

SECTION A – CASE QUESTIONS (Total 50 marks)

Answer **ALL** of the following compulsory questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

Dummy Real Estate Investment Trust (DREIT) is a mid-size real estate investment trust listed in Hong Kong. With a portfolio of 50 real estates comprising retail malls, commercial premises and car park facilities, DREIT was established by a trust deed (Trust Deed) – (also refer to Note* on page 5).

DREIT has a manager (Manager) who has the general power to manage DREIT's assets in the interests of its unitholders (Unitholders) in accordance with the Trust Deed. A Board of Directors is responsible for the Manager's overall governance, including establishing targets for executive management and monitoring the achievement of these targets. DREIT's trustee (Trustee) is responsible under the Trust Deed for the safe custody of DREIT's assets and holds the same for and on behalf of the Unitholders. The Manager is independent of the Trustee.

DREIT aims to produce a sustainable stream of income from its portfolio and to maximise the value through the enhancement of its physical built structure, trade-mix, marketing and customer service. As these enhancement projects progress, the portfolio offers customers better shopping facilities with more choices at reasonable prices, whilst improving returns for the Unitholders.

Since its listing on the Hong Kong Stock Exchange in December 2008, DREIT has been paying the Unitholders at about 90% of its net income and has demonstrated consistent growth in distribution per unit. A substantial portion of the remuneration of DREIT's senior executives is closely linked to the growth rate of the distribution per unit.

Certain DREIT's financial and operating data are set out as follows:

	<u>Year ended</u> <u>31 December 2010</u>	<u>Year ended</u> <u>31 December 2009</u>
Revenue	HK\$404 million	HK\$385 million
Net property income margin	35%	35%
Distribution per unit	49 cents	43 cents
Average monthly unit rent	HK\$26 per square foot	HK\$26 per square foot
Occupancy rate	91%	87%
Gearing	20%	18%

Mr. Kwok is the audit director of a CPA incorporated practice in charge of the audit of DREIT's financial statements for the year ended 31 December 2010.

In April 2010, DREIT made an acquisition of a block of low-rise commercial premises in the New Territories. Part of the premises suddenly collapsed in December 2010. There was no casualty reported and DREIT's Manager believed that the damages are fully covered by its group insurance policy. However, emerging evidence indicates that there was an illegal extension built on the premises which might have caused the collapse. If it is the case, the damage could be an uninsured loss.

Note *: DREIT is a collective investment scheme in the form of a unit trust established by a trust deed, authorised by the Securities and Futures Commission under the Securities and Futures Ordinance and regulated by the provisions of the Code on Real Estate Investment Trusts.

Question 1 (6 marks – approximately 11 minutes)

Define the entity's risk assessment process (which is one of the elements of internal controls) and describe two specific risk assessment processes that Mr. Kwok should expect DREIT has in place to minimise the risks of premises collapse, particularly for those caused by the illegal extension built on the premises.

(6 marks)

Question 2 (9 marks – approximately 16 minutes)

Define fraud risk factors and identify four fraud risk factors for the purpose of DREIT's audit.

(9 marks)

Question 3 (14 marks – approximately 25 minutes)

DREIT has established an audit committee to comply with the Listing Rules of the Hong Kong Stock Exchange.

Required:

(a) To what extent can the establishment of an effective audit committee improve DREIT's corporate governance in the context of external auditing, financial reporting and internal control?

(8 marks)

(b) Describe some ways to gauge the effectiveness of DREIT's audit committee.

(6 marks)

Question 4 (15 marks – approximately 27 minutes)

Assume that Mr. Kwok's estimate of losses to DREIT following the premises collapse is material for audit purposes but the Manager of DREIT has refused to adjust the financial statements. Against such circumstances of the case, assume that any misstatements are not likely to be pervasive to DREIT's financial statements.

Required:

(a) Identify and discuss the most appropriate form of audit opinion. (7 marks)

(b) Assume that you are Mr. Kwok and have decided to modify the audit opinion. Write a draft report comprising the report title, the basis of opinion, the qualified opinion and the report issuer sections ONLY.

(8 marks)

Question 5 (6 marks – approximately 11 minutes)

The tenancy of Mr. Kwok's CPA practice office will expire in November 2011. Mr. Kwok has been offered by DREIT a two-year tenancy in one of its prime commercial premises at a monthly rent of HK\$10 per square foot with an initial three-month rent-free period.

Required:

Briefly discuss the ethical issues that Mr. Kwok and his CPA practice face in the above situation, and suggest the appropriate action for Mr. Kwok.

(6 marks)

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End of Section A

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

Answer **ALL** of the following compulsory questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

Question 6 (24 marks - approximately 44 minutes)

Case A

AA Limited is a multinational electronics manufacturer with operations in over 60 countries. Its production base is in mainland China; headquarters in Hong Kong and research and development centre in Japan. AA Limited uses an operational and accounting system called “Efficiency” which is an enterprise resource planning system (ERP). AA Limited’s annual turnover exceeds US\$20 billion.

In a recent interview of the Chief Operating Officer (COO) of AA Limited by the press, the COO boasted that “Efficiency” is an automated and integrated mechanism that would save the company millions in terms of operations costs. “Efficiency” can also process transactions submitted by different departments of the company, in any part of the world, with the support of a professional IT team.

Case B

BB Limited is an investment holding company with minimal transactions every year. BB Limited’s general ledger is a customised accounting software purchased from a third party.

Required:

- (a) In a computerised environment, the internal controls usually include both manual procedures and procedures designed into computer programs. Identify and explain the two types of IT controls that are usually in place when the system is computerised.

(6 marks)

- (b) In view of each case above:

- Evaluate and explain whether you would consider an IT control reliance audit approach or a manual substantive test approach over the data integrity and reliability.
- Design and explain the audit procedures for IT general controls test and data reliability test.

(9 marks for EACH case)

(18 marks)

Question 7 (13 marks - approximately 23 minutes)

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

Required:

- (a) Evaluate and explain the risk of material misstatement relating to the valuation assertion of CC Limited's goodwill and intangible assets as at 31 December 2011. (4 marks)
- (b) Suggest and discuss the audit procedures you would perform on goodwill and intangible assets respectively in response to the assessed risk of material misstatement in Question 7(a). (9 marks)

Question 8 (13 marks - approximately 23 minutes)

Elegant Ella Limited (EE) is a garment manufacturer with major overseas customers residing in the US. Its annual turnover exceeds US\$500 million.

You are the auditor of EE. In March 2012, you have substantially completed your audit work of the financial statements for the year ended 31 December 2011 and are satisfied that there are no material misstatements. You intend to conclude the audit by 15 April 2012. On 2 April 2012, the Wall Street Journal has reported on the serious financial difficulty of EE's largest customer, Y Limited. According to the report, the customer may declare bankruptcy any time.

Required:

- (a) In view of the facts and the news report, what is your revised assessment of the risk of material misstatement of EE's financial statement as a whole? (4 marks)
- (b) In response to the circumstances, what are the further audit procedures, with reasoning, you would design to complete your audit and to give audit opinion on EE's financial statements for the year ended 31 December 2011? (9 marks)

* * * END OF EXAMINATION PAPER * * *