Executive Training Company (International) Ltd

Examination Technique Seminar on Section A (Case)

- June 2014 and December 2014

Module C Business Assurance

Past Paper Review

JUNE 2014 SECTION A

MC – June 2014 Case

EXECUTIVE TRAINING COMPANY
(INTERNATIONAL) LTD

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.

[Listed Company] + [Manufacturer] + Group + Multi-locations

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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.

[Aggressive business strategy]

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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

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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.

[Current low production capacity]

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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.

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Question 1 (12 marks – approximately 22 minutes)

a) **Explain the characteristics of "risk-based", "transaction cycle" and "top-down" audit approaches.**

(6 marks)

b) **Assuming you are Andy, which audit approaches above would you adopt for the High-Re audit? Explain your reasons for selecting such audit approaches and elaborate on them.**

(6 marks)

[Can you use all or either two or only one ?]

JUNE 2014 SECTION A

Q1 Answer

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Answer 1(a)

The "risk-based" audit approach relies on analysing audit risk into its component parts (inherent risk, control risk and detection risk) and then choosing the appropriate volume of audit procedures to reduce detection risk to the level necessary that audit risk is at an acceptable level.

The analysis of risk is usually performed by a more experienced auditor with more time spent on this work. Once the risk analysis is performed, less time is expected to be spent in the substantive auditing.

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Answer 1(a) (Cont'd)

The "transaction cycle" approach focuses on testing the transactions which have occurred, resulting in the entries in the statement of profit or loss and other comprehensive income or statement of financial position.

By adopting the "transaction cycle" approach, usually a sample of transactions are selected and tested to ensure that each transaction was complete and processed correctly throughout the cycle. Through the "transaction cycle" approach, the transactions that appear in the financial statements are substantiated.

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Answer 1(a) (Cont'd)

The "top-down" approach, sometimes known as the business risk approach, starts with a high level view of the business and its objectives.

This approach is targeted at high level controls and reduces the amount of substantive testing.

The "top-down" approach is usually adopted in larger size entity audits, such as those of multinational corporations.

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Answer 1(b)

High-Re is a corporation with businesses operating in a numerous locations. High-Re has over 80 trading subsidiaries in over 30 countries, 3 major manufacturing plants in mainland China, Mexico and Poland and the headquarters in Hong Kong.

High-Re is classified as a multinational corporation.

Therefore, adoption of the "risk-based, top-down" audit approach is usually more effective and efficient than the "transaction cycle" approach as the "risk-based, top-down" audit approach focuses on high level controls and extensive use of analytical procedures.

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Answer 1(b) (Cont'd)

In addition, by adopting the "risk-based, top-down" audit approach, Andy can add more value to High-Re as the approach focuses on the business as a whole and a lower engagement risk of being sued by having a broader understanding the Group's business objectives and through observing the Group's business and control environment.

A "risk based, top-down" approach is focused on the control environment and corporate governance rather than the detailed transactions tested under the "transaction cycle" approach.

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Answer 1(b) (Cont'd)

Analytical procedures are used more heavily in a business risk approach as they are consistent with the auditor's desire to understand the entity's business rather than to substantiate the figures in the financial statements.

The combined use of the test of controls and analytical procedures, particularly the higher use of analytical procedures will result in a lower requirement for detailed testing, although substantive testing will not be eliminated completely.

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Question 2 (18 marks – approximately 32 minutes)

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. [Fluctuations identified]

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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)

[HKSA 315 (Revised) – items given but no assertions]

b) In response to the risk of material misstatements relating to inventory identified in Question 2(a), propose and explain your audit procedures.

(6 marks)

[HKSA 330 (Revised) - AP not consistent – what shall you do?]

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c) The preliminary analytical review indicated that research and development expenses increased by 70% for the first five months of 2014 compared to the same period in the previous year. In response to the risk of material misstatements relating to research and development expenses, explain your audit consideration and planned audit procedures for the research and development expenses, focusing on recognition of research and development expenses in terms of occurrence and cut-off as well as the presentation and disclosure requirements pertaining to the relevant accounting standards. [Very high material increase] – think about capitalisation of intangible assets !!

(Note: Marks will only be given on your explanation about the audit consideration and procedures. No marks will be given on elaborating the relevant accounting standards.)

JUNE 2014 SECTION A

Q2 Answer

MC – June 2014 Case

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.

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Answer 2(a) (Cont'd)

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. (Therefore valuation is wrong)

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.

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Answer 2(a) (Cont’d)

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.

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Answer 2(b)

In response to the risk of overstatement of inventory value, the proposed audit procedures include:

- **Obtain the inventory provision (Account estimate) analysis from management and discuss with them the provision basis.**
- **Understand and evaluate the reasonableness of the management's inventory provision policies.**
- **Evaluate the reasonableness of the management's provision assessment and test the data used in the management's inventory provision analysis.**

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<u>Answer 2(b) (Cont'd)</u>

- **Understand and evaluate if the management has put in place any specific automated and manual controls for inventory provision.**

- **Test the operating effectiveness of the management's controls over the assessment of inventory provision:**

  (i) validate whether management controls exist for the review and approval of the inventory provision by appropriate levels of management and those charged with governance; and

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Answer 2(b) (Cont'd)

(ii) validate whether the inventory provision is derived from the routine processing of data by the entity's accounting system (e.g. provision is determined by making reference to inventory ageing and with an appropriate inventory provision set-up applied across the Group).

- Perform analytical procedures over the inventory at year end, e.g. compare the finished goods to the turnover ratios of current and prior years, to decide whether if the inventory level is reasonable.

- Review and test the inventory ageing analysis prepared by the management.

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Answer 2(b) (Cont'd)

- **Review subsequent sales and compare them with the management's sales plan derived from the sales strategy.**
- **Trace inventory items to post year-end sales to determine the realisable value of inventory.**
- **Develop a point of estimate or a range based on independent data to assess the appropriateness of the inventory provision.**

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Answer 2(c)

The research and development expenses (“R&D expenses”) increased by 70% for the first five months of 2013 compared to the same period in the previous year, which did not increase proportionately with sales. (Fluctuations!!!)

There may be risk of misstatements in that the R&D expenses may not be incurred and have been overstated.

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Answer 2(c) (Cont'd)

In response to the risk of material misstatements relating to the R&D expenses, the following planned audit procedures should be carried out:

- **Understand and evaluate the management's controls over the R&D expenses, in particular, the controls over expense approval and journal entry posting.**
- **Perform validation of controls to ensure the operating effectiveness of those management controls in place.**

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Answer 2(c) (Cont'd)

- Obtain a detailed breakdown of the R&D expenses and ask the management as to the reasons for the increase in the R&D expenses in the year.
- Perform analytical procedures such as comparing the level of R&D expenses for this year with previous years.
- Review the voucher register for large or unusual items.
- Check the R&D expenses recorded in the general ledger or cash journals to support documents such as approved requisition forms and supplier invoices to ensure all the R&D expenses are valid and recorded in the appropriate financial year.

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Answer 2(c) (Cont'd)

- **Ensure last year accruals are not expenses again in the current year.**
- **R&D expenses usually mainly consist of staff costs; examine personnel records and employment contracts to verify each individual remuneration. (Consider payroll as well)**
- **Perform analytical procedures such as comparing payroll expenses with prior years.**
- **Check the calculations of remuneration by re-computing.**

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Answer 2(c) (Cont'd)

- **Scrutinise monthly payroll records and investigate unusual items, if any.**
- **Understand, evaluate and validate the management's control over the payroll cycle if there are separate processes and controls for the payroll expenses.**
- **Confirm that there is no expense which should be capitalised development costs conform to HKAS 38 criteria by inspecting details of projects and discussion with technical managers.**

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Answer 2(c) (Cont'd)

- **Consider the related presentation and disclosure requirements on research and development expenses in accordance with HKAS 38 e.g. the aggregate amount of research and development expenses, including all expenditure that is directly attributable to research and development activities, recognised as expenses during the period should be disclosed.**

MC – June 2014 Case

Question 3 (14 marks – approximately 25 minutes)

The manufacturing plant in Mexico contributes 20% of the production of the Group on an annual basis. It carries one third of the Group's inventory balance and 20% of the Group's property, plant and equipment. The general manager of the Mexico manufacturing plant was appointed by the headquarters' management. The general manager has over 20 years of experience in managing production and extensive knowledge of the television market. The finance controller is a local Mexican lady who worked in one of the international accounting firms specialising in tax for over 5 years.

[Significant component]

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The manufacturing plant has been audited by another accounting firm, M&A CPA Limited ("M&A"), over the past five years. Apart from being the local statutory auditor of the Mexico plant, M&A is also their tax representative. There were over 10 audit adjustments reported by M&A in last year's group audit report. Half of the adjustments were tax-related matters.

Andy is satisfied with M&A's audit quality except for the late submission of the report from M&A that delayed the audit progress at the consolidation level. Andy is considering taking over the Mexico manufacturing plant's audit from M&A for group audit purposes. Andy's accounting firm does not have any office, joint venture or affiliate in Mexico. Andy asked Nancy to give her views on his proposal.

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Required:

a) **Assume you are Nancy, write an analysis to Andy on his proposal of taking over the Mexico audit from M&A. Explain the factors to be considered and your stand on his proposal.**

(7 marks)

b) **Assume that M&A is considered to be technically competent and independent after your preliminary assessment, and that Andy decides to continue involving M&A in the group audit, should the Mexico plant be considered as a significant component? What audit procedures should be considered from the group engagement team's perspective?**

(7 marks)

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JUNE 2014 SECTION A

Q3 Answer

MC – June 2014 Case

Answer 3(a)

Factors that Andy should consider on taking over M&A's work on auditing the Mexico manufacturing plant include the following:

(Consider acceptance procedures in HKSA 600 (Clarified))

- **Resources – whether the group engagement team has sufficient staff resources for the site fieldwork in Mexico.**
- **Team competency – whether the group engagement team has sufficient experience and knowledge for taking up the audit.**
- **Language barrier – whether the language would be a barrier for the group engagement team to communicate with the local management.**

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Answer 3(a) (Cont'd)

- **Knowledge of local law and regulations – whether the group engagement team has sufficient knowledge to understand the local laws and regulations and the potential implications.**

- **Taxation appears to be a complicated area and audit adjustments were raised in the prior year's audit. The group engagement team should consider if they have sufficient understanding and knowledge of the local tax laws.**

MC – June 2014 Case

Answer 3(a) (Cont'd)

- **Local management may not support these ideas as they may be audited twice.**
- **Group management may not support the arrangement as there may be additional out-of-pocket expenses incurred e.g. travelling and accommodation expenses.**

If I were Nancy, I would advise Andy not to take on the Mexico manufacturing plant audit.

This is because the group engagement team is unlikely to possess sufficient understanding over the local laws and regulations.

MC – June 2014 Case

Answer 3(a) (Cont'd)

In particular, there were numerous audit adjustments raised relating to tax. Taxation may be regarded as a significant risk for the local audit. The group engagement team may not have sufficient knowledge and experience in identifying the tax issues and this would expose the group engagement team to a higher audit risk.

MC – June 2014 Case

Answer 3(b)

HKSA 600 (Clarified) requires that the group engagement team shall formulate an overall group audit strategy, develop a group audit plan and conduct ongoing reviews to monitor progress against audit objectives.

The Mexico plant is considered to be a significant component as it contributes over 20% of the production of the Group.

It also carries a significant portion of inventory, and property, plant and equipment of the Group that have been identified with risk of material misstatements.

MC – June 2014 Case

Answer 3(b) (Cont'd)

The inherent risk for a manufacturing plant is usually higher with more complex procedures and controls around the procurement and manufacturing process.

Since the Mexico plant has been identified as significant component, the group engagement team should have more involvement in the Mexico plant audit in terms of nature, timing and extent. The group engagement team may perform the following procedures:

- **Meet with the general manager and financial controller of the Mexico plant or the M&A engagement team to obtain an understanding of the Mexico plant and its environment.**

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Answer 3(b) (Cont'd)

- **Assign a component materiality to M&A or agree with M&A an appropriate component materiality from a group audit perspective.**

- **Review M&A's overall audit strategy and audit plan.**

- **Perform risk assessment procedures to identify and assess the risk of material misstatements at the Mexico plant level. These may be performed with the component auditor or by the group engagement team.**

MC – June 2014 Case

Answer 3(b) (Cont'd)

- **Discuss with M&A or the general manager and financial controller of the Mexico plant the business activities that are significant to the group and the audit procedures to be carried out.**
- **Discuss with M&A the susceptibility of the component to material misstatement of the financial information due to fraud or error, by considering fraud risk factors.**
- **Review M&A's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum, including the conclusion drawn by M&A.**

MC – June 2014 Case

Answer 3(b) (Cont'd)

- **Consider significant audit findings reported by M&A and additional audit procedures if necessary.**
- **Obtain written management representation from M&A.**

MC – June 2014 Case

<u>Question 4</u> **(6 marks – approximately 11 minutes)**

In response to the recent change in High-Re's payroll function, what audit procedures would you consider regarding the payroll expenses?

(6 marks)

[Consider HKSA 402 (Clarified) Service Organisation]

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JUNE 2014 SECTION A

Q4 Answer

MC – June 2014 Case

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Answer 4

The auditor should perform or consider the following audit procedures for Hi-Re's payroll function:

- **Work with management to understand the processes and controls in place with the third party service provider over the payroll activities performed for High-Re.**
- **Evaluate and validate the operating effectiveness of the controls in place over the payroll activities performed for High-Re by the third party service provider.**

MC – June 2014 Case

Answer 4 (Cont’d)

- **Understand, evaluate and validate the management’s control and review over the work performed by the third party service provider.**

- **Ask management if an auditor’s report is available to confirm the operating effectiveness of the controls in place with the third party service provider over the payroll activities performed for High-Re.**

MC – June 2014 Case

Answer 4 (Cont'd)

- **Consider a substantive test approach if the controls in place with the third party service provider over the payroll activities performed for High-Re is proven to be ineffective or a substantive test approach itself is more effective and efficient.**

- **Substantive test procedures include employee contract review, re-performance of the payroll calculation, agree payments with bank statements, etc.**

MC - Panelists' Report

Section A was based on a practical case of a listed manufacturer and distributor of television sets. The questions were designed to analyse the audit risks, the design of audit procedures and the consideration of incidental audit issues. The candidates' overall performance was fair. However, the candidates' answers were still not specific enough to gain higher marks. A major weakness of candidates as revealed in many QP sessions was related to the ability to understand the question requirements. The candidates' competency requirement in this examination is to demonstrate practical skill and thinking in an auditing environment. It appeared that candidates were too nervous to think in the examination centre or too rushed to answer the examination questions. In the regard, candidates should be aware that good examination time management is related to the allocation of the appropriate time to read and understand the examination requirements and to plan the structure of the written answers. Candidates should never allocate time based on writing as much as possible.

MC – June 2014 Panelists' Report

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Question 1(a) – 6 Marks

This question required candidates to explain the characteristics of the "risk-based", "transaction cycle" and "top-down" audit approaches. Many candidates answered the question satisfactorily because most of the answer could be copied from the Learning Pack. Some candidates mixed up the question requirement with those in Question 1(b) and explained the characteristics of the audit approaches in Question 1(b) instead.

Question 1(b) – 6 Marks

This question required candidates to suggest which audit approaches in Question 1(a) should be adopted for the High-Re audit and explain the reasons for selecting such audit approaches.

MC – June 2014 Panelists' Report

The candidates who scored the lowest marks were those who suggested an audit approach but did not provide the rationale behind the suggestion. Some candidates wasted time explaining the risk assessment of certain audit assertions related to the client which was not necessary. In general, candidates did not identify sufficient justifications to support their choice of audit approaches. The candidates who scored better were those who could link the case facts to their answers, e.g. the client had many operating locations.

MC – June 2014 Panelists' Report

Question 2(b) – 6 Marks

The candidates' performance was only fair. Many candidates stated the standard audit procedures for inventory valuation including the checking of computation and even a stock count which were not effective approaches to tackle the inventory provision situation. Candidates were not awarded better marks when their answers were not comprehensive. Also, quite a lot of candidates provided answers to audit the property, plant and equipment (a question requirement in Question 2(a)) which was not a requirement in this question. It is a worry that either these candidates were too nervous in the examination centre or they did not try hard enough to understand the specific question requirements.

MC – June 2014 Panelists' Report

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Question 2(c) – 6 Marks

Some candidates answered Question 2(a) and 2(b) in the same answer. They should have known that this was not the question requirement and therefore their opportunity to score was limited by this decision.

The candidates' performance was a disappointment. Not many candidates could identify the key audit concern. Most of the answers on the audit procedures were only on general procedures and so were not specific enough. The procedures suggested were mainly related to the substantive procedures while suggestions on procedures related to the test of control were limited. Some candidates also provided irrelevant answers e.g. whether the R&D expenses should be capitalised or not.

MC – June 2014 Panelists' Report

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Question 3(a) – 7 Marks

This question required candidates to write an analysis with a conclusion on the proposal of taking over the Mexico audit from the component auditor, M&A, and to explain the factors to be considered.

The candidates' performance was not satisfactory. Candidates answered the question with only general answers e.g. ethical or independence issues, and the use of the case facts in support or as part of the rationale was a rare occurrence. Some candidates discussed irrelevant issues such as the materiality of inventory or PPE, which had already been covered in the question itself. Some candidates tried to discuss the proposal but did not draw any conclusion as to whether to retain the component auditor or not. It appeared that they had difficulty with this type of question related to analysis and were not confident in providing a conclusion.

MC – June 2014 Panelists' Report

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Question 4 – 6 Marks

This question required candidates to consider what should be the audit procedures regarding the payroll expenses, in response to the recent change in High-Re's payroll function.

The candidates' performance was not satisfactory. Quite a lot of candidates did not attempt this question. Some candidates answered only in general terms about the audit procedures for payroll expenses. Those candidates who did not understand this question requirement treated the third party service provider as an expert or the service provider as one of the client's operating units. They totally ignored the case fact that the payroll function was already outsourced. This may indicate that some candidates are ignorant of the practice of outsourcing which is a very common business practice nowadays.

Module C Business Assurance

EXECUTIVE TRAINING COMPANY
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Past Paper Review

DECEMBER 2014 SECTION A

MC – December 2014 Case

Cherry Holdings Limited and its subsidiaries (collectively referred to as "Cherry Group" or "the Group") are engaged in garment manufacturing. Its headquarters are located in Hong Kong. All the goods of the Group are manufactured in the factories of Cherry China Limited located in mainland China and are sold to customers in Europe, Japan and the United States, through Cherry Hong Kong Limited and Cherry Macau Limited. The organisational chart of the Group as at 31 December 2013 is as follows:

MC – December 2014 Case

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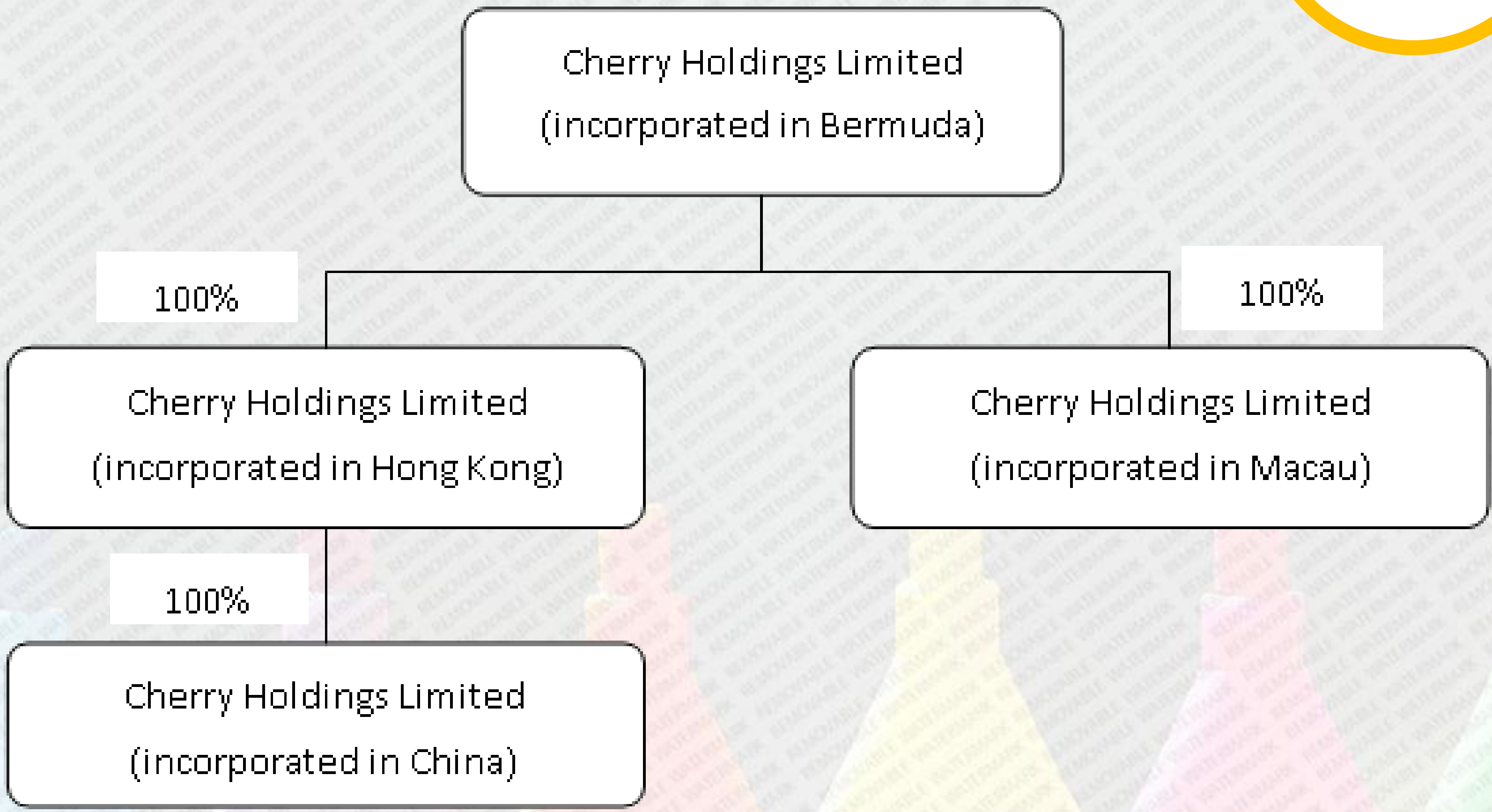

MC – December 2014 Case

The financial information of the Group for the year ended 31 December 2013 (audited) and for the six months ended 30 June 2014, extracted from the unaudited management accounts, is summarised as follows:

	Six months ended 30 June 2014 (unaudited)	Year ended 31 December 2013 (audited)
Revenue	1,845,790	3,070,165
Cost of sales	(1,660,423)	(2,679,371)
Gross profit	185,367	390,794
Operating expenses	(128,952)	(240,361)
Profit before tax	56,415	150,433
Income tax expense	(3,385)	(10,530)
Profit for the period/year	53,030	139,903

MC – December 2014 Case

	As at 30 June 2014	As at 31 December 2013
Property, plant and equipment	404,889	464,156
Inventories	420,665	435,456
Trade receivables	888,002	572,159
Deposits and prepayments	200,632	212,457
Cash and bank balances	206,258	464,147
Total assets	2,120,446	2,148,375

MC – December 2014 Case

	As at 30 June 2014	As at 31 December 2013
Trade payables	150,657	148,957
Accruals	63,241	56,478
Tax payable	9,283	5,898
Share capital	1,000	1,000
Retained profits	1,896,265	1,936,042
Total liabilities and shareholders' equity	2,120,446	2,148,375

MC – December 2014 Case

You are the audit manager in charge of the audit of Cherry Group. From your review of the unaudited management accounts for the six months ended 30 June 2014, you noted that trade receivables are the most significant asset item in the consolidated statement of financial position of the Group. According to the credit policy of the Group, the normal credit term for sales of goods is 60 days. You plan to use computer-assisted audit techniques (“CAATs”) to audit the trade receivables.

MC – December 2014 Case

In September 2014, the Chief Financial Officer (“CFO”) of Cherry Holdings Limited and the Group informed you that they had acquired a group of garment manufacturing companies with operations in Vietnam and Sri Lanka. Based on the financial information provided, these companies are **financially significant** to the audit of the Group’s financial statements for the year ending 31 December 2014. You thus **plan to request the component auditors** in Vietnam and Sri Lanka to perform work on these components.

MC – December 2014 Case

In October 2014, the newly acquired Vietnam company, now renamed Cherry Vietnam Garment Co Limited ("Vietnam Co"), informed Cherry Group's CFO that a competitor in Vietnam, the X&M Group ("X&M") had filed to the local court a claim against Vietnam Co for infringement of clothing design and stealing clients from X&M by means of improper conduct. The claim for compensation, damages and losses had a magnitude equivalent to ten times Cherry Group's cost of acquisition of Vietnam Co. A winding up petition against the Vietnam Co was presented in the Vietnam court by X&M. The legal representative of Cherry Group in Hong Kong also confirmed that Cherry Holdings Limited and Cherry Hong Kong Limited have been named as defendants in the court actions in Vietnam. The Vietnam lawyers of X&M have also indicated to Cherry Group that they intend to apply to the Hong Kong courts to wind up the Hong Kong company in order to meet the financial claims.

MC – December 2014 Case

Question 1 (14 marks – approximately 26 minutes)

a) (i) With the aid of the relevant financial data analysis, assess and explain the level of risk of material misstatements related to the existence and valuation assertions of the trade receivables.

(ii) Based on your risk assessment in Question 1(a)(i), what do you think the possible causes leading to such material misstatements?

Note: Your answers to Question 1(a)(ii) may not be derived all from the case information.

(6 marks)

MC – December 2014 Case

Question 1 (14 marks – approximately 26 minutes)

b) Propose four substantive audit procedures that you would perform to verify the existence of the large outstanding trade receivables balance of Cherry Group.

(4 marks)

c) (i) What are CAATs? IT Question

(ii) Suggest how the auditor would use CAATs in the substantive testing of Cherry Group's trade receivables.

(4 marks)

DECEMBER 2014 SECTION A

Q1 Answer

MC – December 2014 Case

Answer 1(a)

The balance of trade receivables as at 30 June 2014 significantly increased when compared to that of 31 December 2013, which did not match with the half-year performance of the entity.

The debtors' turnover period for the interim period increased significantly to 88 days when compared to 68 days for the year ended 31 December 2013. The debtors' turnover period for the interim period was much longer than the normal credit term granted to its customers. The risk of material misstatement relating to the existence and valuation assertions of trade receivables is high.

Using AP

MC – December 2014 Case

<u>**Answer 1(a) (Cont'd)**</u>

The risk of material misstatements may be caused by:

- **Amounts posted to trade receivables were not related to valid sales.**
- **Cut-off error**
  - **receipt from debtors before report date but not recorded; or**
  - **recorded sales but actual delivery was made after the reporting date.**

MC – December 2014 Case

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Answer 1(a) (Cont'd)

- **The reconciliation between the trade receivables sub-ledger and the general ledger may contain un-reconciling items which could result in a misstatement of trade receivables.**
- **The trade receivables were not recoverable.**
- **Trade receivables were misstated due to the use of an incorrect exchange rate for the foreign currency sales.**
- **Inputting error.**

MC – December 2014 Case

Answer 1(b)

Cherry Group's external auditors can perform the following:

- **circularise year end trade receivable balances to targeted debtors which were identified as having large outstanding balances; [Confirmation]**
- **follow up the replied confirmations with disagreements and the non-replied confirmations;**
- **review post reporting date cash receipts by inspecting bank statements and cash receipts documentation;**

MC – December 2014 Case

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Answer 1(b) (Cont'd)

- **for balances not yet settled after the reporting date, examine their respective invoices, sales order from customers or dispatch documentation, etc; [Documents!]**
- **for specific invoices concerning their validity, examine the customer's account or customer correspondences to confirm their validity; and**
- **apply substantive analytical review procedures to test the reasonableness of the outstanding balance including comparison of prior year outstanding amounts.**

MC – December 2014 Case

Answer 1(c)

(i) Computer-assisted audit techniques ("CAATs") are the application of auditing procedures using the computer as an audit tool.

(ii) Use of CAATs in the substantive testing of accounts receivables includes the followings:

- **Check addition accuracy and inter-ledger agreement of accounts receivable control and sub-ledgers.**
- **Select random sample for circularisation.**

MC – December 2014 Case

Answer 1(c) (Cont'd)

- **Select targeted sample for circularisation eg. major customers or customers satisfying particular selection conditions.**
- **Perform detailed substantive analytical review eg. debtors turnover by product or by segment**
- **Search for unusual items eg. related party for general audit considerations and disclosure.**

MC – December 2014 Case

<u>Question 2 (13 marks – approximately 23 minutes)</u>

Both HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements* and HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial* Statements *(Including the Work of Component Auditors)* state that it is the responsibility of the group engagement team to assess the component auditors' professional competence. As the auditor of Cherry Group, propose your procedures to address the following:

MC – December 2014 Case

Required:

a) **How would you obtain an understanding of the component auditor?**

(7 marks)

b) **How would you assess the component auditor's understanding and compliance with the ethical requirements?**

(3 marks)

b) **How would you assess the component auditor's professional competence?**

(3 marks)

DECEMBER 2014 SECTION A

Q2 Answer

MC – December 2014 Case

Answer 2(a)

Ways to obtain an understanding of the component auditor

In order to obtain an understanding of the component auditor who will be involved in the group audit, the group engagement team may consider to:

- **evaluate the results of the quality control monitoring system where the group engagement team and component auditor are from a firm or network that operates under the common monitoring policies and procedures;**
- **hold discussions with the component auditors;**

MC – December 2014 Case

Answer 2(a) (Cont'd)

- **perform site visits of the component auditors;**
- **request the written confirmation from the component auditor;**
- **request the component auditor to complete questionnaires;**
- **hold discussions with other individuals familiar with the component auditors;**

MC – December 2014 Case

Answer 2(a) (Cont'd)

- 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;
- reflect on prior experience with the component auditors, if applicable; and
- review relevant documentation as it relates to the component auditors.

MC – December 2014 Case

Answer 2(b)

Component auditor's understanding and compliance with the ethical requirements

The group engagement team would normally obtain the acknowledgment from the component auditor as to their understanding and compliance with ethical requirements and properly file it in the working papers.

MC – December 2014 Case

<u>**Answer 2(b) (cont'd)**</u>

If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the component auditor's ability to comply with ethical requirements, professional competence and regulatory environment, the group engagement team is required to obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component.

MC – December 2014 Case

Answer 2(c)

Component auditor's professional competence

The group engagement team's understanding of the component auditor's professional competence should include whether or not the component auditor:

- **possesses an understanding of auditing and other standards applicable to the group audit that is sufficient to fulfil the component auditor's responsibilities in the group audit;**

MC – December 2014 Case

Answer 2(c) (cont'd)

- **possesses the special skills (eg. industry specific knowledge) necessary to perform the work on the financial information of the particular component; and**

- **possesses an understanding of the applicable financial reporting framework that is sufficient to fulfil the component auditor's responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework).**

MC – December 2014 Case

Answer 2(c) (cont'd)

The group engagement team can obtain an understanding of their professional competence through discussions with the component audit team. The group engagement team can request the component audit partner's résumé of their relevant experience which will assist in enhancing understanding of the component auditor. If necessary, further discussions may be held between the group engagement partner and the component audit partner for a thorough understanding of the competence and expertise of the component auditor.

MC – December 2014 Case

<u>Question 3 (10 marks – approximately 18 minutes)</u>

Cherry Group's auditor had the following initial assessment or information after a discussion with the CFO on the claims by X&M:

- **The claims have basic grounds to be heard but the accusation focused mainly on the period before the acquisition of Vietnam Co by Cherry Group.**
- **The acquisition of the companies in Vietnam and Sri Lanka was completed and the indirect shareholding of these companies was achieved by a combined use of off-shore tax haven investment holding companies and newly incorporated Hong Kong investment holding shelf companies.**

MC – December 2014 Case

- **Vietnam Co's estimated % to total revenue, profit before tax and net asset value of the Group are 20%, 8% and 5% respectively, for the year ending 31 December 2014.**

- **The legal representative of Cherry Group believed that it might take a few years to have the claims resolved and it was not clear as to the extent of legal actions to be instigated in Hong Kong until further information is provided by X&M or its legal representative.**

- **Cherry Group's Management believed the general principle that a limited company is treated as a separate legal entity offers initial comfort preventing the claims against Vietnam Co from reaching Cherry Holdings Limited or Cherry Hong Kong Limited.**

MC – December 2014 Case

Required:

a) With reference to the relevant auditing standard(s), explain and discuss the going concern assumption of Cherry Group, related to the legal claims against Vietnam Co, Cherry Holdings Limited and Cherry Hong Kong Limited.

(3 marks)

b) Explore the impact on the Auditor's Report of Cherry Group for the year ending 31 December 2014.

(7 marks)

(Note: assume the auditor will provide a clean audit opinion other than the above issues.)

DECEMBER 2014 SECTION A

Q3 Answer

MC – December 2014 Case

Answer 3(a)

HKSA 570 (Clarified) *Going Concern* should be referred to when the auditor considers the going concern assumption affecting his/her audit opinion. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless the entity management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

MC – December 2014 Case

Answer 3(a) (cont'd)

Before the auditor expresses his/her opinion, he/she should consider the mitigating factors on the casting of significant doubt on Cherry Group's ability to continue as a going concern. The auditor should:

- request management to make its assessment about the entity's ability to continue as a going concern; or
- evaluate management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

MC – December 2014 Case

Answer 3(b)

The auditor has to evaluate Cherry Group's Management assessment on preparing the financial statements on a going concern basis.

Vietnam Co contributes 20% of the Group's revenue and 8% of the net profit before tax. Vietnam Co is regarded as material and is obviously significant in the financial reporting of the Group. Vietnam Co is the defendant of a legal claim. If the claim is successful, Vietnam Co should become insolvent (or be subject to a court order of winding up) and its assets value would have diminished after making the claim.

MC – December 2014 Case

Answer 3(b) (cont'd)

However, the impact of the demise of Vietnam Co on the Group as a whole may not be pervasive although material, because both the profit contribution and net assets value contributed to the Group are less than 10%.

Nevertheless, it will cast significant doubt on the Group's operating under a going concern should the limited liability protection not being available and hence the Hong Kong companies are required to pay compensation. The auditor should consult Cherry Group's lawyer as well as its legal advisor to seek written advices.

MC – December 2014 Case

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Answer 3(b) (cont'd)

With only a few months away from the year end date, it is not certain if the legal claim against Vietnam Co would succeed. It is also not certain if any judgement obtained in Vietnam could be enforced in Hong Kong against the resident companies especially when more than one jurisdiction is involved.

Under the general principles relating to separate legal entity of limited companies, it offers initial comfort preventing the claims against a subsidiary company from reaching the holding company. Therefore, it should still be appropriate for Cherry Group's Management to use the going concern assumption to prepare their financial statements when a material uncertainty exists, at least for the next 12-month period.

MC – December 2014 Case

Answer 3(b) (cont'd)

According to HKSA 706 (Clarified) *Emphasis of Matter Paragraph and Other Matter Paragraphs in the Independent Auditor's Report*, if the auditor agrees that it is still appropriate for the Management to use the going concern assumption, the auditor shall express in his report an unmodified opinion and include an Emphasis of Matter paragraph to disclose the legal claim and its impact. The Emphasis of Matter paragraph must also draw the user's attention to the related disclosure note in the financial statements and indicate that the auditor's opinion is not modified in respect of the matter emphasized.

In Cherry Group's case, the auditor should issue an unmodified opinion and include an Emphasis of Matter paragraph in his report.

MC – December 2014 Case

Question 4 (13 marks – approximately 23 minutes)

Following the acquisition of Vietnam Co, the Management of Cherry Group plans to enhance the corporate governance of the Group by setting up an audit committee. The CFO has approached you for further guidance. Based on your understanding, advise the CFO the following:

Required:

a) What are the roles and responsibilities of an audit committee on financial statements and statutory audit?

(6 marks)

Corporate Governance

MC – December 2014 Case

b) What are the considerations that the audit committee should encompass when they are assessing the following:

- the appropriateness of accounting policies adopted by the Group;
- the oversight of the management's judgement and estimates for preparing the financial statements;
- the adequacy and usefulness of financial disclosures in the financial statements; and
- any other matters.

(7 marks)

DECEMBER 2014 SECTION A

Q4 Answer

MC – December 2014 Case

Answer 4(a)

The main role and responsibilities of the Audit Committee on financial statements and external audit should include:

- **to assist the Board by carrying out their own independent review of financial reports, including any other reports or statements on behalf of the Board. Such reviews should focus on the integrity of the financial statements and on the adequacy and fairness of disclosure;**

MC – December 2014 Case

Answer 4(a) (cont'd)

- **to make recommendations to the board on the appointment, reappointment and removal of the external auditors, to approve the remuneration and terms of engagement of the external auditors and any questions or resignation or dismissal of the external auditors;**

- **to monitor and review the external auditor's independence, objectivity and effectiveness of the audit process in accordance with applicable standards;**

- **to develop and implement policy on engagement of the external auditor to supply non-audit services;**

MC – December 2014 Case

Answer 4(a) (cont'd)

- **to meet the external auditor and discuss accounting and auditing issues;**
- **to review the external auditor's management letter; and**
- **to ensure that the board provides a timely response to the issues raised in the external auditors' management letter.**

MC – December 2014 Case

Answer 4(b)

In this context, the review process would normally encompass consideration by the Audit Committee of the areas discussed below.

The appropriateness of significant accounting policies:

- **The Audit Committee should consider whether the accounting policies adopted by the company are in accordance with accounting principles generally accepted in Hong Kong or any other applicable accounting principles.**

MC – December 2014 Case

Answer 4(b) (cont'd)

- They should consider carefully instances where the company's policies are not in accordance with Hong Kong Financial Reporting Standards and whether the justification for any departure is reasonable.

- The Audit Committee should consider whether the accounting policies adopted are appropriate to the circumstances of the company and whether alternative policies would be more appropriate.

MC – December 2014 Case

Answer 4(b) (cont'd)

Judgmental issues and accounting:

- **Estimates in preparing financial statements which give a true and fair view, management frequently has to make estimates, for example, where the outcome of a particular matter is uncertain.**
- **Accounting estimates fall outside the scope of traditional internal accounting controls applied to systematically processed, recurring transactions.**
- **The Audit Committee should review accounting estimates carefully to satisfy themselves that the judgements made by management are reasonable.**

MC – December 2014 Case

Answer 4(b) (cont'd)

The adequacy and usefulness of disclosures:

- **Members of the Audit Committee should satisfy themselves that all relevant items have been properly disclosed in the financial statements.**

- **The disclosure of related party transactions and any unusual items should receive particular attention.**

MC – December 2014 Case

Answer 4(b) (cont'd)

Material, non-recurring items which may be considered unusual:

- **The treatment and disclosure of unusual items which occurred during the year should be considered by the Audit Committee.**
- **Any material, non-recurring items may be considered unusual and may require greater prominence in the financial statements. Examples of unusual items would include asset acquisitions and disposals, contingent liabilities and litigation.**

MC – Dec 2014 Panelists' Report

Section A was based on a practical case of a Hong Kong garment manufacturer which acquired an overseas company as its subsidiary during the fiscal year. The case incorporated a special event relating to a legal claim against this newly acquired subsidiary. The litigation had casted significant doubt regarding the group's operation under the going concern assumption. Although the facts of this case appeared to be complicated, straightforward questions were designed to test the candidates' application of conceptual knowledge relating to auditors' going concern consideration and certain audit committee's role and responsibilities. Additional questions were designed to test the candidates' practical audit procedures on trade receivables and assess the component auditors' competence with regard to certain aspects.

MC – Dec 2014 Panelists' Report

The performance of the candidates was not satisfactory, in particular on areas relating to the practical execution of procedures of a group audit, role and responsibilities of an audit committee and the going concern consideration. Some candidates answered these questions within the wrong context which might indicate that they did not understand these topics thoroughly or they did not have any practical experience in dealing with these matters.

MC – Dec 2014 Panelists' Report

EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD

Question 2(a) – 7 marks

This question required the candidates to explain how to obtain an understanding of the component auditor. This question tested the candidates' knowledge regarding practical work procedures when a component auditor is involved for a group audit. The candidates' performance in the whole of Question 2 was not satisfactory. Some candidates answered this question based on the wrong context retrieved from the textbook and some even did not attempt to answer this question. This indicated that these candidates did not have the practical experience of a group audit and therefore were not able (or did not attempt) to answer this question.

MC – Dec 2014 Panelists' Report

Question 2(b) – 3 marks

This question required the candidates to suggest practical procedures on how to assess a component auditor's understanding and compliance with ethical requirements. Again, the candidates answered this question based on the irrelevant textbook context.

Question 2(c) – 3 marks

As in Question 2(b), this question required the candidates to suggest practical procedures on how to assess a component auditor's professional competence. The candidates also answered this question based on the irrelevant textbook context.

MC – Dec 2014 Panelists’ Report

Question 3(a) - 3 marks

This question required the candidates to explain and discuss the going concern assumption of Cherry Group initiated by an overseas court case.

This question tested the candidates’ basic knowledge of applying HKSA570 (Clarified) Going Concern. Although this was a 3-mark question, many candidates provided answers which were too long and which must have taken up a lot of their time.

MC – Dec 2014 Panelists' Report

EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD

Question 3(b) – 7 marks Question

3(b) was an extension of Question 3(a) which tested the candidates' knowledge of applying the auditing standard. It required the candidates to use their logical analytical skills when evaluating the facts provided in the case to support their answers. The performance was not satisfactory because (i) some candidates provided the same answers as in Question 3(a), and (ii) some candidates could not evaluate the specific facts to support their answers.

MC – Dec 2014 Panelists' Report

Question 4(a) – 6 marks

This question tested the candidates' basic knowledge regarding the role and responsibilities of an audit committee with regard to financial statements and a statutory audit. This was a straightforward textbook question. However, the candidates' performance in this question was unexpectedly poor because some candidates answered the question incorrectly by including a lot of an audit committee's other role and responsibilities (for example, its function to monitor a listed issuer's internal controls).

MC – Dec 2014 Panelists' Report

EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD

Question 4(b) – 7 marks

This question tested the candidates' knowledge regarding an audit committee's duty to oversee financial reporting. As in Question 4(a), the candidates were not able to answer the questions correctly. This indicated that the candidates in general did not have an adequate knowledge of an audit committee.

Exam Techniques for MC

Common Techniques to pass MC

A. Prepare your critical files

B. Only need 1 set of notes

C. Time yourself

D. Start practice writing

E. Don’t just copy – use key words for application

F. Demonstrate logical thinking – sometimes no right or wrong

G. No need to highlight everything in the question booklet

H. Writing – legible to read

What are the expected topics for June 2015 ?

Final Advice

The time to look-up the textbook is limited during an open-book exam

Students should:

- ✓ have a good understanding of the topics before going into the exam
- ✓ read the case and questions carefully
- ✓ answer what is being asked, not what they wanted to be asked
- ✓ identify the core issues of the question and allocate their time accordingly
- ✓ analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion
- ✓ not copy large passages from the textbook
- ✓ use logical thinking to understand and respond to the questions