## 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

Go-VR Limited ("Go-VR") was set up in 2011 and built the first virtual reality (VR) park in Hong Kong. Go-VR's park offers attractions made up of VR games.

Go-VR is a wholly-owned subsidiary of a Japanese company (the "parent" company). Go-VR has a sole director who is seconded by the senior management from the parent company. Because its parent company is engaged in the manufacturing of VR games and machinery, Go-VR can only source VR games and machinery from its parent company. The purchase prices of these game machines are determined based on a cost-plus margin of 30%.

In addition, Go-VR's administrative and accounting functions are handled by its parent company. Go-VR is required to pay a fixed monthly management fee to its parent company. These fees are approximately 50% of Go-VR's total administrative expenses.

Between 2011 and 2014, Go-VR was recognised as the "No. 1 VR park in Asia" because it had the widest variety of VR games in comparison to other VR parks in the region. Go-VR reached its peak in 2014 and the park attracted many visitors who travelled from nearby countries. However, starting in 2015, the park began to face severe competition. Immediately, its ranking dropped. Number of visitors is a key performance indicator for management because it is linked to the annual management bonus. In order to boost sales, Go-VR has introduced various promotional offers with a variety of discounts and different price cuts.

The following visitor information is published by Go-VR on its website:

| Year | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Number of visitors (in millions) | 0.9 | 1.2 | 2.4 | 3.5 | 3.2 |

| Year | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Number of visitors (in millions) | 3.0 | 2.7 | 2.3 | 1.8 | 0.5 |

In December 2020, Go-VR acquired an adjacent Go-Karting centre ("Go-Kart") aiming to attract more visitors through a synergy effect. The acquisition of Go-Kart was financed by a bank loan. Go-Kart had been operating profitably for the preceding three years prior to its acquisition by Go-VR. After this acquisition, Go-Kart has become Go-VR's subsidiary.

Go-VR has a year end date of 31 December and its financial statements are primarily used by its parent company, the tax bureau and creditors like banks.

During the year, Go-VR changed its auditor to your firm. You are the audit manager and are currently planning the audit of Go-VR for the year ended 31 December 2020.

Extract of Go-VR's management accounts which exclude the financial information of its subsidiary, Go-Kart, for the fiscal years 2019 and 2020 are shown below.

| | 2020 (Unaudited) HK$'000 | 2019 (Audited) HK$'000 |
|---|---|---|
| Revenue | 58,900 | 74,105 |
| Cost of sales | (55,366) | (51,727) |
| Gross profit | 3,534 | 22,378 |
| | | |
| Other income and gains | 1,092 | 1,079 |
| Marketing expenses | (4,357) | (4,220) |
| Administrative expenses | (5,456) | (5,342) |
| Management performance bonus | (1,200) | (500) |
| Finance costs | (153) | (166) |
| | | |
| (Loss)/ Profit before tax | (6,540) | 13,229 |
| | | |
| Income tax expense | (133) | (775) |
| (Loss)/ Profit for the year | (6,673) | 12,454 |

| | 2020 (Unaudited) HK$'000 | 2019 (Audited) HK$'000 |
|---|---|---|
| Non-current assets | | |
| Property, plant and equipment | 28,683 | 36,375 |
| Right-of-use assets | 4,563 | 5,576 |
| Investment in Go-Kart Limited | 20,000 | - |
| | 53,246 | 41,951 |
| Current assets | | |
| Prepayment and other receivables | 523 | 703 |
| Inventories | 586 | 698 |
| Trade receivables | 540 | 582 |
| Cash and cash equivalents | 4,749 | 3,665 |
| | 6,398 | 5,648 |
| Current liabilities | | |
| Trade and other payables | 462 | 647 |
| Lease liabilities | 897 | 903 |
| Interest-bearing bank borrowings | 2,000 | - |
| Tax payable | 567 | 530 |
| | 3,926 | 2,080 |

| | | |
|---|---|---|
| Non-current liabilities | | |
| Lease liabilities | 3,607 | 4,597 |
| Interest-bearing bank borrowings | 18,000 | - |
| | 21,607 | 4,597 |
| | 34,111 | 40,922 |

**Question 1** **(12 marks – approximately 22 minutes)**

**During the audit planning meeting, Mr Donald Ho, the audit partner, instructed the audit engagement team to analyse the information of visitors published by Go-VR. He also instructed the team to identify which accounts as set out in the 2020 management accounts of Go-VR and the related assertions are considered as significant risks. Prepare a memorandum to the audit partner to explain your answers.**

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

**(12 marks)**

**Question 2** **(10 marks – approximately 18 minutes)**

**(a)** **Evaluate the risks of material misstatement in Go-VR's financial statements that result from the related party relationships and transactions between Go-VR and its parent company.**

**(6 marks)**

**(b)** **Propose audit procedures responding to the risk evaluation as set out in Question 2(a) above.**

**(4 marks)**

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

During the planning meeting, the management told you that the acquisition of Go-Kart has resulted a goodwill which will be recorded in the consolidated financial statements of Go-VR for year ended 31 December 2020. The goodwill is further detailed in the management schedule shown below:

| | HK$'000 |
|---|---|
| Consideration for the acquisition of Go-Kart | 20,000 |
| Less: Fair value of identifiable net assets | |
| Machineries and vehicles based on external valuation (Note) | (8,453) |
| Right-of-use assets | (6,243) |
| Cash at bank, trade and other receivables, trade and other payables and lease liabilities, net | 453 |
| Unallocated - goodwill | 5,757 |

*Note: Assume that there is no impact on deferred taxation.*

**Required:**

**Propose audit procedures to audit the above goodwill calculation and describe the audit evidence that you expect to obtain.**

**(12 marks)**

**<u>Question 4</u>** **(8 marks – approximately 14 minutes)**

During the audit, you realise Go-VR had breached the bank loan financial covenants as at 31 December 2020. Unless the management had already obtained a waiver from the bank before the year end date, the breach would cause the whole amount of the long-term portion of the bank loan to become due immediately.

**<u>Required:</u>**

**Describe your audit consideration and propose respective procedures relating to:**

**(a)** **the presentation and disclosure of Go-VR's financial statements if the management can obtain a waiver from the bank.**

**(4 marks)**

**(b)** **the going concern assessment if the management cannot obtain any waiver from the bank.**

**(4 marks)**

**<u>Question 5</u>** **(8 marks – approximately 14 minutes)**

Currently Go-Kart has its own administrative and accounting teams to handle their respective functions. Pursuant to a post-acquisition restructuring plan, Go-Kart will transfer all of its administrative and accounting staff to Go-VR. Go-VR will no longer rely on the administrative and accounting support by its parent. Thereafter, the new administrative and accounting personnel of Go-VR will also support Go-Kart's operation. Go-VR and Go-Kart will establish a new basis for the management fee for the provision of administrative and accounting services by Go-VR to Go-Kart.

**<u>Required:</u>**

**Propose controls or measures to ensure the management fee charged by Go-VR is fair and reasonable to Go-Kart.**

**(8 marks)**

* * * * * * * *

End of Section A

**<u>SECTION B – ESSAY / SHORT QUESTIONS</u> (Total 50 marks)**

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

**<u>Question 6</u> (10 marks – approximately 18 minutes)**

**Analyse and explain any ethical issues for each of the following series of scenarios and advise relevant safeguards if applicable.**

**(a) Joshua and Martin were primary school classmates but they did not meet for more than 30 years since graduating from primary school. They have just bumped into each other in a recent primary school alumni dinner. Joshua is the Chief Financial Officer of a large retail bank in Hong Kong which is owned and run by his family. Martin is an audit partner of MNM & Co. Joshua invites Martin to participate in the audit service proposal for his bank.**

**(3 marks)**

**(b) Joshua and Martin are both art lovers and are especially fond of surrealist paintings. Martin bought a painting at a gallery visit and would like to give it to Joshua. MNM & Co has recently submitted their audit service proposal to Joshua's bank for consideration.**

**(3 marks)**

**(c) MNM & Co just won the bidding to provide Joshua's bank audit service. Martin has just bought a property in Hong Kong and is looking for a mortgage. Joshua has introduced to Martin a few mortgage plans that his bank offers in the market.**

**(2 marks)**

**(d) Joshua's bank holds significant private equity investments which are required to be revalued at each of the reporting periods. Joshua would like MNM & Co to perform the valuation for his bank and seeks a fee quotation from Martin.**

**(2 marks)**

**Question 7** (16 marks – approximately 29 minutes)

(a) Kin Hong Tong is one of the most well-known retailers of herbal products and soups in Hong Kong. Its principal business is the production and sales of Chinese herbal products and Chinese-style soups under its own brand. It has ten retail stores in Hong Kong, and all of these stores are operating under its self-owned properties.

Kin Hong Tong was founded by the Kin family in the 1980s. Over the past 30 years, Kin Hong Tong has been led by the three brothers of the Kin family who are directors of the board:

- Kin Tai Gor - Chairman of the board and chief executive officer is responsible for business strategy and development

- Kin Yee Gor - Executive director and chief operation officer is responsible for daily operations and administration

- Kin Sam Gor - Executive director is responsible for production development and production

The Kin family has been planning to further expand Kin Hong Tong's business to Taiwan and Singapore and is considering different sources of financing. Taking Kin Hong Tong to initial public offering is one of the possible options though the corporate governance of Kin Hong Tong will have to be enhanced.

**Required:**

**Advise Kin Hong Tong what relevant changes to the board composition should be made to comply with the Main Board Listing Rules of Hong Kong Stock Exchange.**

**(6 marks)**

(b) Chan & Co is the newly appointed auditor of Kin Hong Tong. Alex Chan is the audit engagement leader of Kin Hong Tong's audit for the year ended 31 December 2020. The board of directors understand from Chan & Co that they may need to perform audit procedures on certain opening balances of the financial statement line items.

Alex has obtained the audited financial statement of Kin Hong Tong for the year ended 31 December 2019 and has discussed the business updates in 2020 with the financial controller of Kin Hong Tong. Below is an extract of Kin Hong Tong's audited financial information for the year ended 31 December 2019.

| | HK$'000 |
|---|---|
| Property, plant and equipment | 26,000 |
| Financial assets at fair value through profit or loss | |
| - Equity and bond investments with market quote | 14,600 |
| Trade receivables and other assets | 3,100 |
| Inventories | 3,520 |
| Bank and cash | 4,560 |
| | |
| Trade and other payables | 1,230 |
| Provision and other liabilities | 1,895 |
| | |
| Shareholder's equity | 48,655 |

**Required:**

**Assume you are Alex. Explain which of the above financial statements line items are subject to opening balance audit procedures and propose audit procedures on these balances.**

**(10 marks)**

**Question 8** **(14 marks – approximately 25 minutes)**

Spotless Beauty Limited ("Spotless Beauty") is a leading Hong Kong based medical aesthetic device company. It is headquartered in Hong Kong. Spotless Beauty and its subsidiaries have operations around the world. Its products are applied in a broad range of medical aesthetic treatments including facial resurfacing, wrinkle reduction, body shaping, tattoo removal, etc.

For two consecutive years, certain research costs were inaccurately capitalised and recognised as intangible assets by the research and development centre in Hangzhou. Audit adjustments were put through by management before the finalisation of the audited consolidated financial statements of the company.

This is the third year that Wong & Co, a reputable international accounting firm, is the auditor of Spotless Beauty Limited.

The financial data below are extracted from Spotless Beauty group's management accounts for the year ended 31 December 2020:

| Company | Function | Revenue (HK$ million) | Assets (HK$ million) | Profit/ (Loss) (HK$ million) |
|---|---|---|---|---|
| Spotless Beauty | Hong Kong headquarter | N/A | 267 | (32) |
| Sub B | Research and development centre in Hangzhou | N/A | 72 | (28) |
| Sub C | Manufacturing base in Shenzhen and Greater China sales hub | 348 | 2,305 | 259 |
| Sub D | North America sales hub in New York | 470 | 385 | 134 |
| Sub E | Europe sales hub in Amsterdam | 321 | 296 | 87 |
| | Total | 1,139 | 3,325 | 420 |

**<u>Required:</u>**

**(a) Assume you are the audit engagement manager of Spotless Beauty Limited. The audit engagement partner has asked you to prepare a detailed audit scoping (e.g., full scope audit, review, specified procedures on a financial statement line item, etc.) based on the preliminary financial data presented above and provide your rationale for discussion with him.**

**Explain your proposed audit scope for Spotless Beauty, Sub B and Sub D.**

**(6 marks)**

**(b) The audit engagement leader has decided that Sub E is an individually significant component of the group and the component audit of Sub E will be carried out by Wong & Co's network firm in the Netherlands.**

**The group engagement team has determined the component materiality for audit of the financial information of Sub E and met with Sub E's management to understand the business activities and control environment of Sub E.**

**Propose other relevant audit procedures that should be performed by the group engagement team.**

**(8 marks)**

**Question 9** (10 marks – approximately 18 minutes)

Happy Bee Limited is a honey manufacturer in Hong Kong. It has no distribution stores and only sells its honey products online but it has own delivery team. Happy Bee Limited has been using a self-developed comprehensive system for handling sales orders and customer payments, tracking goods delivery and managing inventory. The system is highly customised and self-maintained. During the audit planning meeting, the financial controller of Happy Bee Limited confirmed that there have been no changes to the system design and configuration during the year apart from removing system access of resigned employees.

XYZ & Co is the auditor of Happy Bee Limited. The prior year's audit findings indicated that the system is properly designed and well maintained with clearly documented system processes and controls and detailed system logs of changes and access. Both the IT general and application controls have been operating effectively as designed.

During the audit planning, XYZ & Co has decided to continue to adopt the control reliance approach in auditing the system of Happy Bee Limited.

**Required:**

(a) **Propose relevant audit procedures to test the operating effectiveness of the IT general controls of Happy Bee Limited.**

**(7 marks)**

(b) **Recommend THREE possible IT application controls over revenue recognition of Happy Bee Limited.**

**(3 marks)**

* * * END OF EXAMINATION PAPER * * *

## SECTION A – CASE QUESTIONS (Total: 50 marks)

### Answer 1

To: Donald Ho, Audit Partner
From: Audit engagement team
Date: XXX
Subject: Significant risks of GO-VR

This memorandum is written regarding the accounts and the related assertions which are considered as significant risks in the 2020 management accounts of Go-VR.

Go-VR belongs to an industry subject to a high level of vulnerability because consumers are looking for new entertainment. It reached its peak in 2014 but since then, due to direct and keen competition when other VR parks were introduced, it has suffered a downturn in this industry.

The continuous drop in the number of visitors with a much larger magnitude in recent years and the suffering of an operating loss has further indicated that Go-VR has been facing a more severe and difficult situation in 2020.

Based on the information of visitors published by Go-VR and the above analysis, the following accounts with assertions should be identified as significant risks:

- The occurrence of revenue may be materially misstated: The number of visitors has decreased by around 70% but revenue has only decreased by 20%. The decline percentage in revenue did not align with the downward trend as indicated by the decrease in the number of visitors in 2020.

- The accuracy of revenue may be materially misstated: Go-VR has introduced various promotional offers with a variety of discounts and different price cuts. Due to the complexity of the ticket pricing, such offers may not be properly accounted for.

- The accuracy of management bonus may be materially misstated: The management performance bonus increased by 140% from HK$500,000 to HK$1.2 million while the revenue and profitability of Go-VR decreased significantly. This unusual relationship could indicate a material error of its accuracy.

- Management fraud may exist: Number of visitors is a key performance indicator for management because it is linked to the management bonus distributed annually. Such personal financial pressure increase the likelihood of management fraud.

- Valuation of the non-current assets may be materially misstated: In view of the current severe competition faced by Go-VR, impairment provision may be required for non-current assets, including property, plant and equipment and right-of-use assets. Impairment assessment would involve significant management judgement and estimations which have a higher risk of material misstatement.

Conclusion:

The above accounts and the related assertions are considered as significant risks based on the available information currently known to us. The audit engagement team will timely consider any new information should it come to light during the audit process.

**Answer 2(a)**

The related party relationship and transactions between Go-VR and its parent company comprise the presence of the parent company's senior management as Go-VR's sole directorship, purchases of fixed assets from its parent company, and monthly management fees paid to the parent company.

The excessive participation by the parent company in Go-VR has increased the risk of material misstatement of its financial statements.

The domination of management by its sole director who is the senior management of the parent company could give rise to significant risk of material misstatement due to fraud. His oversight over the related party transactions with the parent company may be compromised and any controls over these transactions may not be objective and hence not effective. Significant management override may give rise to significant fraud risk which is related to these related party transactions.

Property and equipment are the significant assets of Go-VR. As Go-VR purchases the game machines solely from its parent company, it is unable to source supplies from the open market, which may limit the choices of its purchases. Further, as all these purchases are set at a price which allows its parent company to earn a 30% margin, it may be difficult to substantiate that the price is at arm's length. Accordingly, this related party transaction may give rise to increased risk because it may not be conducted under normal terms and conditions.

The monthly management fees paid to the parent company may lack an audit trail and may not have adequate supportable evidence to substantiate the amounts being charged. As the aggregate fees payable to the parent company account for 50% of the total administrative expenses of Go-VR, it could also give rise to increased risk. In addition, as one of the users of the financial statements is the tax bureau, any unsupportable expenses may have consequences with tax filing which may cause understatement of tax expenses.

**Answer 2(b)**

The auditor shall inquire of management the types and the purposes of these related party transactions to understand the underlying business rationale.

The auditor shall also inspect the agreements (if any) entered between Go-VR and its parent company for the purchase of the fixed assets, particularly any basis to support the pricing, such as benchmarking to quoted prices obtained from open market or other third-party suppliers.

The auditor shall inspect any service agreement or documentary evidence (if any) to understand the basis of the monthly charges of the administrative and accounting functions provided by the parent company.

The auditor shall review the management meeting minutes to ascertain if these related party transactions are properly considered and approved.

The auditor shall review Go-VR's tax return filing and correspondences communicated by the tax bureau. The auditor shall also review the transfer pricing study (if any) conducted by the management or external tax consultant engaged by Go-VR.

The auditor should obtain any understanding of the entity level control over related party transactions and ascertain if these controls are deficient or non-existent.

The auditor can enquire with the out-going auditor to ascertain the risk level of these related party transactions in prior years.

**Answer 3**

The audit team should perform the following procedures to audit the goodwill arising from the acquisition of Go-Kart:

- Obtain the sale and purchase agreement for Go-Kart to verify the amount of consideration. Identify if there are any variable considerations which may affect the calculation of goodwill.

- Obtain the share transfer document or legal document for the registration of Go-VR as the holding company of Go-Kart. Assess whether acquisition has been completed and whether the date of acquisition has been appropriately used for the determination of the fair value of the identifiable assets and liabilities.

- Obtain the valuation report provided by the external valuer and enquire the external valuer for the basis of its valuation and assess the external valuer's competence and objectivity to perform such valuation. Evaluate if the valuation methodology applied is appropriate. Verify the data used in the valuation report. When possible, involve an internal valuation expert to assist the audit team for such evaluation.

- Obtain a list of machineries and vehicles at the date of acquisition and reconcile the items to the year end register. Perform physical inspection of the machineries at the year-end date or a different date for this reconciliation.

- Obtain all the lease agreements signed by Go-Kart. Re-calculate the calculation of right-of-use assets based on terms as set out in this agreement. Obtain the underlying schedule which supports the calculation of the lease liabilities by reference to these lease agreements, and evaluate the appropriateness of the use of estimates such as the discount rate for the calculation of such liabilities at the acquisition date.

- Obtain the underlying schedules of the trade and other receivables, trade and other payables and the bank balances, and verify the material balances by inspecting the supporting documents such as invoices, suppliers' statements and bank statements.

- Enquire with the management to identify any intangible assets and unrecorded liabilities of Go-Kart.

- Review the subsequent payment of Go-Kart to assess if there are any unrecorded liabilities which should have been considered when calculating the goodwill.

- Reperform the calculation and perform arithmetical check of the management's schedule.

**Answer 4(a)**

If the management can obtain a waiver from the bank, the audit team should examine any written documentation issued by the bank. Based on the evidence obtained, the audit team should evaluate whether the presentation of such bank loans in current or non-current liabilities is appropriate in accordance with the relevant accounting standards. In addition, disregarding whether the bank loans will be presented as current or non-current liabilities, the audit team should also consider whether the breach of covenants should be disclosed in the financial statements to provide useful information to the users of the financial statements.

**Answer 4(b)**

If the management cannot obtain any waiver from the bank, the bank loans will become immediately due, which will result in a net current liabilities situation at the year-end date. The audit team should enquire the management regarding its remediation plan to repay the bank loans within the next 12 months. The audit team should assess whether the management remediation plan can support the going concern assumption of the financial statements. The audit team should also consider whether adequate disclosure has been made in the financial statements for the support of going concern basis in the financial statements.

If material uncertainties relating to going concern exist, the audit team should consider including a paragraph in the audit report to draw the financial statements readers' attention of such material uncertainties.

If the audit team concludes that the use of going concern assumption for the preparation of the financial statements is not appropriate, the audit report should be modified.

**Answer 5**

The following measures or controls can be established:

- Enter into a written service agreement between Go-VR and Go-Kart which sets out the terms and conditions for the charges of the administrative and accounting services.
- Establish a reasonable basis to determine the fee charged, e.g. based on number of headcount input by Go-VR, or based on the number of hours spent on Go-Kart by the respective personnel.
- Separate management maintained by Go-VR and Go-Kart.
- Each local management evaluates if the fee charges are at market term. They can compare the upcoming fee charges to the historical costs incurred by Go-Kart's own staff.
- Incorporate fair terms in the agreement. For example, both parties have the right to terminate the agreement. The fees are subject to review by both parties on a regular basis.
- Document the management evaluation and evidence the proper approval by local management in the directors' meeting.
- Local management should monitor the pricing of these fees in accordance with the terms as set out in the agreement.
- A monthly invoice should be provided by Go-VR to set out how the fees are drawn and local staff should reconcile these fees to the terms set out in the respective agreement.

* * * END OF SECTION A * * *

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

### Answer 6(a)

Though Joshua and Martin were primary school classmates, they did not meet for more than 30 years but just have bumped into each other in a recent school alumni dinner. They are not familiar with each other. The familiarity threat and self-interest threat are considered low. Martin may lead MNM & Co to participate in the audit service proposal.

### Answer 6(b)

A painting bought from a gallery is usually not trivial and inconsequential. Especially during this sensitive time when MNM & Co is being assessed in the bidding of the audit service to Joshua's bank, Martin should not give the painting to Joshua as a gift as this may be considered an inducement which could impair the independence of MNM & Co.

### Answer 6(c)

As Joshua has only introduced to Martin the mortgage plans that his bank offers to the market, Joshua has not offered any preferential benefits to Martin, thus this is not considered as an inducement to Martin by Joshua and does not heighten the self-interest threat for Martin.

### Answer 6(d)

MNM & Co as the auditor of Joshua's retail bank should not perform the valuation of the private equity investments for Joshua's bank as the valuation service would have a material effect, individually or in the aggregate, on the financial statements of the bank. This may create a self-review threat where MNM & Co will perform audit procedures against its valuation of the private equity investments and impair the independence of MNM & Co.

**Answer 7(a)**

The relevant changes to the board composition should include the following:

The roles of Chairman and Chief Executive Officer should be separated and should not be performed by the same individual. The division of responsibilities between the Chairman and Chief Executive Officer should be clearly established and set out in writing. Kin Tai Gor should no longer take up both the roles as the Chairman and Chief Executive Officer of Kin Hong Tong.

In addition, the Hong Kong Stock Exchange Main Board Listing Rules specify that there must be at least three independent non-executive directors on the board of directors for listed companies, representing at least one-third of the board. It should include a balanced composition of executive and non-executive directors (including independent non-executive directors) so that there is a strong independent element on the board which can effectively exercise independent judgement. Currently, Kin Hong Tong has no non-executive directors. Kin Hong Tong should appoint at least three independent non-executive directors.

Furthermore, the board should have a balance of skills, experience and diversity of perspectives appropriate to the requirements of the listed company's business. Currently, all executive directors of Kin Hong Tong are very experienced in the industry and business operation of Kin Hong Tong in Hong Kong. However, none of them is specialised in financial reporting and management or has experience running businesses overseas. Kin Hong Tong should consider appointing another director who has expertise in finance and accounting, especially when King Hong Tong plans for IPO. Kin Hong Tong should also consider recruiting a director who has the relevant experience of running businesses in Taiwan and Singapore.

**Answer 7(b)**

The total net assets of Kin Hong Tong amounted to HK$49 million as at 31 December 2019, of which total assets amounted to HK$52 million and total liabilities amounted to only HK$3 million. Given that the 10 retail stores of Kin Hong Tong are operating under its self-owned properties, under this business mode there are no right-of-use assets and lease liabilities that have arisen from the operating lease. Therefore, the total liabilities of Kin Hong Tong as at 31 December 2019 were relatively minimal compared to its assets. Apart from performing searching for unrecorded liabilities, no specific audit procedures are proposed to be performed on the liability opening balances.

The property, plant and equipment and financial assets at fair value through profit or loss are the largest assets of Kin Hong Tong as at 31 December 2019, representing 50% and 28% of its total assets, respectively. Considering the significance of the opening balances of these financial statements line items, additional audit procedures are planned to be performed.

(i) Property, plant and equipment

- Obtain breakdown of property, plant and equipment as at 31 December 2019 from management and identify the fixed asset items with material cost value/net book value as at 31 December 2019;

- Perform land search on the 10 self-owned stores of Kin Hong Tong to ensure these properties are under the title of Kin Hong Tong as at 31 December 2019;

- Perform site visits to the 10 self-owned stores of Kin Hong Tong;

- For fixed asset items with material cost value/ net book value as at 31 December 2019, inspect purchase documents such as sales invoices or sales agreements and relevant payment records/bank statements;

- Assess the appropriateness of the fixed asset depreciation policy adopted by Kin Hong Tong; and

- Perform reasonableness test of accumulated depreciation of the fixed asset items with material cost value/net book value as at 31 December 2019.

(ii) Financial assets at fair value through profit and loss

- Inquire and obtain from management any broker statements as at 31 December 2019 to ascertain if these investments were held by Kin Hong Tong as at 31 December 2019;

- If no broker statements are available, obtain from management and sight the shareholder certificates of these investments; and

- Since these equity and bond investments are with market quote, perform internal search to check against the market prices of these investments as at 31 December 2019.

**Answer 8(a)**

The proposed audit scope and related rationale:

- No detailed audit work is proposed for Spotless Beauty as it generated no external revenue during the year and its assets as at year end and losses for the year represented only 8% and 8% of the group's total assets and profit, respectively, which are not considered as material. However, Spotless Beauty will be subject to high level analytical review.

- Though Sub B generated no external revenue during the year and its assets at year end and losses for the year represented only 2% and 7% of the group's total assets and profit, respectively, which are clearly immaterial, there were audit adjustments in two consecutive years relating to research cost capitalisation and related intangible asset recognition, so the risk of material misstatements in research and development expenses and intangible assets is high. Specified audit procedures are proposed to be performed for these two financial statement line items.

- Sub D contributed 41% and 32% respectively to the group's revenue and profit for the year. Sub D is considered as an individually financial significant component of the group and therefore full scope audit is proposed.

**Answer 8(b)**

The proposed audit procedures of the group engagement team should include the following:

- Assess the competence and independence of the component auditor;

- Be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements;

- Issue group audit instructions to the component auditor setting out the audit scoping, materiality, specific audit requirements, expected deliverables and reporting time, etc;

- Determine the nature, timing and extent of its involvement in the work of the component auditor in the Netherlands;

- Review the component auditor's overall audit strategy and audit plan (including the control reliance strategy at the component, IT audit strategy, etc);

- Discuss with the component auditor regarding the business activities of Sub E (mainly revenue recognition) and the audit procedures to be carried out;

- Discuss with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error by considering fraud risk factors;

- Review the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditor;

- Review the group reporting deliverables from the component auditor and consider significant findings reported by the component auditor;

- Review the component auditor's working papers;

- Maintain ongoing communication with the component auditor (e.g. progress meeting, audit clearance meeting, etc); and

- Give appropriate advice to the component auditor.

**Answer 9(a)**

The relevant audit procedures include the following:

- Meet with the IT team of Happy Bee Limited to confirm the structure and organisation of the IT team;

- Confirm with the IT team of Happy Bee Limited that there were no system process and control changes to IT general controls during the year and review the latest system processes and controls documentation;

- Check the system version and the latest date of system change shown in the system to confirm there were no changes to the system design and configuration during the year;

- Generate the system access log from the system to check whether only the system administrator had access to the system configuration and restricted access setting;

- Generate the system changes log from the system to check what changes have been made to the system;

- Confirm with the management/IT team the processes and controls on system restricted access monitoring and review;

- Obtain the system restriction setting and test if only valid persons are granted access to the system; and

- Review the system access log to confirm whether the invalid persons (e.g. resigned staff) have accessed the system and ask management to provide a reason if access was made.

**Answer 9(b)**

The possible IT application controls over revenue recognition of Happy Bee Limited include the following:

- The system can check and notify customers of product availability. If products are not available, the system will not allow customers to continue the transactions;

- The system can automatically calculate the total sales amount of each transaction based on products ordered by respective customers;

- The system can issue sales invoices to customers in sequential order;

- The system can check and match each customer payment to the respective sales transaction;

- The system can track the delivery time and recognise the relevant sales in the sales ledger; and

- The system can automatically calculate and recognise the cost of goods sold of each sales transaction based on data from the inventory record.

* * * END OF EXAMINATION PAPER * * *

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

**Qualification Programme Examination Panelists' Report**

**Module 13 – Business Assurance**
**(December 2021 Session)**

*(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)*

## (I) Section A – Case Questions

### General Comments

The case was related to the operation of theme park which had gone through its peak following severe competitions. In order to improve its business performance, the entity acquired another entertainment business aiming for synergy. The entity was a subsidiary owned by a foreign entity therefore it had various relationship and reliance from its parent company. Certain market data and published information was provided in the case. This section aimed to test the candidates as to how to evaluate and analyse the non-financial information and embed into their audit strategy, it tested the candidates' analytical skill, risk assessment, related party transactions, and accounting for business combination.

### Specific Comments

Question 1 – 12 marks

This question required candidates to analyse the non-financial information which included the number of visitors for the past ten years in order to evaluate the audit risk on certain accounts and assess its risk based on various assertions. As the data provided in the case background was clearly illustrated, candidates were generally able to make use of this information and assess the risk. The results were satisfactory. This question had 4 marks for communication and analytical skills, and candidates generally obtained marks on top of their analysis.

Question 2(a) – 6 marks

This question required the candidates to evaluate the risk of material misstatements in the financial statements that result from the related party relationships. The first step of this question was for the candidates to identify the specific related party relationship from the case background. However, not many candidates were able to identify all these relationships. As a result, they were unable to obtain adequate marks for this question. The overlooked related party relationship was the dominant management which was controlled by the parent company.

Question 2(b) – 4 marks

This question required the candidates to propose audit procedures to respond to the risk identified in question 2(a) above. In this part, candidates have done better as they can propose procedures to audit related party transactions which can be found in the text books.

Question 3 – 12 marks

This question required the candidates to propose procedures to audit the calculation of goodwill. This is a new style of question as in the past we would normally test the candidates' ability to assess impairment of goodwill. The question itself is not difficult, if the candidate can make use of all the information as set out in the question, they could score adequate marks. However, the results were not very good because most candidates seemed inclined to copy certain general audit procedures instead of specific procedures to audit the goodwill calculation. Certain candidates even provided answers which were related to the use external expert in an audit which was beyond the scope of this question.

Question 4

This question was related to a situation when the entity had breached the bank loan covenants at the reporting date. It was divided into two hypothetical situations in (a) and (b) and expected the candidates to distinguish the differences in the audit risk focus and provide evidence of how to respond to the risk of each of these two situations.

Question 4(a) – 4 marks

This question required candidates to describe how to consider a situation when management obtained a waiver for a breach of bank loan covenants and proposed audit procedures. The situation is not commonly seen but it can test the candidates' ability to how to obtain relevant and reliable evidence from this scenario. The candidates did not perform well perhaps this is a situation they have not faced before.

Question 4(b) – 4 marks

This question required the candidates to describe how to consider a situation if management cannot obtain the waiver and what next steps and procedures the candidates should perform. This included consideration of any material uncertainties may exist for the support of the going concern assumptions. Same as question 4(a), the candidates did not perform well due to the lack of experience.

Question 5 – 8 marks

This question required the candidates to propose controls and measures for a new process entered into between the existing entity and the newly acquired entity. The candidates did not perform well. The controls were too general and therefore not specific enough to mitigate the risk hidden in the question.

## (II) Section B – Essay/Short Questions

### General Comments

Section B covered a wide range of topics from ethics, corporate governance, opening balance audit, group audit and IT audit. The case facts provided in each of the questions simulated real-life experiences that auditors encounter on a daily basis. The candidates were expected to attempt and solve these questions applying both business and auditing knowledge.

### Specific Comments

Question 6(a) – 3 marks

This question required the candidates to analyse the scenario provided, explain the ethical issue, if any, and advise relevant safeguards if applicable.

The performance of the candidates in this question was not satisfactory. Quite a lot of the candidates considered the scenario from the perspective of familiarity or self-interest threat which was on the right direction. However, they missed the point that Joshua and Martin did not meet for more than 30 years and misinterpreted that they were good friends. Many candidates provided a wrong assessment in their analyses and were not able to score high marks.

Question 6(b) – 3 marks

This question required candidates to analyse the scenario provided, explain the ethical issue, if any, and advise relevant safeguards if applicable.

The performance of the candidates in this question was fair. Some candidates were able to point out this case was concerned with inducement. However, some candidates did not read the question carefully and misunderstood that the painting was given as gift from the potential client to the auditor and analysed the case from the wrong angle.

Question 6(c) – 2 marks

This question required the candidates to analyse the scenario provided, explain the ethical issue, if any, and advise relevant safeguards if applicable.

The performance of the candidates in this question was fair. A lot of candidates were able to point out the potential threat related to the mortgage loan but failed to provide a correct assessment by reference to the case fact that the mortgage loan was offered based on market terms.

Question 6(d) – 2 marks

This question required the candidates to analyse the scenario provided, explain the ethical issue, if any, and advise relevant safeguards if applicable.

Most of the candidates performed well in this question and were able to analyse and point out the issue of the self-review threat based on the case facts. However, some candidates considered that separating the service team from the audit team would be an appropriate safeguard, which was not appropriate for this case, given the significance of the private equity investments to the financial statements of the bank.

Question 7(a) – 6 marks

This question required the candidates to advise the relevant changes to the board composition which should be made to King Hong Tong to make it comply with the Main Board Listing Rules of Hong Kong Stock Exchange.

The performance of the candidates in this question was fair. Many candidates demonstrated that they were familiar with this topic. However, some candidates were unable to offer recommendations on specific changes based on the case facts and therefore could not score high marks.

Question 7(b) – 10 marks

This question required the candidates to explain which of the financial statements line items were subject to opening balance audit procedures and propose audit procedures on these balances.

The performance of the candidates in this question was unsatisfactory. A lot of the candidates proposed audit procedures on each of the financial statements line items instead of doing so for the identified financial statements line items. This question required the candidates to apply business judgement to first analyse which areas warrant the audit effort. The candidates were expected to understand that our profession always requires judgement application and there will not be unlimited resources for an audit in reality.

Question 8(a) – 6 marks

This question required the candidates to propose the audit scope for Sportless Beauty, Sub B and Sub D and explain the rationale.

The performance of the candidates in this question was fair. They demonstrated evidence of using of the case information correctly to provide their analyses and the proposed audit scope. However, not many candidates scored high marks with appropriate proposed audit scope. This may be because not many candidates have hands-on experience of participating in a group audit scoping exercise.

Question 8(b) – 8 marks

This question required the candidates to propose relevant audit procedures that should be performed by the group engagement team considering Sub E was an individually significant component of the group audit and the component audit of Sub E would be carried out by the network firm in the Netherlands.

Most of the candidates did not perform well in this question. This question required the candidates to propose audit procedures from the perspective of the group auditor on how to assess and evaluate the audit evidence gathered by the component auditor on Sub E and how to monitor the audit quality of the component auditor. However, many candidates proposed audit procedures from the angle of the group auditor to directly perform the audit procedures over Sub E.

Question 9(a) – 7 marks

This question required the candidates to propose relevant audit procedures to test the operating effectiveness of the IT general controls of Happy Bee Limited.

Most of the candidates did not perform well in this question. Many candidates failed to propose specific audit procedures in response to the case facts but only suggested some general audit procedures copied from the Learning Pack. This would not help the candidates score high marks. As the business world continues to evolve and technology advances over time, candidates are encouraged to sharpen their IT audit skillset.

Question 9(b) – 3 marks

This question required the candidates to recommend three possible IT application controls over revenue recognition of Happy Bee Limited.

Most candidates did not perform well in this question. Some common observations are some candidates could not differentiate between IT general controls and IT application controls, some candidates mixed up the audit procedures with management's controls, some candidates suggested certain IT applicable controls which were too general and were not relevant to case or specific to revenue recognition. To score high marks, the candidates are required to provide specific recommendations in accordance with the question requirements.

## (III) Conclusion and Recommendation

Overall, the candidates demonstrated sensible analysis and application of standard onto the practical situation. This indicates that the candidates are becoming more competent when dealing with real live situations and applying their own judgement from an audit perspective. The candidates understood that they would not be able to score high marks by just coping the answers from the Learning Pack or other learning materials. Many candidates demonstrated that they have applied their knowledge learnt to the case facts when solving the question problems. However, it is still expected that the candidates' analyses should be more in-depth and specific to the detail of the case facts.

More importantly, a good solution to the problem would balance both business and audit needs. Sometimes the candidates suggested audit procedures or solutions which were impractical and not feasible in real life. In addition, the IT audit topic in this examination is still a weak area for many of the candidates. They are therefore encouraged to sharpen their auditing knowledge relating to IT which is an essential skill for auditing these days. It is recommended that the candidates to join practical workshops and also leveraged from the practical experience.