SECTION A – CASE QUESTIONS (Total: 50 marks)

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.

Answer 1(b)

In response to the existence and valuation of property, plant and equipment, the following procedures should be considered:

- Perform physical inspection of the existence and condition of property, plant and equipment on the year end date.
- Obtain the valuation report from experts on the usability and fair value of those affected assets.
- Evaluate the competence, capabilities and objectivity of the experts of the valuation report to consider whether their work is adequate for the audit purposes.
- Check the records of the disposal of property, plant and equipment after the flooding so as to assess the recoverable value if any.
- Evaluate the adequacy of the impairment assessed by the management of Superior.

In response to the existence and valuation of inventories, the following procedures should be considered:

- Perform inventory count on the year end date.
- Check the subsequent selling prices of inventories for the net realisable value.
- Evaluate the adequacy of impairment recognised for the inventories.

In response to the valuation of the insurance claim, the following procedures should be considered:

- Obtain a copy of the insurance policy.
- Evaluate the coverage of the policy.
- Inspect the correspondence with insurance company for the claim.
- Check the claim received records for the validity of the claim income recognised.

In response to the completeness of compensation loss to employees, the following procedures should be considered:

- Discuss with management if they have any lay off plan. If so, check the minutes or related documents for approval and details.
- Obtain the calculation of compensation from the management of the entity.
- Check the formula with reference to the statutory requirements.
- Check the payments of calculated compensation to employees.
- Check the acknowledgement of receipt.

In response to the completeness of potential liability, the following procedures should be considered:

- Check the breakdown of legal expenses for any claims.
- Seek direct communication with the external legal counsel through a letter of inquiry.

Answer 2

The internal audit function has a two-fold role in relation to key risk management:

- monitoring the organisation's overall risk management policy to ensure it operates effectively; and
- monitoring the strategies implemented to ensure that they continue to operate effectively.

A significant risk management policy in companies is to implement internal controls, and internal audit has a key role in assessing systems and testing controls.

The key consideration factors in building an internal audit function capable of carrying out the roles and duties related to risk management include:

Factors for consideration	Reasoning or expectations
Retains objectivity	• generally not be involved in the assessment of risks and the design and implementation of the system; and • reporting directly to the audit committee or the Board of Directors.
Requires sufficient competence, including skills and experience, in the organisation's business systems	• meet the technical expertise and experience requirements to carry out the roles and duties of monitoring.
Requires sufficient manpower resources meeting business scale and continuity/ contingency needs	• the monitoring process is a continual process rather than a one-off exercise; and • the internal audit function should have an appropriate size to meet the requirements related to volume and locations of workload.

Answer 3(a)

The following are the risk of material misstatements identified:

Completeness of disclosure of related party transactions:

- Superior may not identify all transactions with related parties according to HKAS 24.
- There is a risk that Superior has not disclosed all related parties and relevant information in the financial statements as required.

Answer 3(b)

HKSA 550 (Clarified) Related Parties deals with the auditor's responsibilities with regards to related party relationships and transactions in an audit of financial statements.

The audit team should update their understanding of the related party transactions of Superior including relevant internal controls and accounting procedures, by inquiry, observation, examination and performing a walk-through test.

Then the audit team should evaluate the design effectiveness of the controls and identify those key controls which can mitigate the risks of material misstatements at the assertion level.

Validate the operating effectiveness of the internal controls and accounting procedures over the related party transactions during the year:

- The entity maintains a listing of all related parties. The finance head is responsible for ensuring the list is updated with any changes and changes are communicated in a timely manner.
- All transactions with related parties are approved by the board of directors of Superior.

The audit team should also consider performing the following substantive procedures:

- Obtain from management a list of related parties and transactions with related parties.
- Send confirmations to related parties for the transactions and balances.
- Review the list and determine, based on your knowledge of Superior, whether they have been properly disclosed in the financial statements in compliance with accounting standards for related party transaction, i.e. HKAS 24.
- Review prior year's working papers to identify known related parties and any previously identified related party transactions.

- Inquire as to the affiliation of directors and officers with other parties having business dealings with the company.

- Review the company's statutory records to identify any related parties and transactions with these parties.

- Inquire of other auditors currently involved in the audit, as to their knowledge of additional related party transactions.

The subcontracting fee of HK$200 million is outside Superior's normal course of business as the amount is significant and involves only one single party. The auditor should also perform the following:

- Inspect the underlying contracts or agreements.

- Evaluate whether the business rationale of the significant related party transactions suggests they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

- Evaluate whether the terms of the transactions are consistent with management's explanations.

<u>Answer 4</u>

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.

HKSA560 (Clarified) Subsequent Events provides guidance to auditors in the area. The objectives of the auditor are:

- to obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

- to respond appropriately to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report.

The loss of inventory is a subsequent event. The event may not be significant in monetary terms but it is significant by nature especially when the exact cause and details are not known yet. It is also unclear if the event should be an adjusting or a non-adjusting event although comments from the company management related the loss of inventory to purchases after the year end date.

Auditors have a responsibility to identify subsequent events and consider if sufficient and appropriate audit evidence have been obtained. In this case, the auditors are required to verify the facts provided by the company's management and assess the impact of the event. To discharge the responsibility, we need to perform the following audit procedures:

- discuss the matter with management and those charged with governance;
- consider the impact on the company's internal controls and the previous audit risk assessment on assertions related to inventory;
- perform additional responsive audit procedures if the auditor's reliance on company internal controls was considered to be improper by new information resulting from this event;
- determine whether the financial statements require amendment, including both numbers and disclosure, and inquire as to how management intends to address the amendment; and
- if the management does not amend the financial statements while required, we should discuss with the management and consider alternatives ways to communicate with the shareholders.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS **(Total: 50 marks)**

Answer 5

The major difference could be explained as follows:

(1) Framework

An audit engagement should be conducted in accordance with Hong Kong Standards of Auditing (HKSAs), while a review engagement and an agreed upon procedures engagement should be conducted in accordance with HKSRE 2400 "Hong Kong standard on review engagements" and HKSRS 4400 "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" respectively.

(2) Assurance

An audit is designed to obtain reasonable assurance that the financial information is free from material misstatement.

A review engagement is an exercise similar to an audit engagement, which is designed to give a reduced degree of assurance (i.e. limited assurance) concerning the proper preparation of a set of financial statements.

An agreed upon procedures engagement expresses no assurance on the financial information.

(3) Report

An audit engagement provides a basis and confirms in the report an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

A review engagement assesses whether any information obtained during the review indicates that the financial statements do not give a true and fair view or are not presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

An agreed upon procedures engagement reports on factual findings only with no conclusion provided. The recipients of the report must form their own conclusions from the report by the auditor.

(4) Procedures involved

The audit procedures required for an audit engagement are far more than a review engagement and an agreed upon procedures engagement as an audit engagement provides a higher level of assurance.

An audit requires procedures for the understanding, evaluating and testing of respective process and controls, supplemented by a substantive analytical review and test of details.

In a review engagement, the auditor relies more heavily on procedures such as enquiry and analytical review than on more detailed substantive testing such as testing accounting records through inspection, observation or confirmation.

A review may bring significant matters affecting the financial information to the auditor's attention, but it does not provide all of the evidence that would otherwise be required in an audit.

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

Answer 6(a)(i)

We should make reference to HKSA 510 (Clarified) "Initial Audit Engagements – Opening Balances" which provides guidance on an opening balance audit when the auditor conducts an initial audit engagement.

Given the last appointed auditor might have performance issues, we should question and consider carefully the competence and independence of the last appointed auditor.

We may consider a review of the last appointed auditors' working papers and certain re-performance work should be planned.

We should assess whether the prior period's closing balances have been correctly brought forward to the current period.

We should also evaluate the appropriateness of the accounting policies applied – whether the opening balances reflect the application of appropriate accounting policies; whether accounting policies have been consistently applied; whether changes in accounting policies have been accounted and disclosed.

We should also consider if the current period audit procedures performed provide audit evidence on opening balances or additional audit procedures should be performed.

Answer 6(a)(ii)

Given the significance of the following balance sheet items, suggested additional procedures performed include:

(i) Property, plant and equipment – Given the property, plant and equipment balance is so significant, we should validate the title of respective significant fixed assets by examining their legal documents to verify their existence.

A physical count of the property, plant and equipment may also provide some audit evidence as to the existence of the fixed assets at the beginning of the period.

(ii) Accounts receivables / Accounts payables – The collection / payment of opening accounts receivables / accounts payables tested during the current period may provide some audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

However, additional procedures may be required such as sending confirmation on a sample basis to confirm the existence and accuracy of the larger balances with the larger customers / suppliers at the beginning of the period.

(iii) Inventory – The current period's audit procedures for the closing inventory balance provide little audit evidence regarding the inventory on hand at the beginning of the period.

Additional procedures may be necessary such as observing a current physical inventory count and reconciling it with the opening inventory quantities, etc.

(iv) Cash – We may consider sending bank confirmations to confirm the existence and accuracy of the opening bank balance if we believe that the last auditor's work does not provide sufficient audit evidence as to the opening bank balance.

(v) Convertible bond – It is clear that the opening balance of the convertible bond may contain misstatements that could affect the current period's financial statements as it is unlikely that the face value of the convertible bond equals its carrying value.

Additional audit procedures should be performed and include:

(a) engaging an independent valuer to perform the valuation exercise of the convertible bond;

(b) evaluate the effects of misstatement on the prior periods and current period's financial statements; and

(c) consider restatement of prior period financials and related disclosures in the current year financial statements.

Answer 6(b)

In response to the implementation of the new ERP system, Daniel should consider the following audit procedures in his audit plan:

- Consider whether the audit team possesses the required expertise in auditing the new ERP system.
- Consider the timing of the audit procedures, e.g. performing pre-implementation review or post-implementation review.
- Consider whether the computer expert is required to use CAATs and other audit software in carrying out the testing.
- Obtain an understanding from management as to whether the implementation of the new ERP system has changed the processes and controls of the company's inventory cycle.
- Evaluate and validate the key management controls over the inventory cycle.
- Obtain an understanding from management of the processes and controls in place for the data conversion from the old system to the new ERP system (i.e. how management ensure the data conversion is accurate and complete).
- Evaluate the effectiveness of management's controls over data conversion.
- Validate the key management's controls over data conversion.
- If management's controls over data conversion are not effective, design appropriate substantive test of details to ensure the data conversion from the old system to the new system is accurate and complete.
- Test the IT general controls of the new ERP system, covering controls over data centre operations, system software acquisition and maintenance, access security, and application system development and maintenance.
- Use the control reliance approach rather than substantive testing approach for the inventory costing calculation.

Answer 6(c)

Daniel and the audit team should discuss with management in order to understand if the exception found is an isolated case.

The audit team should exercise professional judgement in assessing management's response and extend the test of control sample size.

A control reliance testing approach will only be considered as effective if management is able to demonstrate that the exception found is an isolated case. Under the circumstances that of no further exception found in the extended sample size of the control testing, control reliance approach can be continued.

If a control reliance testing approach is considered to be ineffective, the audit team should consider performing a combination of substantive tests and extending the testing samples for a vouching test.

For example,

- perform substantive analytical review, including reasonableness test;
- review the sales contracts and relevant terms and conditions;
- re-compute the sales rebates based on sales contracts;
- circulate confirmation to key customers to confirm the sales rebates; and
- test the subsequent settlement of committed sales rebates.

Answer 7

As a professional accountant in public practice, Peter has to consider compliance with the fundamental principles included in the Code of Ethics (Revised) ("the Code") when accepting a new assurance client or continuing engagement of an existing client. The concessionary mortgage rate offer and the close relationship between Peter, the audit engagement partner, and Charles, Head of Consumer Credit, raise concerns on both self-interest and familiarity threats to independence.

By accepting gifts or hospitality from an assurance client, self-interest and familiarity threats may be created, unless the value is clearly insignificant.

A self-interest threat occurs as a result of the financial or other interests of a professional accountant or of an immediate or close family member. SMP staff or members of the assurance team may benefit financially from its assurance client, BNT, by taking up the below market mortgage rate offer.

A familiarity threat occurs when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others. Peter's association with Charles in sport activities in the last 3 years may indicate a potential close relationship affecting Peter's objectivity in decision making but this is not clear from the information given how closely associated they have become or whether it is only a business networking relationship.

The Code requires a professional accountant in public practice to evaluate the significance of any threats. If threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce such threats to an acceptable level.

The mortgage offer would be considered normal or not a problem if BNT lends to the assurance staff members on commercial terms and lending is its normal business. However, the offer is an in-house staff benefit. This will also be a benefit to the SMP assurance staff and other staff in the film if accepted. It is within the context of the Code's guidelines on gifts and hospitality (preferential treatment) because the interest rate charged is below the market rate. The concessionary rate would apply to the borrower over a number of years, and represents a significant discount. The financial amount involved is therefore unlikely to be modest. As such, SMP should conclude that to accept such a benefit would represent a significant threat to the objectivity of the firm, through its staff, in relation to the audit. SMP should refuse the offer.

To deal with the potential familiarity threat to independence, SMP should consider the following safeguards or procedures:

- involve an additional professional accountant to review the work done;
- remove Peter out from the team;
- discuss with those charged with governance in BNT the potential close association; and
- document the safeguards and rationale in the planning document.

* * * END OF EXAMINATION PAPER * * *