SECTION A – CASE QUESTIONS (Total 50 marks)

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

CASE

Dymi Limited ("Dymi"), together with its subsidiaries ("Dymi Group"), is a listed company on the Stock Exchange of Hong Kong Limited. Its principal business is sales of stylish and innovative home appliances such as air purifiers, vacuum cleaners, electric fans, dehumidifiers, hair dryers and LED lights. Dymi mainly sells its products through its self-operated stores in Hong Kong and over 20 well-known chain distributors in Hong Kong, Taiwan, and Singapore. Dymi targets high-income groups and young adults by emphasising its products' excellent designs and functions. Its products have recently become very popular. Dymi has a long business relationship with its distributors.

Dymi has no self-owned manufacturing facilities. It has a small factory in Hong Kong and an innovation team mainly responsible for product design and prototyping. Its product manufacturing activities are all outsourced to third party suppliers who specialise in original equipment manufacturing. Dymi has a team in Shenzhen working closely with the outsourced manufacturers on procurement and quality control.

ABC & Co has been the auditor of Dymi for years and is very familiar with Dymi's business operation and its management team. John Chan is the engagement leader of Dymi's audit. To plan for the coming annual audit, John had a meeting with Dymi's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") in September 2021 to understand Dymi's latest business development. Below is an extract from the meeting notes:

- During the first half of 2021, Dymi further expanded its number of self-operated stores from five to eight. The three newly opened stores are different from the previous stores. Each new concept store is over 10,000 square feet and contains a showroom, café, and activity rooms for workshops and events. In addition to demonstrating Dymi's new products, the new concept stores also aim to provide a place for customers to relax. The concept stores have proven popular with the customers and provided Dymi with a new revenue stream. The CEO commented that the concept stores have turned from breakeven to profit-making in just 4 months' time and provide Dymi with good cash flow. Most of the transactions in the concept stores are settled by electronic payments, and Dymi usually receives the cash from the payment service providers within a month.

- Dymi launched its Dymi customer loyalty programme in February 2021. Customers who purchase Dymi products are automatically registered as Dymi club members and earn points. Every HK$250 spent earns 1 Dymi point. 20 Dymi points can be used to redeem a cash coupon of face value HK$20. Dymi club members can use these coupons toward their next purchase, to buy a meal at a Dymi café, or to pay for Dymi club activities. Dymi points will expire automatically at the end of each calendar year. The CEO considers the Dymi club customer loyalty programme to be a big success and says that it has helped boost sales during the year.

- To facilitate the launch of the Dymi customer loyalty programme and the opening of the concept stores, Dymi has implemented a highly customised new point-of-sales system during the year that connects to all of its online and offline stores and stores operated by the chain distributors. Dymi has also upgraded its mobile application ("Dymi APP"), which now shows customers their points earned and cash coupons redeemed, used and expired. The new point-of-sales system and the upgraded Dymi APP provide Dymi's management with instant and transparent data on product sales in each location. The new point-of-sales system and the Dymi APP directly interface with Dymi's general ledger, which enhances the preparation of management accounts in terms of revenue and deferred revenue recognition.

- Dymi has further strengthened its due diligence procedure on accepting new distributors. There is no new distributor during the year. Dymi's policy allows no return of goods from distributors. During the year, two of Dymi's distributors in Hong Kong and Taiwan have experienced financial difficulty due to the prolonged impact of pandemic. For prudence's sake, management has decided to make a full provision against these trade receivables of HK$30 million in aggregate. The CFO also explained that the trade receivable turnover day will increase for the year as there are delays of settlement from certain distributors in Taiwan and Singapore. Historically, Dymi has experienced no default of payments due from any of its distributors. The CFO expects that no credit loss provision will have to be considered for the trade receivables due from the distributors other than the two distributors which are in financial difficulty.

Extract of Dymi Group's consolidated financial statements for the year ended 31 December 2021

Consolidated statement of financial position

	2021 (Unaudited) HK$'million	2020 (Audited) HK$'million	Change HK$'million	%
Fixed assets	230	200	30	15%
Right-of-use assets	50	6	44	733%
Inventory	80	50	30	60%
Trade receivables	164	69	95	138%
Prepayment and other receivables	30	28	2	7%
Cash and bank	180	200	(20)	(10%)
Other assets	4	7	(3)	(43%)
Total assets	738	560	178	32%

Lease liabilities	46	6	40	667%
Trade payables	188	142	46	32%
Accrual and other payables	15	17	(2)	(12%)
Other liabilities	5	6	(1)	(17%)
Total liabilities	254	171	83	49%
Net assets	484	389	95	24%

Consolidated statement of profit or loss

	2021 (Unaudited) HK$'million	2020 (Audited) HK$'million	Change HK$'million	%
Sales of products				
- HK self-operated stores	150	125	25	20%
- HK distributors	488	375	113	30%
- Taiwan distributors	154	140	14	10%
- Singapore distributors	338	260	78	30%
Sales of services and meals	48	-	48	N/A
Total revenue	1,178	900	278	31%
Cost of sales	754	567	187	33%
Gross profit	424	333	91	27%
Gross profit margin	36%	37%		
Selling and distribution expenses	118	90	28	31%
General and administrative expenses	48	40	8	20%
Profit before tax	258	203	55	27%
Profit tax	46	39	7	18%
Profit after tax	212	164	48	29%

John calculated the overall materiality using the financial figures in the consolidated financial statements of Dymi Group and determined that the overall materiality amounted to HK$13 million, calculated as 5% of the profit before tax.

Question 1 **(16 marks – approximately 28 minutes)**

(a) Evaluate the risk of material misstatements relating to revenue recognition in the consolidated financial statements of Dymi in terms of occurrence.

(3 marks)

(b) In response to the launch of the customer loyalty programme and implementation of the new point-of-sales system and the Dymi APP, ABC & Co has assessed that the risk of material misstatements relating to revenue recognition in the consolidated financial statements of Dymi in terms of accuracy is high.

(i) Explain ABC & Co's risk assessment of the above.

(5 marks)

(ii) Propose audit procedures to address the risk of material misstatements identified in Question 1(b)(i) in terms of accuracy.

(8 marks)

Question 2 **(12 marks – approximately 22 minutes)**

Considering the business updates and unaudited consolidated financial statements for the year ended 31 December 2021, provided by Dymi management as set out in the case background, Sean, the audit senior, considers the risk of material misstatements of expected credit losses on trade receivables to the consolidated financial statements of Dymi to be low.

Required:

(a) Advise on whether you agree with Sean's risk assessment. Please state your reasons.

(5 marks)

(b) Propose audit procedures to address the risk of material misstatements identified in Question 2(a), in particular the audit procedures in assessing management's judgements and estimates applied in the expected credit losses assessment.

(7 marks)

Question 3 **(12 marks – approximately 22 minutes)**

Subsequent to the meeting with Dymi's CEO and CFO, the CFO provided John with a copy of the three new lease contracts entered into with the respective landlords in the year. The CFO explained that the terms and conditions set out in the lease contracts regarding rental period, rent-free period, rent per month, rental payment date, etc. are clearly specified. Dymi also successfully negotiated with the landlords the following terms:

- Dymi has the sole discretionary right to extend the lease contracts for another 3 years upon expiry of the original contract terms of 3 years.

- Dymi has the right to terminate the lease contracts anytime during the contract periods as long as a 6-month notice has been given to the landlord(s) in advance.

Required:

(a) Evaluate the risk of material misstatements relating to right-of-use assets in the consolidated financial statements of Dymi in terms of accuracy and completeness.

(5 marks)

(b) Propose audit procedures to address the risk of material misstatements identified in Question 3(a).

(7 marks)

Question 4 **(10 marks – approximately 18 minutes)**

(a) Listed companies in Hong Kong are required to include a corporate governance report in each annual report. Certain disclosures in the corporate governance report are mandatory. Failure to include these mandatory disclosures are regarded by the Stock Exchange of Hong Kong Limited as a breach of the Listing Rules.

List FIVE mandatory disclosures relating to the board of directors in a corporate governance report.

(5 marks)

(b) From a corporate governance perspective, explain the responsibilities of the board of directors in communicating and sharing information with shareholders relating to Dymi's latest business development in the year and advise the expected actions.

(5 marks)

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End of Section A

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

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

Question 5 (14 marks – approximately 25 minutes)

Cho Kee Sewage System Limited ("Cho Kee") is an unlisted entity which provides sewage maintenance services. Your audit firm has acted as the auditor of Cho Kee for many years.

The financial controller of Cho Kee resigned close to this financial year-end. In view of this situation, Cho Kee's directors foresee many audit adjustments may arise to correct material misstatements, therefore, to enhance efficiency, they request your firm to prepare the financial statements.

Cho Kee has made an investment in a private entity in this year. In accordance with the accounting policy, the investment is required to be stated at fair value in the financial statements. Cho Kee's management, therefore, determined its fair value by themselves. Management knows that, as part of the audit, the audit team will engage an internal valuation team to assess the fair value of this investment. Accordingly, management wants to simply take up the fair value to be proposed by the auditor's internal valuation team in its financial statements.

In addition, Cho Kee has received an enquiry from the Inland Revenue Department ("IRD") regarding the previous years' onshore and offshore claims. As Cho Kee does not have an in-house tax advisor, the management has proposed engaging your tax partner to act on Cho Kee's behalf to negotiate with the IRD regarding the tax disputes, including suggesting any terms on the tax settlements. This tax partner is also assisting the audit team to review the adequacy of Cho Kee's tax provision in the upcoming audit.

You are Thomas Lee who has been newly assigned as the audit manager for Cho Kee this year.

Required:

Prepare a memo to Richard Chan, your audit partner reporting the independence threats based on the above, and propose safeguards to mitigate these threats.

Note: A maximum of 2 marks for communication skill and 2 marks for analytical skill will be awarded.

(14 marks)

<u>Question 6</u> (12 marks – approximately 22 minutes)

You are the auditor of the following subject companies. Evaluate whether the misstatements identified are material to the financial statements of the respective companies. Provide detailed explanations with your answers.

(a) Company A is wholly-owned by Mr Adam Au. Adam is also the director of Company A and prepares the company's financial statements. The primary users of Company A's financial statements are Adam and the tax bureau for tax filing. During the year, the audit team identified a cut-off error which caused an understatement of payroll costs by HK$2.3 million. In the prior year, the same nature of uncorrected error (HK$0.9 million) was also noted, which was subsequently charged to the current year's profit and loss account. Company A recorded a profit of HK$32 million for the current year before these corrections. The materiality is set at HK$1.5 million.

(4 marks)

(b) Company B is a biotech company which is wholly owned by Mr Brian But. The primary user of Company B's financial statements is its shareholder, Brian. Brian is also the director of the Company. During the year, Company B capitalised HK$2.3 million development costs of a new product as an intangible asset. However, the audit team considers the HK$2.3 million development costs should be charged to the profit and loss account because there is doubt about whether the new product can generate probable future economic benefits. Brian disagrees and considers that the capitalisation has met the criteria as set out in the relevant accounting standard. Should this be adjusted, Company B will then have recorded a loss of HK$55 million and intangible assets with a carrying value of HK$52.5 million (excluding the HK$2.3 million development costs of the new product). The materiality is set at HK$3 million.

(4 marks)

(c) Company C is a listed entity which is engaged in the manufacturing of electronic devices. The users of Company C's financial statements are public shareholders who focus on Company C's financial ratios, including gross profit margin, to indicate how well Company C is performing. During the year, the audit team identified certain direct costs amounting to HK$17.8 million which were wrongly classified as selling expenses. Management did not correct the classification error during the current year because management regarded this error as only affecting the classification and not having any impact on Company C's net profit. In addition, if this reclassification error is corrected, it will result in a downward trend in Company C's gross profit margin which may affect the evaluation of management bonuses. The materiality is set at HK$2 million. The analysis made by the audit team is as follows:

	Prior year	Current year		
	(Audited) HK$'000	As previously reported HK$'000	Error identified HK$'000	If corrected HK$'000
Revenue	145,157	138,224		138,224
Cost of sales	(58,214)	(52,102)	(17,801)	(69,903)
Gross profit	86,943	86,122		68,321
Gross profit margin	60%	62%		49%

(4 marks)

<u>Question 7</u> (10 marks – approximately 18 minutes)

You are the auditor of Excellent Limited ("Excellent"). In last year's audit, you assessed that Excellent's IT general controls were not effective and, hence, issued a management letter which is extracted below:

"*… During our audit, we have identified the following weaknesses relating to the Company's IT general controls.*

(i) *There was no proper access control for the Company's hardware, software, and data; and*

(ii) *The Company's system is connected to the Internet, but there is no security control over programme changes; therefore, there is a risk of cyber-attack."*

This year, during the audit planning you enquired of the management if there had been any updates and improvements in respect of the previous year's management letter points. The management replied that they have moved the Company's servers from the warehouse to a newly rented separate premise, and this premise is now restricted to authorised personnel access only.

<u>Required:</u>

(a) Evaluate if the changes made by the management during the current year have fully improved the weaknesses identified in the prior year's audit. If not, propose possible remediation plans so that Excellent can further improve its IT general controls.

(4 marks)

(b) Based on management's responses regarding the improvements as set out in the question, formulate an assessment of the current year's effectiveness on its IT general controls and your strategies of testing the application controls. Provide detailed explanations with your answers.

(6 marks)

<u>Question 8</u> (14 marks – approximately 25 minutes)

iHom provides property management services for approximately 20 residential and commercial properties in Hong Kong. iHom has 20 operating entities and each of them manages services for one property. In addition, it has 30 dormant entities. The whole group maintains approximately 300 bank accounts.

You are the new auditor of iHom. The audit team has obtained the following information. The materiality is set at HK$10 million.

	Number of bank accounts	Amount HK$'000
Group A: Cash at bank		
Group A1: Each bank account balance exceeds HK$100,000		
- HKD	4	98,145
- USD	9	28,159
- RMB	9	78,180
Group A2: Each bank account balance is below HK$100,000		
- HKD	85	3,347
- USD	110	1,137
- RMB	10	144
Group A3: Bank account with no balance	67	-
Group B: Time deposits		
- HKD (1 year)	1	447,318
- USD (1 year)	1	157,165
Group C: Wealth management products	1	290,152
Group D: Bank borrowings		
- HKD	5	(548,140)

Required:

(a) Identify any unusual observations or irregularities from the given facts for the purpose of the audit.

(8 marks)

(b) The audit team has decided to send confirmations to all the bank accounts to confirm all balances as set out in Groups A, B, C and D.

Justify the reasons for audit team's strategy made on bank confirmation procedures for each group of bank accounts.

(6 marks)

* * * END OF EXAMINATION PAPER * * *