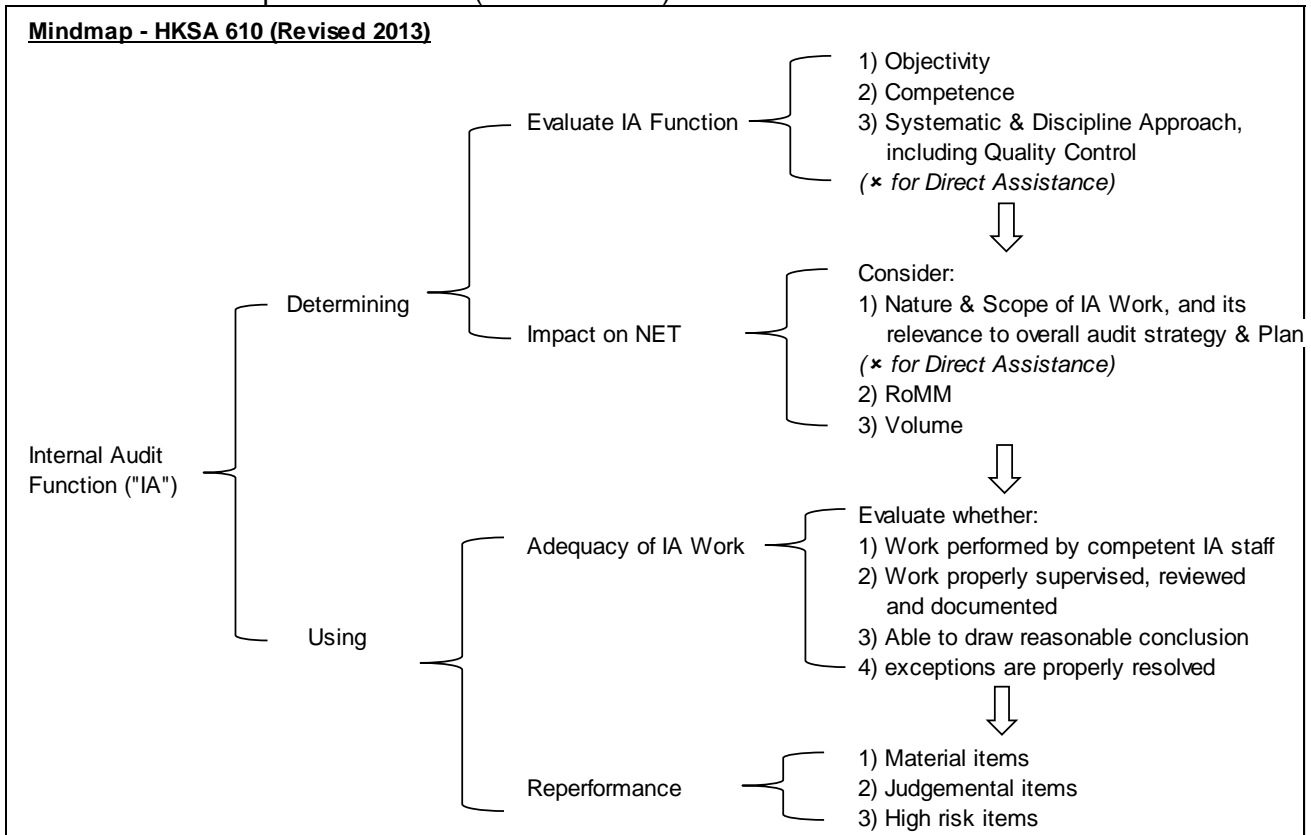
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This can be illustrated by the following flowchart:



The overall mindmap for HKSA 610 (Revised 2013) is as follows:



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### Evaluating the Internal Audit Function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

Considerations	Using IA work	Direct Assistance	Factors
Objectivity	✓	✓	<ul style="list-style-type: none"> <li>• Status of Internal Audit Function and its effect on objectivity?</li> <li>• Line of reporting?</li> <li>• Management willing to act on Internal Audit's recommendation?</li> <li>• Any conflicting responsibilities?</li> <li>• Employment decisions overseen by TCWG?</li> <li>• Any constraints or restrictions to communicate with external auditor?</li> </ul>
Level of Competence	✓	✓	<ul style="list-style-type: none"> <li>• Member of professional bodies?</li> <li>• Adequate training and proficiency?</li> <li>• Established policies for hiring and training?</li> </ul>
Whether the Internal Audit function applies a Systematic and Disciplined Approach, including Quality Control	✓	✗ (The external auditors direct, supervise and review)	<ul style="list-style-type: none"> <li>• Work properly planned, supervised, reviewed and documented?</li> <li>• Appropriate quality control policies and procedures (e.g. audit manual, work program) in place?</li> </ul>

Note carefully that the above factors are evaluation of the overall internal audit function in terms of quality and reliability.

### Impact on NET of External Audit Procedures

Essentially, the external audit should determine which areas and to what extent the work of internal audit function can be used by considering the following factors:

Factors	Using IA work	Direct Assistance	Remark
Relevance of nature and scope of internal audit work to overall audit strategy and audit plan	✓	✗ (The nature of audit procedures performed by internal auditor are decided by the external auditors)	External auditors are only interested in areas that are relevant to external audit (e.g. physical inspection of property, plant and equipment).
Assessed RoMM at the assertion level	✓	✓	The higher the assessed risk (e.g. high degree of subjectivity), the less likely and lesser extent of reliance would be.
Level of judgement	✓	✓	The higher the level of judgement, the less likely and lesser extent of reliance would be.
Volume of items in the population	✓	✓	Typically, the higher the volume of items in the population, the more likely and greater extent of reliance would be.

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If the external auditors intend to use the work of internal audit function, it may be useful to agree the following in advance:

- timing of work
- extent of audit coverage
- materiality
- methods of item selection
- format of documentation

If the external auditors intend to obtain direct assistance from the internal auditors, the external auditors shall obtain written agreement:

- from an authorised representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditors
- from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity

**Adequacy of work performed by Internal Audit Function**

The external auditors cannot blindly adopt the work performed by Internal Audit Function. They should:

Evaluate whether:	Procedures
the work is performed by the internal audit staff who has adequate technical training and proficiency	<ul style="list-style-type: none"> <li>• Make inquiries of appropriate individuals within the internal audit function</li> <li>• Observe procedures performed by the internal audit function</li> <li>• Review the internal audit function’s work program and working papers</li> <li>• Examine samples of items already examined by the internal audit function</li> </ul>
the work performed by the internal audit staff is properly supervised, reviewed and documented	
sufficient appropriate audit evidence is obtained to draw reasonable conclusions	
any exceptions or unusual matters found by the internal auditor are properly resolved	

**Reperformance**

There is no 100% reliance.

The external auditor should still examine:

- material items
- areas where more judgement was exercised by the internal audit function
- areas of higher RoMM

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**Practice Question 8 (extracted and modified from MC May 09)**

**CASE**

Hong Kong Manufacturing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Manufacturing Company Limited and its subsidiaries (“HKM”) are principally engaged in the manufacture and distribution of garment and apparel products. All HKM’s production facilities are located in Mainland China. HKM’s operating results in the last five years are summarised as follows:

	<b>2008</b> <b>HK\$’m</b> <b>(Draft)</b>	<b>2007</b> <b>HK\$’m</b>	<b>2006</b> <b>HK\$’m</b>	<b>2005</b> <b>HK\$’m</b>	<b>2004</b> <b>HK\$’m</b>
Revenue	3,322	2,488	2,045	1,368	975
Operating profit	400	353	349	167	56
Profit after tax	335	283	255	132	33

The draft summary of the financial position of HKM as at 31 December 2008 is as follows:

	<b>2008</b> <b>HK\$’m</b>	<b>2007</b> <b>HK\$’m</b>
Intangible assets	150	52
Property, plant and equipment	547	446
Other non-current assets	42	86
Inventories	486	282
Trade and other receivables	704	479
Bank balances and cash	580	567
Other current assets	106	36
<b>Total Assets</b>	<b>2,615</b>	<b>1,948</b>
Equity	1,903	1,556
Long-term bank loans	14	7
Taxation payable	79	49
Bank overdrafts	68	11
Trade and bills payable	377	228
Accruals and other payables	174	97
<b>Total Equity and Liabilities</b>	<b>2,615</b>	<b>1,948</b>

You are a manager at XYZ & Co., HKM’s auditor since its listing in 2006. You are the manager-in-charge of the audit of HKM’s financial statements for the year ended 31 December 2008.

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**Question 3 (12 marks - approximately 21 minutes)**

Mr. Lee, the Managing Director of HKM, has asked your team to rely on some of the work which is regularly performed or will be performed by HKM's internal auditors for the purpose of carrying out the audit of HKM's 2008 financial statements. Particularly, Mr. Lee has suggested your team to rely on the following work, which is regularly performed or will be performed by HKM's internal auditors:

- (i) year-end physical inspection of the property, plant and equipment; and
- (ii) on-going monitoring activities of the completeness of acquisition of merchandise from suppliers.

**Required:**

- (a) When your team intends to use the work of HKM's internal auditors, how would your team evaluate their work?  
(4 marks)
- (b) Explain whether your team would use the work of HKM's internal auditors in the specific ways suggested by Mr. Lee?  
(8 marks)

**Answer 3(a)**

In accordance with HKSA 610 (Revised 2013), when intending to use the work of HKM's internal auditors, the engagement team should evaluate its adequacy for the external audit's purposes by considering whether:

- 1) The work is performed by persons having adequate technical training and proficiency as internal auditors, and the work of assistants is properly supervised, reviewed and documented;
- 2) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;
- 3) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
- 4) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.

**Answer 3(b)**

The engagement team should first consider the objectivity and technical competence of the internal audit. In addition, the engagement should also assess whether the internal audit applies a systematic and disciplined approach, including quality control.

The case did not mention the quality of the internal audit, but the engagement team should not use the work of the internal auditor if there is any issue about the above areas.

Physical inspection of property, plant and equipment ("PPE") provides evidence of the existence of the PPE and therefore is relevant to the audit.

With respect to the year-end physical inspection of PPE, it would be time-consuming and costly for the engagement team to inspect all PPE. Consequently, PPE is a key area in which the engagement team may rely on the work of HKM's internal auditors.

On-going monitoring activities of the completeness of acquisition of merchandise from suppliers relate to internal controls over purchase which is also relevant to the audit.

Key internal controls for the completeness of merchandise acquisition from suppliers are likely to include pre-numbering and accounting for the sequence of purchase orders, goods received notes and vouchers.

The work of HKM's internal auditors is likely to relate to performing regular sequence checks on a sequence of the pre-numbered purchase orders, goods received notes and vouchers.

Since it is likely that a large number of acquisition transactions will be involved, this internal auditors' work will be of interest to the external auditors. The engagement team may rely on the work of HKM's internal auditors.

Before relying on HKM's internal auditors, the engagement team should review and appraise the internal audit work program for the above work scope, and review their work afterwards. Having said that, the engagement team would still need to inspect all the material or judgemental items.

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