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

Hong Kong's CPA Qualification
香港會計師專業資格

Examination Technique Seminar

on

Section B (Essay/Short Question)

Speaker
Mr. Harvey Lam

22 May 2014

HKCA - HKICPA MC Seminar 22 May 2014

About HKCA

HKCA Learning Media Limited ("HKCA") is established to provide professional accountancy training to university graduates and working adults who are keen to pursue an accountancy qualification in Hong Kong and Mainland China.

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Lecturer's Profile

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Harvey is currently a full-time lecturer at HKCA Learning Media Limited, lecturing on auditing, financial reporting and corporate governance subjects for HKICPA's Qualification Programme and ACCA. He is the author of *Master Guide – Business Assurance*.

Graduated from the UK, Harvey holds a Bachelor's degree with First Class Honours and a Master's degree with Distinction in Accounting and Finance, and was the prize winner in both of his undergraduate and postgraduate degrees as the best performer.

Harvey has worked in one of the 'Big Four' firms in Hong Kong as an auditor for more than 7 years, and has accumulated extensive practical experience in dealing with issues in auditing and financial reporting. Harvey is a member of the HKICPA and ICAEW and is a PC holder to provide assurance and accounting services to his portfolio of clients.

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Agenda

- June & December 2013 Section B Review
- Q&A session

Ethics

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.

Required:

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)

Tips:

- Not "OPTIC"
- 3-Step "Conceptual Framework" Approach
- IFAIR
- Focus on Step 2 – Evaluation of Significance of Threat
- 6R
- Technical jargons

Approach	**Explanation**
Refuse	Do not let the scenario happen
Rotate	Audit Rotation; Modify Audit Plan; Separate Teams
Remove	It can be the Personnel or Subject Matter in question.
Review	Have second partner review or quality control partner review
Reveal	Discuss with TCWG and/or audit committee; Obtain acknowledgement of responsibility of management
Resign	Arguably the last resort to the auditor.

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.

- 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.

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.

- 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.

Question 7 **(10 marks – approximately 18 minutes)**

With 25 branches in the New Territories, Bank of New Territories ("BNT") is a top tier retail bank in Hong Kong specialised in home loans. SMP & Co. ("SMP") has been the external auditor of BNT for five years.

BNT operates a staff mortgage scheme offering all members of staff concessionary mortgage rate deals. The staff rate is currently at one-month HIBOR plus 0.5% while the market rate is plus 1.5%.

Before the upcoming Annual General Meeting, Charles Chow, BNT's Head of Consumer Credit, suggests to Peter Chan, the SMP audit engagement partner, that BNT would like to extend the concessionary staff mortgage scheme to all SMP members of staff, in recognition of SMP's services. Charles and Peter have been golf teammates in the Annual Golf Team Tournament organised by the HKICPA for the last three years.

Required:

Assess and explain the professional and ethical issues in each of the situations above. State the possible safeguards to address the professional and ethical issues.

(10 marks)

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.

Materiality

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:

	For the nine months ended 31 March 2013 (HK$'000)	For the year ended 30 June 2012 (HK$'000)	For the year ended 30 June 2011 (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

Required:

(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?**

(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?**

(6 marks)

(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:

(i) impairment of property, plant and equipment of HK$3 million; and

(ii) share-based payment expenses on granting one-off share options to a director of Mary Limited of HK$2 million.

Required:

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)

Tips:

- How many question requirements are there?
- What are the relevant audit issues in each topic?
- "Range of Benchmarks", not "Range of %"

Other side matters:

- How do you evaluate misstatements using materiality?

For Illustration Only:

(HK$'000)	**2006**	**2005**
Turnover	3,044,505	2,832,638
Cost of sales	(2,722,517)	(2,487,302)
Gross profit	321,988	345,336
Other revenue	9,111	11,098
Other operating gains (net of losses)	2,898	10,423
Distribution and selling expenses	(11,605)	(5,837)
Administrative expenses	(79,849)	(80,222)
Other operating expenses	(2,724)	(12,695)
Profit from operations	239,819	268,103
Finance costs	(73,970)	(31,484)
Profit before taxation	165,849	236,619
Income tax expense	(27,273)	(41,300)
	138,576	195,319
Attributable to shareholders of EMM	116,979	174,760
Minority interests in profit or loss	21,597	20,559
	138,576	195,319

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

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).
- 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.

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.

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.

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

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.

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.

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.

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.

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
- 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.

Confirmation

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.

Required:

(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.**

(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:**

- **selecting confirmation parties;**
- **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)

Tips:

- Risk of Material Misstatements: how do you understand this term?
- Again, what are the relevant audit issues in each topic?

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).
- 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.

- 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.

- 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

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:

- 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.

(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.

(3) Control the proper response

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

Answer 7(c)

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:

(i) Obtain statements of the selected suppliers as at 30 June 2013.

(ii) Agree the balances with the samples selected.

(iii) Select a sample of reconciliations between the accounts payable sub-ledger and the statements received from suppliers and review the reconciliation.

(iv) Test reconciling items by tracing them to supporting documentation.

(v) Evaluate whether the reconciling items are valid.

(vi) 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.

- 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.

Internal Control

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.

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.

Required:

(a) **Identify the possible internal control weaknesses relating to the misappropriation of funds by the finance manager.**

(4 marks)

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

(7 marks)

Tips:

- Concept of Controls
- EARISM
- SPAMSOAP
- No Copying

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.
- 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

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.

Segregation of duties

- Incompatible accounting functions involved in cheque preparation and clearance procedures should be assigned to different personnel.
- Incompatible functions include the following:
  - cheque signing or authorisation
  - custody of company chop and cheque books
  - preparation of cheques for signature
  - checker of cheque preparation accuracy
  - reconciliation of cheque payments to general ledger

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.

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.

Other Services

Question 5 (12 marks – approximately 22 minutes)

Discuss and explain the difference between the following engagements:

- **An audit engagement**
- **A review engagement**
- **An agreed-upon procedures engagement**

(12 marks)

Tips:
- Knowledge Question – how well have you prepared your critical file?
- Concept of Assurance

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.

Various

Question 6 **(28 marks – approximately 50 minutes)**

Assume you are Daniel Lai, an audit partner of ABC CPA Co. ("ABC"). Recently you accept a new audit engagement of a listed company in Hong Kong, Big Bang Limited ("Big Bang").

You have reviewed the latest audited financial statements of Big Bang and noted that an unqualified opinion was issued by the predecessor auditor in the last financial year. Big Bang is principally engaged in apparel manufacturing with annual turnover exceeding US$500 million. Its organization structure is simple with only one manufacturing plant in China and a trading company in Hong Kong. Big Bang's business is very stable. There has been no material fluctuation in the statement of financial position items over the years.

Below is an extract of the significant statement of financial position items from the audited financial statements for the year ended 31 December 2012. Other items are regarded as insignificant.

	US$'million	
Property, plant and equipment	1,500	
Accounts receivables	100	
Inventory	200	
Cash	30	
Accounts payables	240	
Convertible bond issued to a private equity investor	300	(Note - Face value equals carrying value)

(a) Assume that ABC has accepted the audit engagement, you are now considering the overall audit approach for the opening balances.

Required:

(i) **Discuss your overall opening balance audit strategy, with consideration that the last appointed auditor might have had performance issues.**
(5 marks)

(ii) **Suggest and explain your audit procedures for each of the statement of financial position items listed above.**
(10 marks)

Tips:

- Always name the relevant HKSA
- What are the audit concerns of Opening Balance?
- General Procedures or Specific Procedures?
- Passage of Time

Techniques	Remarks
Analytical Procedures	▪ Cannot address existence and occurrence ▪ Useful for valuation and allocation, accuracy and completeness
Enquiry	▪ Useful for most assertions
Inspection	▪ Useful for most assertions
Observation	▪ Useful for physical assets
Recalc**U**lation and reperformance	▪ Useful for valuation and allocation and accuracy
Confirmation	▪ Useful for most assertions (except for valuation and allocation of accounts receivables)
Reconciliation	▪ Cannot address existence and occurrence ▪ Useful for valuation & allocation, accuracy and completeness

It is virtually not possible to list out all audit procedures to address each item by assertions. In fact, the audit procedures to address the same assertion of the same item would vary according to the specific circumstances.

Nevertheless, the below "MAP" approach would prove to be useful which makes use of "AEIOU CR" model.

Approach	Sample Substantive Procedures
Test what **M**anagement has done (E, U)	▪ Enquire into/Discuss with management regarding [ascertain the assertions] ▪ Assess experience, competence, objectivity of staff/expert performing the [management's actions] ▪ Examine compliance of accounting policies with HKFRS ▪ Reperform/recalculate management's calculation
Auditor designed procedures (A, I, O, C, R)	***Basic procedures:*** ▪ Obtain reconciliations/breakdowns showing [……] ▪ Agree opening balance to prior year's audited F/S ▪ Agree closing balance to F/S ▪ Check mathematical accuracy of the [accounting record] ***Main procedures:*** ▪ Vouch [supporting documents] for breakdown/movement items ▪ Vouch or Physically Observe from list to floor ▪ Vouch or Physically Observe from floor to list ▪ Send confirmations to [….] confirming [….] ▪ Test reconciliating items by vouching […..] and obtain explanations…. ▪ Review minutes and correspondence for…. ▪ Review agreements for….. ▪ Analytical Procedures (Compare A to B…) ▪ Search for unrecorded liabilities

	Procedures involving Accounting Estimates or Fair Value: ▪ Assess reasonableness of models and assumptions used by management ▪ Develop an independent estimates and compare with management's calculations (may also use auditor's expert) ▪ Review subsequent events to assess reasonableness ▪ Obtain LoR to confirm [state specific matters]
Post balance sheet indication	▪ Check for any subsequent settlements

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.

(b) For the purposes of improving production efficiency and better management of work in progress and inventory, Big Bang has implemented a new enterprise resources planning ("ERP") system, TIME system, during the year which allows real time recording of inventory in and out and automates the weighted average inventory costing calculation. Daniel learnt this information from his interview with the IT head and is considering this change in the audit plan.

Required:

What audit procedures should Daniel plan to perform?

(7 marks)

Tips:

Impact of IT on Audit Cycle

- No Change in Overall Audit Objectives and Scope
- Focus on Data Integrity, Accuracy and Completeness
- Understanding of Internal Controls – HKSA 315
- Assess IT on RoMM
- Determine Audit Approach – HKSA 330
- Test General IT Controls and Application Controls
- Either Manual Procedures or CAATs
- Consider Team IT Expertise

If Conversion of New System

- Pilot System Approach or Parallel Operation Approach
- Consider Timing of Audit Procedures
- Test Controls on Data Mitigation
- Reconcile "Opening Balance"

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.

(c) After understanding the processes and controls in place in the sales rebates cycle, Daniel considered a control reliance testing approach for sales rebates is preferable in view of efficiency and effectiveness. However, after completing the test of control, the audit team reported to Daniel that one sample of the sales rebates was not properly supported by the approved documents.

Required:

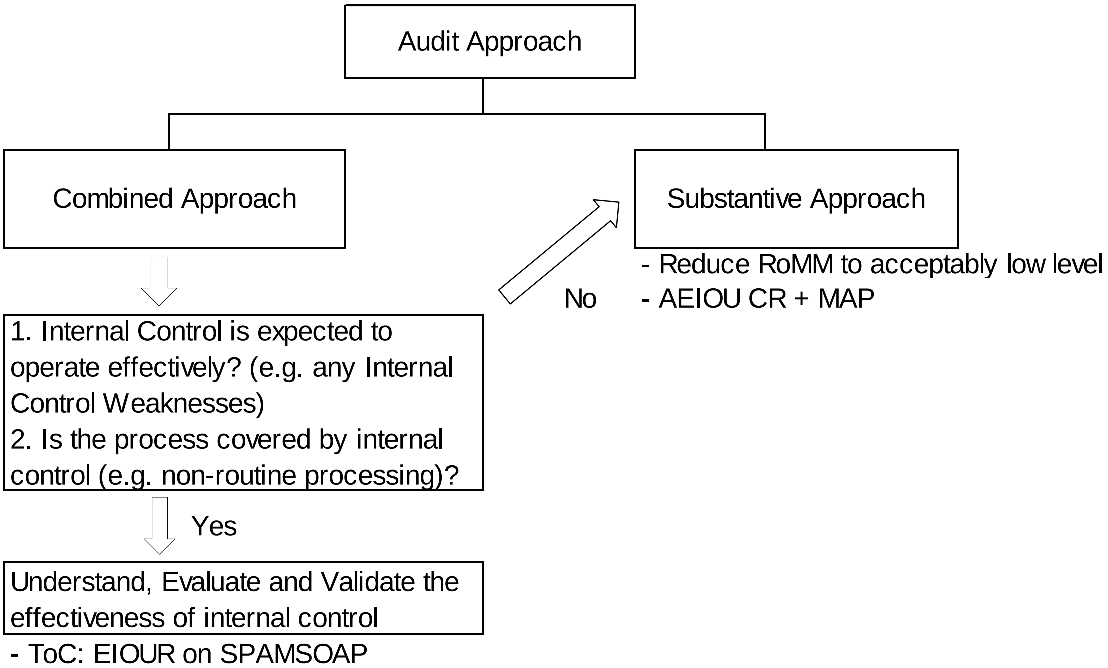
Discuss whether Daniel should continue a control reliance testing approach for sales rebates and what additional audit procedures are required.

(6 marks)

Tips:

Nature	It refers to the audit approach and what type of audit testings would be performed.
Timing	It refers to whether to perform audit procedures at interim stage or at period end. Typically, if the RoMM is higher, audit procedures should be performed nearer or at period end or at unpredictable times.
Extent	It refers to the quantity of audit evidence. Typically, the higher the RoMM the greater extent is required. One way to increase extent is by increasing sample size.

Determine Audit Approach



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.

Observations

- **Thinking Process** is key – this is **Open Book exam**
- **Read the questions carefully** before you start writing – Questions may sometimes be lengthy or clumsy
- **Expect the Unexpected**
- Module C is **NOT all about copying** – if so, the passing rate would have been 100%
- Always take note of the **Complete Picture** of each topic and **Focus on Issues**
- **Time Management** – do you really have 1.5 hours for Section B?

Q&A Session

Any questions?

GOOD LUCK IN MODULE C EXAM!