



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



Examination Technique Seminar (Essay)
for
Module C on Business Assurance

Speaker
Dr. Fiona Lam

3 December 2013



EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD



About the Lecturer



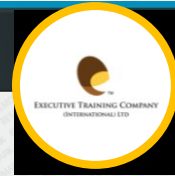
Dr Fiona Lam

Managing Director and Principal Lecturer - MC & MD

*PhD, ACA(UK), FCCA, FAIA,
CPA(Practising), BBA(Acc & Fin), ATiHK*

- ❖ Practising partner of a medium size firm
- ❖ Practical experience in auditing, tax, corporate governance and risk management
- ❖ Passed QP exams and other exams ie ACCA, AIA, PC all in one go
- ❖ Professional training 10 years ago and commenced teaching MC & MD for many years
- ❖ Taught over 5000 students

www.etctraining.com.hk



Examination Technique Seminar on Section B (Essay/Short Question)

- **December 2012 and June 2013**

www.etctraining.com.hk



Past Paper Review

DECEMBER 2012 SECTION B

www.etctraining.com.hk

MC Business Assurance



DECEMBER 2012 SECTION B

Q5 Question

www.etctraining.com.hk

MC – December 2012 Section B

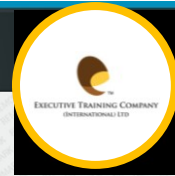


Question 5 (15 marks – approximately 27 minutes)

You are working on an audit engagement for a client who owns over 150 chain shoe stores in Hong Kong. Your client owns 5 different shoe brands and each of the brands specializes in a different style of shoe products. During the course of the audit, you look into the inventory ledger and find that the inventory balance as at year end increased three-fold to HK\$200 million compared to last year, representing 20% of the total assets of the company as at year end, and the inventory aging has been deteriorating significantly compared to last year. **[Inventory is very material – significant increase in ending balances]**

www.etctraining.com.hk

MC – December 2012 Section B



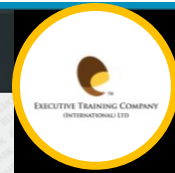
Question 5 (15 marks – approximately 27 minutes)

You therefore discuss with the management their assessment on the **appropriateness of the inventory provision**. The managing director explains to you that he is very optimistic about their future development. According to the managing director, they have just **acquired 3 more shoe brands** and will **open another 50 shoe stores in Hong Kong in the coming year** and therefore the inventory balance as at year end had tripled compared to last year. In addition, he is confident that there will be no inventory provision required against their shoe products given that their shoe products are always well-received by their customers in the market.

**[Fast Expansion + unrealistic comments by the managing director]
Remember – Valuation is an estimate**

www.etctraining.com.hk

MC – December 2012 Section B



Question 5 (15 marks – approximately 27 minutes)

- a) Assess and explain the risk of material misstatement relating to the accounting estimate over the inventory valuation as at year end. **[HKSA 315 (Revised)]**
- (5 marks)
- b) After talking to the managing director, you are not satisfied with the explanation from the managing director on the inventory. What audit procedures would you further perform in response to the risk of material misstatement discussed in Question 5(a)?
- [HKSA 330 (Clarified)]**
- (10 marks)

www.etctraining.com.hk



DECEMBER 2012 SECTION B

Q5 Answer

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(a)

The risk of material misstatement over the inventory valuation is **high**. **[Can determine the risk level after mentioning the factors concerned]** The increase in risk of material misstatement over the inventory valuation is mainly due to: **[Give reasons for the increase of risk]**

- the inventory balance as at year end is significant to the company's total assets (i.e. 20%). Any material misstatement in the inventory balance could result in pervasive misstatement in the financial statement as a whole. **[Material increase = increase in risk]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(a) (Cont'd)

- the financial trend does not look reasonable. The increase in inventory is **far more than** the company's plan of expansion which indicates that there may be slow-moving inventory piling up. **[Fluctuations – unreasonable] – cannot match with other corroborative evidence]**
- the deterioration of inventory ageing is supportive that there may be **slow-moving inventory** and management should factor it in the inventory provision assessment. **[Should consider writing off to lower of cost or NRV – therefore provision should be made]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(a) (Cont'd)

- management's assessment of inventory provision purely relies on **past trend** without taking into account a totality of facts which may indicate **management bias**. **[Not taking into account of future events]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(b)

In response to the risk of material misstatement over the inventory valuation, the following **audit procedures** should be considered:
[Can mention tests of controls or substantive testing]

- validate the **managing director's representation** by obtaining the company's expansion plan and an understanding in detail of how their expansion plan affects the inventory balance as at year end; **[Verify management's representation – can also consider management's honesty and management bias]**
- obtain from management their inventory provision assessment and understand the judgement and assumptions used in the assessment; **[It is management's responsibility to make provision assessment]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(b) (Cont'd)

- evaluate the **reasonableness** of management's judgement and **assumptions** used in the inventory provision assessment;
- **test the data** used in the inventory provision assessment;
- consider **management's response** and if there is an **indicator of possible management bias**;
- ask the management if they have an inventory realisation plan;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(b) (Cont'd)

- check **subsequent sales** and compare them with the inventory realisation plan; and
- understand and **evaluate management's controls** over the assessment of inventory provision [**Estimate**].
- test the operating effectiveness of the management's controls over the assessment of inventory provision, in particular:
 - validate **whether controls exist** for the review and **approval** of the inventory provision by appropriate levels of management and those charged with governance; and

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(b) (Cont'd)

- 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).
- develop a **point of estimate or a range based** on independent data for assessing the appropriateness of the inventory provision;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 5(b) (Cont'd)

- perform **detailed analysis on inventory ageing** (by products, by brand lines) to identify if **specific provision** is required for certain brand products; and
- consider the **totality of facts**, both management's representation and the independent data acquired, make a **final assessment** as to whether the reasonableness of the accounting estimates on inventory provision determined by management would lead to material misstatements.

[What happen if auditor does not agree with the final inventory provision, made by management?]

www.etctraining.com.hk

MC Business Assurance

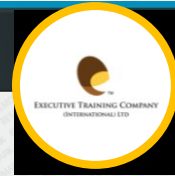


DECEMBER 2012 SECTION B

Q6 Question

www.etctraining.com.hk

MC – December 2012 Section B



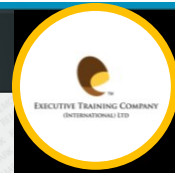
Question 6 (18 marks – approximately 32 minutes)

In a recent dialogue with the Internal Audit, you understand that the **Internal Audit** has issued an unsatisfactory report on the bank reconciliation process of your client. The Internal Audit report indicated that there **was significant control deficiency over the cash management process**, and that the management processes and controls were not properly exercised by the operation team.

[Internal audit is an important topic.]

www.etctraining.com.hk

MC – December 2012 Section B



Question 6 (18 marks – approximately 32 minutes)

- a) Assess and explain the risk of material misstatement relating to the existence and accuracy assertions of the cash and bank balance as at year end. **[HKSA 315 (Revised)]**
(3 marks)

- b) Suggest and explain the audit procedures you would perform in response to the risk of material misstatement identified in Question 6(a). **[HKSA 330 (Clarified) – Audit procedures can include TOC and substantive testing]**
(7 marks)

www.etctraining.com.hk

MC – December 2012 Section B

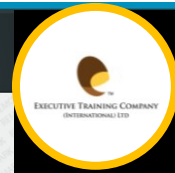


Question 6 (18 marks – approximately 32 minutes)

- c) Explain the meaning of control activities **[HKSA 315 (Revised)]** and the required procedures relating to control understanding in addressing significant risks. **[Must test controls.]**
(5 marks)
- d) The Code on Corporate Governance Practices in Hong Kong ("the Code") clearly states the responsibilities of the board of directors relating to internal controls. Explain the responsibilities of the board of directors relating to internal controls in the context of principle and code provisions under the Code. **[Corporate governance]**
(3 marks)

www.etctraining.com.hk

MC Business Assurance



DECEMBER 2012 SECTION B

Q6 Answer

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(a)

The risk of material misstatement on cash and bank balances is **high** because of the following:

- the **bank reconciliation** process does not operate effectively which may increase the risk of **unidentified accounting errors** and adjustments; and **[Lack of procedures on cash-in-transit and unrepresented cheques]**
- there is an increased opportunity for misappropriation of cash given that the management's processes and controls were not properly exercised by the operation team. **[Lack of internal controls]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(b)

The audit team should consider the following audit procedures in response to the risk of material misstatement over cash and bank balances identified in (a):

- review the Internal Audit Report in detail and discuss with Internal Audit findings with management and reassess the risk of material misstatements of cash and bank balance; **[HKSA 330 (Clarified) and HKSA 610 (Revised)], rely on internal auditors or not]**
- understand from management the **remedial action plan** and implementation timeline; **[For HKSA 265 (Clarified), auditor needs to consider any remedial actions for responding to the deficiencies]**

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(b) (Cont'd)

- identify whether there are **compensating controls** and consider performing the testing of the compensating controls by understanding, evaluating and validating the **key management compensating controls**;
- instead of relying on management's control over cash management, consider a **substantive testing approach** by performing test of details; [Consider the NET]
- circulate **bank confirmations** directly to every bank with which the company conducted business; verify the **bank balances** with the replies to the standard bank letter;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(b) (Cont'd)

- check the bank balances against the respective bank statements; [**Compare ledger to bank statement**]
- **reperform the bank reconciliation** by comparing the cash ledger balance and the balance stated on bank statements/ bank confirmations, obtain an explanation from management for any large or unusual items not cleared at the time of audit;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(b) (Cont'd)

- obtain **satisfactory explanations** for all items in the cash book for which there are **no corresponding entries** in the bank statement and vice versa through **discussion** with finance staff; and
- check **subsequent bank statements** to confirm the validity of the bank reconciliation items (e.g. un-presented cheques).
[Subsequent settlement checked]

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(c)

Control activities are those **policies and procedures** which are established to achieve the entity's specific objectives and are designed to prevent, or to detect and correct errors.

HKSA 315 (Revised) requires that if the auditor has determined that a significant risk exists, the auditor should obtain an **understanding of the entity's controls**, including control activities relevant to these significant risks.

HKSA 315 (Revised) states that the auditor shall obtain an understanding of control activities relevant to the audit.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(c) (Cont'd)

Control activities that are relevant to the audit include:

- control activities that relate to significant risks or relate to risks for which **substantive procedures alone** do not provide sufficient appropriate audit evidence; or
- those that are considered to be relevant in the **judgement** of the auditor.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(c) (Cont'd)

In addition, the auditor should consider whether management has specifically responded to these significant risks by:

- **implementing control activities** e.g. a **review** of the assumptions by senior management;
- **documenting** the processes and control activities; and
- **review and approval** by those charged with governance the control activities.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(d)

The general principle of the Code on Corporate Governance Practices (“the Code”) in Hong Kong requires **the board of directors to maintain a sound and effective system of internal control** to safeguard the shareholder’s investment and the company’s assets.

In Section C of the Code, the board is required to conduct a **review of the effectiveness of the company’s system of internal controls** and report to the shareholders that they have done so in their Corporate Governance Report at least **annually**.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 6(d) (Cont’d)

The review should **cover all material controls**, including financial, operational and compliance controls and **risk management functions**; and consider the adequacy of resources, qualifications and experience of staff of the company’s accounting and financial reporting functions, and their training programmes and budget.

www.etctraining.com.hk

MC Business Assurance



DECEMBER 2012 SECTION B

Q7 Question

www.etctraining.com.hk

MC – December 2012 Section B

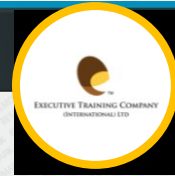


Question 7 (18 marks – approximately 32 minutes)

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. **[You are the group engagement , responsible for the group audit]**

www.etctraining.com.hk

MC – December 2012 Section B



Question 7 (18 marks – approximately 32 minutes)

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?

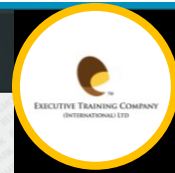
- a) Solid Inc. has a retail business in Asia Pacific which contributed to the group's 20% revenue and 10% net profit. The retail business is audited by another reputable well-known audit firm that you have confidence in the competence of that audit firm.

[Consider the component is a significant component + consider the component auditor's work]

(7 marks)

www.etctraining.com.hk

MC – December 2012 Section B



Question 7 (18 marks – approximately 32 minutes)

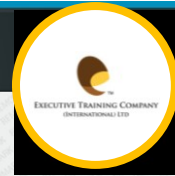
- b) Solid Inc. has a real estate project in Brazil with investments of over US\$300 million. This is the first time that Solid Inc. has entered into the real estate industry. The project is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity.

[Consider component auditor's work as the investment is very material]

(7 marks)

www.etctraining.com.hk

MC – December 2012 Section B



Question 7 (18 marks – approximately 32 minutes)

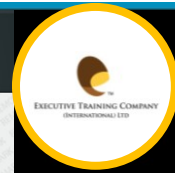
- c) Your team has been the auditor of Solid Inc.'s shipping business over a period of 10 years before you were engaged as the group auditor. The partner in charge of the shipping business audit has extensive knowledge and experience with the client. He has been involved in the shipping business audit for 7 years and has known some of the senior management of Solid Inc. for a long time.

[The partner has long association with the client's senior management – consider code of ethics]

(3 marks)

www.etctraining.com.hk

MC Business Assurance



DECEMBER 2012 SECTION B

Q7 Answer

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



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. **[Sometimes we use the word “participation”]**

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.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(a) (Cont'd)

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;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(a) (Cont'd)

- 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;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(a) (Cont'd)

- 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.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



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;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(b) (Cont'd)

- **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;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(b) (Cont'd)

- 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;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(b) (Cont'd)

- 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**;

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(b) (Cont'd)

- **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.

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(c)

The partner in charge of the shipping business audit has **extensive knowledge and experience of the client**, he has been involved in the shipping business audit for 7 years and is close with the senior management.

The group auditor should consider whether the partner in charge is subject to a **familiarity threat and self-interest threat**.

The group auditor should evaluate the **significance** of the threats and consider other safeguards as suggested in the Code of Ethics for Professional Accountants (Revised).

www.etctraining.com.hk

MC – December 2012 (Section B) – ANSWER



Answer 7(c) (Cont'd)

For examples:

- **rotating the partner in charge** off the audit team;
- having another **professional accountant** in the firm who is not a member of the audit team review the work of the partner in charge; and
- having regular **independent internal or external quality reviews** of the engagement.

www.etctraining.com.hk

MC Business Assurance



Past Paper Review

JUNE 2013 SECTION B

www.etctraining.com.hk

MC Business Assurance

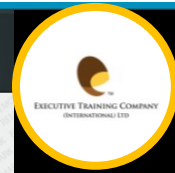


JUNE 2013 SECTION B

Q5 Question

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 5 (8 marks – approximately 14 minutes)

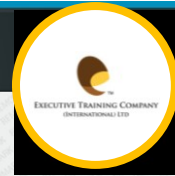
You are the audit partner of ABC CPA Hong Kong and have just received a request from ABC CPA London on a fee proposal for the audit of Peter Hong Kong Limited, a subsidiary of Peter Limited which is the potential audit client of ABC CPA London for the year ending 30 June 2013. During the client acceptance procedures, you have identified that the spouse of your fellow tax partner is the Chief Financial Officer of Peter Hong Kong Limited.

You are a local firm and you have to clear all the client acceptance procedures for the local company before the affiliate company can accept the overseas holding company.

Key issue – Tax partner is not audit partner

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 5 (8 marks – approximately 14 minutes)

What **independence issues** should you consider for the engagement acceptance of the audit of Peter Hong Kong Limited and what relevant safeguards should be in place?

(8 marks)

(Ethical questions – consider multiple threats)

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q5 Answer

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



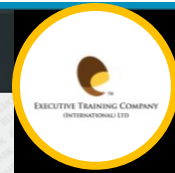
Answer 5

A family member of a partner of ABC CPA Hong Kong is an officer of Peter Hong Kong Limited and this constitutes a serious threat to independence. These are **familiarity threat, self-interest threat and intimidation threat due to the family and personal relationships**. The significance of the threats is assessed as follows:

- The individual's responsibilities on the assurance engagement. Whether the **tax partner** is a member of the **audit engagement team** and provides any advices on the audit.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 5 (Cont'd)

- The **closeness** of the relationship. A spouse is an **immediate family member** as defined in the Code of Ethics.
- The role of other party at the entity. We need to assess the responsibilities of the Chief Financial Officer in the entity. Normally, the **Chief Financial Officer** is responsible for the accounting and financial functions of the entity who will prepare the accounting information for the audit.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 5 (Cont'd)

Based on the above assessment, the threat is considered to be **significant**. ABC CPA Hong Kong should inform ABC CPA London of the threat and determine the appropriate measures to eliminate the threats such as:

- **Removing the tax partner** from the engagement team.
- Changing the **role of the spouse** of the Tax Partner to a position which does not involve the accounting and financial functions of the entity. **(Quite impossible in practice)**

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 5 (Cont'd)

- **Declining the engagement.**

ABC CPA Hong Kong should not provide any assurance service to ABC CPA London on its services rendered on Peter Limited including group reporting as long as the threat still exists.

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q6 Question

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 6 (15 marks – approximately 27 minutes)

Mary Limited is a company **listed** on the Main Board of The Hong Kong Stock Exchange and is **engaged in the manufacturing and trading of garments**.

You are the auditor of Mary Limited and are performing audit planning for the year ending 30 June 2013. The following financial information has been extracted from the latest management accounts prepared by management of Mary Limited:

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 6 (15 marks – approximately 27 minutes)

For the **nine months** ended 31 March 2013 For the year ended 30 June 2012 For the year ended 30 June 2011

	(HK\$'000)	(HK\$'000)	(HK\$'000)
Revenue	1,000,000	2,000,000	1,500,000
Profit before tax from continuing operations	500	10,000	7,000
Net current assets / (liabilities)	(200)	2,000	2,500
Shareholders' equity	3,000	5,000	8,000

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 6 (15 marks – approximately 27 minutes)

- a) What is **materiality**? In setting the planning materiality for Mary Limited's financial statements as a whole, what **factors** (including client information and your understanding about the client) you should consider? (**HKSA 320 (Clarified) and HKSA 450 (Clarified)**)

(5 marks)

- b) Auditors often select a **benchmark item** from the financial statements and apply a **percentage** when setting materiality. Propose a possible **range of benchmarks** and the source documents containing them in the case of Mary Limited. What are your considerations when you decide a benchmark and the percentage? What **documentation** you would suggest for such work?

www.etctraining.com.hk

(6 marks)

MC – June 2013 (Section B)



Question 6 (15 marks – approximately 27 minutes)

- c) Based on the information provided by Mary Limited, the **profit before tax** from continuing operations for the nine months ended 31 March 2013 includes the following items:
- 1) impairment of property, plant and equipment of HK\$3 million; and
 - 2) share-based payment expenses on granting one-off share options to a director of Mary Limited of HK\$2 million.

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 6 (15 marks – approximately 27 minutes)

- c) How would you consider the impact of the above unusual items when determining materiality for Mary Limited?

What is your response to these unusual items in concluding a benchmark and its amount or magnitude?

(4 marks)

(Consider the volatility of the benchmark)

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q6 Answer

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(a)

Materiality is an expression of the **relative significance or importance of a particular matter** in the context of financial statements as a whole.

The consideration of materiality is divided into:

- **HKSA 320 (Clarified)** Materiality in Planning and Performing an Audit
- **HKSA 450 (Clarified)** Evaluation of Misstatements Identified during the Audit

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



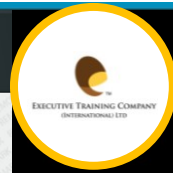
Answer 6(a) (Cont'd)

The following factors or the understanding of client may be considered:

- The **elements of the financial statements** (e.g., assets, liabilities, equity, revenue, expenses).
- Whether there are items on which the **attention of the users** of Mary Limited's financial statements tends to be focused (e.g., for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets).

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(a) (Cont'd)

- The nature of the **entity and the industry** and **economic environment** in which the entity operates.
- The entity's **ownership structure** and the way it is **financed** (e.g., if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings).
- The **relative volatility of the benchmark** chosen for materiality.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(a) (Cont'd)

The determination of materiality is not a mechanical exercise without the appropriate consideration of the facts and circumstances surrounding the audit engagement. An **exercise of professional judgment** is involved.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(b)

Examples of benchmarks that may be appropriate for the materiality setting, include the following:

- Categories of reported income such as **profit before tax**
- Total revenue, gross profit and total expenses
- Total equity or **net asset value.**

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(b) (Cont'd)

In relation to the chosen benchmark, relevant financial data ordinarily include:

- **Prior periods' financial results** and financial positions
- The **period-to-date financial results** and financial position
- **Budgets or forecasts** for the current period, adjusted for significant changes in the circumstances of the entity (e.g., a significant business acquisition)

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(b) (Cont'd)

- Relevant **changes of conditions** in the industry or economic environment in which the entity operates.

Apply to the case :

Mary Limited is a **listed** entity, **profit before tax from continuing operations** is often used as the benchmark of the financial statements because that is typically what users of the financial statements primarily focus on. When **profit before tax from continuing operations is volatile**, other benchmarks may be more appropriate, such as gross profit or total revenues.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(b) (Cont'd)

Determining a percentage to be applied to a chosen benchmark involves the **exercise of professional judgment**. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(b) (Cont'd)

A technique that is often used to determine materiality involves estimating profit before tax from continuing operations for the current period and then applying a percentage in the range of **5-10 per cent** to that amount. Other percentages may be used based on the professional judgment of the auditor.

The auditor shall include in the **audit documentation** the **amounts** and the **factors** considered in determination of materiality for the financial statements as a whole.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(c)

Materiality for the financial statements as a whole is determined for Mary Limited based on a percentage of profit before tax from continuing operations, circumstances that give rise to an **exceptional decrease or increase** in such profit may lead us to conclude that materiality for the financial statements as a whole is more appropriately determined using a **normalised profit before tax from a continuing operations figure based on past results.**

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(c) (Cont'd)

When we decide to normalize the benchmark amount, it may be appropriate to:

- **remove the unusual circumstance** from the current period results;
- **use a simple average of the current period and two or more preceding periods;** or

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 6(c) (Cont'd)

- use another **method to estimate** the amount for the current period.

In considering whether it is appropriate to normalise the benchmark, we need to consider the trend in the benchmark.

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q7 Question

www.etctraining.com.hk

MC – June 2013 (Section B)

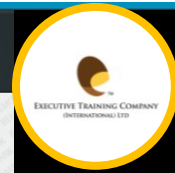


Question 7 (16 marks – approximately 29 minutes)

You are a CPA (Practising) and are engaged as the auditor of Amy Limited, a garment manufacturing company. In the course of audit planning for the year ending 30 June 2013, you noted that the balance of the **accounts payable**, which is a material item on the financial statements, is **50% lower** than the corresponding amount of 30 June 2012 and there is no significant change in the business scale of Amy Limited.

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 7 (16 marks – approximately 29 minutes)

- a) Assess and explain the level of risk of material misstatements relating to the completeness assertion of the accounts payable of Amy Limited as at 30 June 2013. **[HKSA 315 (Revised)]**
(5 marks)
- b) Audit confirmation is a common audit tool. Suggest the audit confirmation procedures you would perform for Amy Limited's accounts payable in the following: **[HKSA 505 (Clarified)]**
- selecting confirmation parties;
 - controlling the accuracy and validity of the confirmation letters; and

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 7 (16 marks – approximately 29 minutes)

- controlling the **accuracy and validity** of the confirmation letters; and
- controlling proper **response** to the confirmation request.

(7 marks)

- c) What are the appropriate **follow up procedures** if you do not receive the confirmation reply after a reasonable period of time?

(4 marks)

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q7 Answer

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(a)

As the balance of accounts payable is **significantly reduced** from the prior year and does not match with the performance of the entity, the risk of material misstatement relating to the **completeness assertion** of Amy Limited's accounts payable as at 30 June 2013 is **high**.

The risk of material misstatements may be caused by:

- Amounts posted to accounts payable **do not relate to valid adjustments** (credit notes).

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(a) (Cont'd)

- Payments to trade creditors being **recorded prior to the period end in error**.
- Amounts in respect of **goods (in-transit) where risks and rewards of ownership have passed** to the entity in accordance with the applicable shipping terms are not posted to accounts payable.
- Accounts payable is **misstated due to goods and services received and adjustments (credit notes)** being recorded in the incorrect period.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(a) (Cont'd)

- The **reconciliation** between the accounts payable sub-ledger and the general ledger may contain invalid reconciling items which could result in a misstatement of accounts payable.
- The reconciliation between the accounts payable sub-ledger and the statements received from the suppliers may contain **invalid reconciling items** which could result in a misstatement of accounts payable.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(a) (Cont'd)

- Accounts payable is misstated due to **all costs associated with importing raw materials not being recorded or being recorded in the incorrect financial period.**
- **Inputting error**

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(b)

Procedures for audit confirmation of Amy Limited's accounts payables include:

1) Selecting confirmation parties:

Make a **selection of relevant account balance** items and prepare or have the entity prepared confirmation requests for such selection. The samples for confirmations are selected from the accounts payable sub-ledger with total amount tied to the general ledger by representative sampling. Selection may be based on the following:

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(b) (Cont'd)

- **Major suppliers** by reference to the purchase transactions throughout the year.
- **Material balance** as at the year end.
- Accounts showing material **fluctuation from prior year**.
- Auditor may also send confirmation to accounts payable with **small or zero balance** on some situations to address the completeness assertions.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(b) (Cont'd)

2) Accuracy and validity of confirmation letters:

- Compare the **addressees** with the invoices or purchase orders of the selected suppliers.
- Agree the amounts shown on the confirmations to the accounts payable **sub-ledger**.
- Obtain the client's **authorisation** by endorsing or signing the confirmations.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(b) (Cont'd)

3) Control the proper response

- Request the **suppliers to send the confirmations to the auditor directly**.
- Send confirmations requests under the **auditor's control**.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(c) (Cont'd)

If the confirmation is not received within a reasonable period of time, the auditor should perform the following procedures:

- 1) Arrange **second request** and / or phone up the party to respond the original request.
- 2) Perform the following **alternative procedures**:
 - Obtain **statements of the selected suppliers** as at 30 June 2013.
 - Agree the **balances with the samples selected**.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(c)

- Select a sample of **reconciliations** between the accounts payable sub-ledger and the statements received from suppliers and review the reconciliation.
- Test reconciling items by **tracing them to supporting documentation**.
- Evaluate whether the reconciling items are valid.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(c) (Cont'd)

- If suppliers' statements are not available, perform the following procedures:
 - Select a **sample of debits to accounts payable** and trace each selection to credit notes or payments; documentation of **payments made or other supporting documentation**; and evaluate whether debits are valid and have been recorded in the appropriate period.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 7(c) (Cont'd)

- Select a sample of goods received after period end; trace to invoices and shipping terms and evaluate whether goods in-transit at period end where ownership had passed to the entity have been recorded in accounts payable.
- 3) Consider if the **non response** is an indication of a previously **unidentified risk of material misstatement** and the need to reconsider or revise the assessed risk of material misstatement or the necessity to modify planned audit procedures.

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q8 Question

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 8 (11 marks – approximately 20 minutes)

Peace Limited discovered that some **bank balances** of its factory in the Mainland was **unaccounted** for and a finance manager was suspected to have been involved. The loss has been reported to the local police. The police were trying to locate the finance manager. Initial findings of the investigation indicated that the loss amount was approximately HK\$20 million. **[Fraud]**

Peace Limited's management investigated the cause and nature of the loss of funds in the factory and identified that the finance manager **stole the company chop** and issued a few cheques to withdraw money from Peace Limited's bank account to his personal bank account. Then, the finance manager **removed these transactions** from the bank statements downloaded from the internet banking facility before sending them to the head office in Hong Kong.

www.etctraining.com.hk

MC – June 2013 (Section B)



Question 8 (11 marks – approximately 20 minutes)

a) Identify the possible internal control weaknesses relating to the misappropriation of funds by the finance manager.
[Components in the internal control]

(4 marks)

b) Suggest the relevant control activities management should have implemented to address the weaknesses identified.

[Authorisation, performance review, information processing, physical control and segregation of duties]

(7 marks)

www.etctraining.com.hk

MC Business Assurance



JUNE 2013 SECTION B

Q8 Answer

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



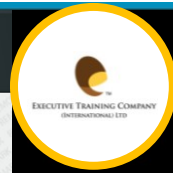
Answer 8(a)

Possible internal control weaknesses

- Lack of **physical security** or control over financial assets including company chop and cheque books.
- Inadequate **authorisation** control when an individual could sign singly to effect cheque payment.
- Inadequate **segregation** of incompatible duties.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(a) (Cont'd)

- Lack of timely **bank reconciliation** and improper bank reconciliation procedure where informal bank statements downloaded from internet website were used in reconciliation.
- Lack of timely and proper **management control and review** of banking activities

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(b)

Relevant control activities

Physical security

- The company chop and the bank account cheque books should be safe-kept by accounts department staff who are not staff holding authorisation functions.

Authorisation

- Cheque signing requirement should be dual signatories based and include tiered signing limit to involve senior personnel for larger cheque amounts.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(b) (Cont'd)

Segregation of duties

- Incompatible accounting functions involved in cheque preparation and clearance procedures should be assigned to different personnel.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(b) (Cont'd)

- Incompatible functions include the following:
 - cheque signing or **authorisation**
 - **custody** of company chop and cheque books
 - preparation of cheques for signature [Dual signatures]
 - checker of cheque preparation accuracy
 - reconciliation of cheque payments to general ledger

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(b) (Cont'd)

Reconciliation

- The bank account general ledger should be **reconciled to bank statements** received from bank by staff not involved in cheque issuance on a regular or daily basis with unusual entries explained and signed off by level-up reviewers.

www.etctraining.com.hk

MC – June 2013 (Section B) – ANSWER



Answer 8(b) (Cont'd)

Management monitoring

- The management should **monitor the performance** of cheque preparation and bank reconciliation activities and sign off at regular intervals.
- The management may arrange surprise check on cheque preparation and cheque book/company chop custody or re-perform bank reconciliation.

www.etctraining.com.hk



Common Hot Topics for MC

www.etctraining.com.hk

Common Hot Topics for MC



- **Corporate governance – NEDs, composition of the board, CEO and chairman**
- **Code of ethics (“The Code”)**
 - Threats to independence – self-interest, self-review
 - Confidentiality – client consent, obligatory disclosure
 - Professional clearance – change of auditors S440 and 441
- **Client acceptance procedures – HKSQC 1 (Clarified) – Management integrity, competence and ethics and HKSA 510 (Clarified) – Opening balances**

www.etctraining.com.hk

Common Hot Topics for MC



- **HKSA 240 (Clarified) – Fraud**
- **HKSA 315 (Revised) – Risk of material misstatement – financial statement level, assertion level, significant risks**
- **HKSA 500 (Clarified) *Audit Evidence* – sufficient and appropriate audit evidence**
- **HKSA 330 (Clarified) – Internal controls – tests of controls**
- **HKSA 520 (Clarified) *Analytical Procedures***

www.etctraining.com.hk

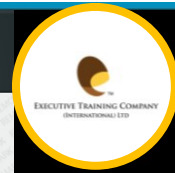
Common Hot Topics for MC



- Substantive testing – intangible assets, inventories (HKSA 501 (Clarified)), financial instruments, accounts receivables, sales, and loan (HKSA 330 (Clarified))
- HKSA 540 (Clarified) – Accounting estimates – provisions and contingent liabilities
- HKSA 610 (Revised) *Using the Work of Internal Auditors*
- HKSA 560 (Clarified) *Subsequent Events*
- HKSA 550 (Clarified) *Related Parties*

www.etctraining.com.hk

Common Hot Topics for MC



- HKSA 450 (Clarified) *Evaluation of Misstatement Identified during the Audit*
- HKSA 700 (Clarified), 705 (Clarified) & 706 (Clarified) – Audit report – modified and unmodified
- IT – General and application controls, system development

www.etctraining.com.hk



Exam Techniques for MC

www.etctraining.com.hk

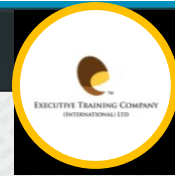
Common Techniques to pass MC



- 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

www.etctraining.com.hk

MC Preparation with ETC



Knowledge Course: 10 Sessions

→ Boost your knowledge

Revision Course: 9 Sessions

→ Practice past papers and other ETC questions

Only got 1 months left – What shall you do?

- Do past papers with updated answers
- Practice writing out:
Progress test + Exam Pack (2 additional tests) + Final Mock
- Write as many questions out as possible
- Practice using your critical file
- Time yourself

www.etctraining.com.hk

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

www.etctraining.com.hk