



Hong Kong Institute of
Accredited Accounting Technicians
香港財務會計協會

Accredited Accounting Technician Examination

Pilot Examination Paper

Paper 8 Principles of Auditing and Management Information Systems

Questions & Answers Booklet

The Suggested Answers given in this booklet are purposely made to give more details for educational purpose.

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Pilot Examination Paper

Paper 8 Principles of Auditing and Management Information Systems

Time allowed – 3 hours

Section A: Multiple-choice Questions – Attempt all 20 Questions

Section B: Compulsory Questions – Attempt all 3 Questions

Section C: Optional Questions – Attempt any 2 out of 3 Questions

**DO NOT OPEN THIS QUESTION PAPER UNTIL
INSTRUCTED TO DO SO BY THE SUPERVISOR**

SECTION A (MULTIPLE-CHOICE QUESTIONS) (20 marks)

Answer **ALL** questions in this section. Choose the best answer for each question.
Marks will not be deducted for incorrect answers.

(Questions A1 to A20 carry 1 mark each. Total: 20 marks)

- A1.** Which of the following actions is considered a misappropriation of assets?
- A To borrow a notebook computer from office and not return it.
 - B To deposit surplus cash with a bank at 0.5% per annum instead of paying off a loan where the company is being charged interest at 8% per annum.
 - C To classify stocks held for resale as supplies.
 - D To classify current portion of a bank loan as long-term bank loan.
- A2.** What should the auditors do if the walk-through test reveals that the accounting system is not operated in the manner ascertained and recorded?
- A The auditors will have to withdraw from the audit engagement.
 - B The auditors will have to reconfirm the system with the client and reperform the walk-through test accordingly.
 - C The auditors will have to issue a qualified audit opinion stating the disagreement.
 - D The auditors will have to issue an unqualified audit opinion stating the areas of uncertainty.
- A3.** In planning an audit, which of the following statements is **NOT** correct?
- A An audit plan sets the direction for the audit and provides guidance for the development of the audit programme.
 - B The audit programme sets out the detailed procedures required to implement the strategy.
 - C Auditors plan to perform the audit for the lowest cost and in a timely manner.
 - D Auditors formulate the general audit strategy in an overall audit plan.
- A4.** Adoption of risk-based auditing results in auditors needing to understand their clients':
- A organisation.
 - B business.
 - C industry.
 - D All of the above.
- A5.** As the acceptable level of detection risk decreases the assurance directly provided from:
- A substantive tests should increase.
 - B test of controls should increase.
 - C substantive tests should decrease.
 - D test of controls should decrease.

- A6.** Which of the following is a source document?
- A Fixed assets register.
 - B Time card.
 - C General ledger.
 - D Audit confirmation.
- A7.** Why do auditors need to ascertain and record the internal control system?
- A To design substantive tests.
 - B To determine the level of audit fee.
 - C To make a preliminary evaluation of the effectiveness of the internal control system.
 - D To assess the appropriateness of accounting entries.
- A8.** Auditors usually issue management letters to the audit committee or senior executives of the company at:
- A the commencement of the interim audit.
 - B the conclusion of the interim audit.
 - C the conclusion of both the interim and final audit.
 - D the commencement of both the interim and final audit.
- A9.** Which of the following procedures in performing tests of controls would the auditors adopt?
- (1) Trace a representative sample of transactions throughout the period.
 - (2) Check that the controls are as effective in practice as they are documented.
 - (3) Perform tests of balances.
 - (4) Perform analytical review procedures.
- A (1) and (2).
 - B (1), (2) and (3).
 - C (3) and (4).
 - D All of the above.
- A10.** Which of the following is **NOT** a purpose of analytical procedures?
- A To assist the auditors in planning the nature, timing and extent of other audit procedures.
 - B As a test of control.
 - C As an overall review of the financial statements in the final review stage of an audit.
 - D As substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions.
- A11.** Which of the following techniques does an auditor ordinarily select in assessing control risk?
- A Observation and reperformance.
 - B Comparison and confirmation.
 - C Inspection and verification.
 - D Inquiry and analytical procedures.

- A12.** Which of the following is a type of statistical sampling?
- A Random sampling.
 - B Haphazard sampling.
 - C Non-monetary unit sampling.
 - D Monetary-unit sampling.
- A13.** Which of the following statements is **NOT** correct about representation by management?
- A It can take the form of a representation letter from the management.
 - B It is a letter from the auditors outlining the auditors' understanding of management's representations, duly acknowledged and confirmed by the management.
 - C It can take the form of relevant minutes of meetings of the board of directors.
 - D It considers an oral representation as better evidence than a written representation.
- A14.** An auditor should design the audit programme so that:
- A each account balance is tested under either tests of controls or tests of transactions.
 - B substantive tests prior to the balance sheet date are minimized.
 - C all material transactions are selected for substantive testing.
 - D the audit procedures selected achieve specific audit objectives.
- A15.** Which of the following statements is **NOT** correct about an executive information system?
- A It is a type of decision support system.
 - B It gives the executive easy access to key internal and external data.
 - C It is a computerised package designed to allow non-expert users to make expert decisions.
 - D It monitors reality and facilitate actions that improve business results.
- A16.** Which of the following statements correctly describe the use and benefit of an extranet?
- A It provides on-line information for customers and suppliers can add value to an organization.
 - B It helps users to locate and view information from anywhere within the company workstations and thus enhance workforce productivity.
 - C It uses as a platform for developing and deploying applications to support business operations and decisions across the company.
 - D It decreases the price of finished products by removing the mark-up obtained by wholesalers and retailers.
- A17.** Which organization has set out its regulatory approach on e-banking services and to provide authorised institutions with recommendations on the risk management for these activities?
- A Bankers Association.
 - B Institute of Bankers.
 - C The Postmaster General.
 - D Hong Kong Monetary Authority.

- A18.** Which type of computer packages are software solutions purchased from a software vendor and used without any amendments in the organisation?
- A Ready-to-eat packages.
 - B Tailor-made packages.
 - C Off-the-shelf packages.
 - D General purpose packages.
- A19.** Which of the following statements is **NOT** an advantage of general purpose packages?
- A They are consistently much less expensive than a bespoke system.
 - B They are available more quickly than a bespoke system.
 - C There is likely to be a number of people with expertise in the relevant package who are already employed by the organisation or who can be recruited.
 - D The system can be modified to fit changing needs.
- A20.** Which of the following controls can minimise the threat from hackers and viruses?
- A Encryption.
 - B System logs.
 - C Restrictive access.
 - D Firewall.

(Total: 20 marks)

[END OF SECTION A]

SECTION B (COMPULSORY QUESTIONS) (30 marks)

Answer **ALL** questions in this section. Marks are indicated at the end of each question.

- B1.** Most entities make use of information technology (“IT”) systems for financial reporting and operational purposes. The extent of automation may vary with some systems substantially automated with few related manual elements and others, even within the same entity, predominantly manual. As a result, an entity’s system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor’s risk assessment and further audit procedures based thereon.

An entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in IT systems consist of a combination of manual and embedded in computer programs controls.

When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

REQUIRED:

- (a) In respect of the effectiveness and efficiency for an entity’s internal control, list **FOUR** potential benefits that IT systems provide. **(4 marks)**
- (b) List **SIX** specific risks that IT systems may pose to an entity’s internal control. **(6 marks)**

(Total: 10 marks)

- B2.** It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement.

An auditor has a statutory responsibility to report to the members of the audit client whether in his opinion the financial statements give a true and fair view and whether these financial statements have been properly prepared in accordance with the Companies Ordinance.

REQUIRED:

- (a) List the principal contents of an audit engagement letter. (7 marks)
- (b) Under section 141(4) of the Hong Kong Companies Ordinance, what should be satisfied by an auditor in order to enable him to form an opinion? (3 marks)

(Total: 10 marks)

B3. Information is a key resource to an organisation and can serve its information needs in the following respects:

1. Planning and corporate strategy development for management.
2. Control and monitoring performance to ensure that work has been carried out as planned.
3. Decision making for managers at different levels.
4. Recording and processing transactions that can affect significantly the working relationships within an organization.
5. Communication of information within an organisation and with external parties.

An information system of an organisation supplies relevant information and compiles appropriate analysis for the purpose of providing assistance to management in developing and implementing corporate strategies.

REQUIRED:

- (a) List the **SIX** stages of developing corporate strategy and plans. (6 marks)
- (b) How do information systems contribute to the success of the implementation of corporate strategy? (4 marks)

(Total: 10 marks)

[END OF SECTION B]

SECTION C (OPTIONAL QUESTIONS) (50 marks)

Answer any **TWO** questions only in this section. Each question carries 25 marks.

- C1.** An executive information system (“EIS”) is a type of decision support system which gives the executive easy access to key internal and external data. EIS monitors reality and facilitates actions that improve business results.

On the other hand, an internal control system extends beyond those matters that relate directly to the functions of the accounting system and comprises the control environment and the control procedures.

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. There is an inverse relationship between materiality and the level of audit risk.

Audit risk means the risk that the auditors give an inappropriate audit opinion when the financial statements are materially misstated.

REQUIRED:

- (a) List **FOUR** advantages or benefits of EIS. (4 marks)
- (b) List **THREE** shortcomings of EIS. (3 marks)
- (c) Describe control environment. (3 marks)
- (d) Describe control procedures. (2 marks)
- (e) Explain the importance of a strong control environment. (2 marks)
- (f) List **THREE** factors reflected in the control environment. (3 marks)
- (g) State the determining factors on materiality. (2 marks)
- (h) List and explain the three components of audit risk. (6 marks)

(Total: 25 marks)

- C2.** Auditors obtain audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures in the form of risk assessment procedures; tests of controls; and substantive procedures.

The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained.

The auditors obtain some audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information.

Other information that the auditors may use as audit evidence includes minutes of meetings; confirmations from third parties; analysts' reports; comparable data about competitors; controls manuals; information obtained by the auditors from such audit procedures as inquiry, observation, and inspection; and other information developed by, or available to, the auditors that permits the auditors to reach conclusions through valid reasoning.

In a computer information systems ("CIS") environment, general controls relate to the overall information processing environment and have a pervasive effect on the entity's computer operations. General controls can be classified into five categories:

- (1) Organisational controls
- (2) Data centre and network operations controls
- (3) Hardware and system software acquisition and maintenance controls
- (4) System security controls
- (5) Application system acquisitions, development, and maintenance controls.

Backing up of data and files is essential because hard disks and computer systems can fail, viruses can destruct a disk, careless operators can delete files, and computers can also be damaged or stolen.

REQUIRED:

- (a) **State FOUR generalizations about the reliability of audit evidence.** (4 marks)
- (b) **Describe how auditors perform the audit procedure of inspection of tangible assets, the type of audit evidence obtained, and its limitations.** (3 marks)
- (c) **Describe how auditors perform the audit procedure of observation, the type of audit evidence obtained, and its limitations.** (3 marks)
- (d) **Describe how auditors perform the audit procedure of inquiry, the type of audit evidence obtained, and its limitations.** (3 marks)
- (e) **Give FIVE factors that auditors would consider when determining whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions.** (5 marks)

- (f) Match the following list of computer audit procedures with the relevant general controls (1) to (5).

	Computer audit procedures	General controls
(i)	Review the documentation of a sample of application systems to determine if systems development and modification policies and procedures are being followed.	
(ii)	Review the CIS department's disaster recovery plan.	
(iii)	Ask CIS personnel about the types of systems software and whether any modifications have been made to the programs.	
(iv)	Review controls over work flow and error correction procedures.	
(v)	Review job descriptions of key CIS personnel to ensure that there are no incompatible duties.	

(5 marks)

- (g) Why does a business organisation have to ensure the continuity of the computer operations? Provide ONE example of control procedure to mitigate this threat.

(2 marks)

(Total: 25 marks)

C3. In practice, management may not agree to correct all misstatements identified by the auditors who will evaluate the materiality of the aggregate of uncorrected misstatements in the financial statements. Furthermore, auditors should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements. Elements of an auditor's report in an audit conducted in accordance with Hong Kong Standards on Auditing include:

- (1) Title;
- (2) Addressee;
- (3) Introductory paragraph;
- (4) Management's responsibility for the financial statements;
- (5) Auditor's responsibility;
- (6) Auditor's opinion;
- (7) Other reporting responsibilities;
- (8) Auditor's signature;
- (9) Date of the auditor's report; and
- (10) Auditor's address.

Auditors may not be able to express an unqualified opinion in certain matters. Some of these matters do not affect the auditors' opinion, but some of them do affect the auditors' opinion.

For a company implementing knowledge management systems ("KMS"), staff from different departments can have access to the company's financial data, and even the identified misstatements. KMS assists companies to manage organisational learning and business know-how. Knowledge management has thus become one of the major strategic uses of information technology.

REQUIRED:

- (a) **State the management's responsibilities for the financial statements.** (3 marks)
- (b) **State the auditor's responsibilities with respect to an audit.** (4 marks)
- (c) **What does an auditor conclude when he has given an unqualified opinion on the reported financial statements?** (3 marks)
- (d) **Name the two components forming the aggregate of uncorrected misstatements.** (2 marks)
- (e) **What should the auditors do to ensure the audit risk can be maintained at a low level if the aggregate of uncorrected misstatements identified are considered material to the financial statements?** (3 marks)
- (f) **State the THREE types of opinion that auditors may give on matters that affect their opinion.** (3 marks)

- (g) Briefly describe KMS. (3 marks)
- (h) List TWO benefits of KMS. (2 marks)
- (i) List TWO limitations of KMS. (2 marks)
- (Total: 25 marks)

[END OF EXAMINATION PAPER]

Suggested Answers

Pilot Examination Paper

Paper 8

Principles of Auditing and Management Information Systems

SECTION A (MULTIPLE-CHOICE QUESTIONS) (20 marks)

(Questions A1 to A20 carry 1 mark each. Total: 20 marks)

- A1. A
- A2. B
- A3. C
- A4. D
- A5. A
- A6. B
- A7. C
- A8. C
- A9. A
- A10. B
- A11. A
- A12. D
- A13. D
- A14. D
- A15. C
- A16. A
- A17. D
- A18. C
- A19. D
- A20. D

(Total: 20 marks)

SECTION B (COMPULSORY QUESTION) (30 marks)

- B1. (a)** IT systems provide potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to:
- (i) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
 - (ii) Enhance the timeliness, availability, and accuracy of information;
 - (iii) Facilitate the additional analysis of information;
 - (iv) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
 - (v) Reduce the risk that controls will be circumvented; and
 - (vi) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.
- (Any 4 items, 1 mark each, maximum 4 marks)**

- (b)** IT poses specific risks to an entity's internal control, including the following:
- (i) Reliance on systems or programs that inaccurately process data, process inaccurate data, or both.
 - (ii) Unauthorized access to data that may result in destruction of or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
 - (iii) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
 - (iv) Unauthorized changes to data in master files.
 - (v) Unauthorized changes to systems or programs.
 - (vi) Failure to make necessary changes to systems or programs.
 - (vii) Inappropriate manual intervention.
 - (viii) Potential loss of data or inability to access data as required.
- (Any 6 items, 1 mark each, maximum 6 marks)**

(Total: 10 marks)

B2. (a) The form and content of audit engagement letters may vary for each client, but the principal contents would generally include:

- (i) The objectives of the audit of financial statements; **[1 mark]**
- (ii) Management's responsibility for the financial statements, such that directors are responsible for the preparation of financial statements showing a true and fair view; **[1 mark]**
- (iii) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres; **[1 mark]**
- (iv) The form of any reports or other communication of results of engagement; **[1 mark]**
- (v) The fact that because of the nature of test and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered; **[1 mark]**
- (vi) Unrestricted access to whatever records, documentation and other information requested in connection with the audit; and **[1 mark]**
- (vii) Management's responsibility for establishing and maintaining effective internal control. **[1 mark]**

(7 marks)

(b) An auditor has a statutory responsibility to report to the members of a company whether in his opinion the financial statements give a true and fair view and whether these financial statements have been properly prepared in accordance with the Companies Ordinance. In arriving at the audit opinion, the auditor is required to consider the following matters, and to report on any in respect of which he is not satisfied:

- (i) whether proper books of account have been kept by the company and proper returns adequate for his audit have been received from branches not visited by him; **[1 mark]**
- (ii) whether the company's balance sheet and profit and loss account are in agreement with the books of account and returns; and **[1 mark]**
- (iii) whether he has obtained all the information and explanations which he considers necessary for the purposes of his audit. **[1 mark]**

In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in the audit report. For example, where the financial statements do not give details of directors' remuneration or of loans to officers, the Companies Ordinance requires an auditor to disclose such matters in his report.

(3 marks)

(Total: 10 marks)

- B3. (a)** The stages of developing corporate strategy and plans are as follows:
- (i) Establish mission based on the culture and developments in an organization's environment. **[1 mark]**
 - (ii) Perform background situation analysis based on results of past activities that contributes to different alternatives. **[1 mark]**
 - (iii) Set measurable objectives by converting the results of background situation analysis into company's financial standards and requirements. **[1 mark]**
 - (iv) Develop strategies define the long-term ways of achieving the objectives. Information required for developing strategy covers a wide range of subjects, but not in detail. **[1 mark]**
 - (v) Develop tactics based on the directions provided by corporate strategy. Tactics are shorter-term ways to achieve success with the strategies. Information required for developing tactics is more detailed and specific than strategic information. **[1 mark]**
 - (vi) Develop operational plans for managers of different functional areas. Operational plans are detailed and specific and show the ways that the tactics will be carried out. They define who is responsible for implementing the plan, and when each operation will be completed. **[1 mark]**
- (6 marks)**
- (b)** Information systems contribute to the success of the implementation of corporate strategy in the following respects:
- (i) Provide information to support business processes. **[1 mark]**
Business processes and activities increasingly rely on the supports provided by information systems. The implementation of corporate strategies involves many changes in business processes within an organization. If business management is to adopt a strategic approach in running their business, then it follows that a strategic perspective must take information systems into account.
 - (ii) Initiate changes in business strategies. **[1 mark]**
The developments in information system can lead to or initiate changes in business strategies because it can provide the needed information for developing and implementing business strategy. Without these strong links, either one of the strategies or both of them may fail.
 - (iii) Support the process control of strategy implementation. **[1 mark]**
In some cases, businesses are evolving their information systems from a supporting role into a proactive use of information technology. In particular, information systems promote the effectiveness and efficiency of strategy implementation by means of providing valuable information and compiling relevant analysis for decision-making, control and monitoring purposes.

- (iv) Assist in maintaining competitive strategy. **[1 mark]**
When both opportunities and strengths are present, the company is in a position to attack its competitors through the use of information systems so as to have good prospect of success. On the other hand, when threats are faced and where there are weak capabilities, the company must take steps to protect itself from competitors' attacks by strengthening its information system.

(4 marks)

(Total: 10 marks)

SECTION C (OPTIONAL QUESTIONS) (50 marks)

- C1. (a)** Advantages of EIS to the tactical or strategic level decision-makers are:
- (i) EIS does not require decision-makers to have extensive computer experience. Information provided by EIS is presented on user-friendly interfaces or on graphical displays.
 - (ii) EIS provides timely delivery of information. Management can make decisions more promptly.
 - (iii) EIS provides easy-to-understand information since it filters data for management.
 - (iv) EIS offers strong reporting and drill-down capabilities. This helps top-level executives analyse, compare, and highlight trends in important variables so that they can monitor performance and identify opportunities and problems.
 - (v) EIS provides information relevant to meeting the strategic goals of the organisation.
 - (vi) EIS can facilitate internal communications such as personal correspondence, reports and meetings.
 - (vii) EIS can serve as a database for scanning for news on government regulations, competition, financial and economic development and scientific subjects.

(Any 4 items, 1 mark each, maximum 4 marks)

- (b)** Despite EIS being used extensively by many executives, it has its shortcomings:
- (i) Functions are limited. Cannot perform complex calculations.
 - (ii) Executives may encounter information overload; system may become slow, large, and hard to manage.
 - (iii) Difficult to maintain up-to-date data and this may lead to less reliable and insecure data. Furthermore, the executives often find that after a relatively short period of time, reporting against the original criteria is no longer relevant.
 - (iv) Small companies may encounter excessive costs for implementation.
 - (v) Because executive support systems deal with strategic decisions that are difficult to plan for in advance, it is unusual to find any routine reports being produced on paper.

(Any 3 items, 1 mark each, maximum 3 marks)

- (c)** Control environment means the overall attitude, awareness and actions [1 mark] of directors and management [1 mark] regarding the internal control system and its importance in the entity. **[1 mark]**

(3 marks)

- (d) Control procedures mean those policies and procedures [1 mark] in addition to the control environment which management has established to achieve the entity's specific objectives. [1 mark] (2 marks)
- (e) A strong control environment can significantly complement specific control procedures. [1 mark] However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. [1 mark] (2 marks)
- (f) Factors reflected in the control environment include:
- (i) The function of the board of directors and its committees;
 - (ii) Management's philosophy and operating style;
 - (iii) The entity's organisational structure and methods of assigning authority and responsibility;
 - (iv) Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.
- (Any 3 items, 1 mark each, maximum 3 marks)
- (g) Determining factors on materiality are:
- (i) Quantitative factors. [1 mark] Materiality is a relative rather than absolute term. Bases are needed for measuring materiality, such as pre-tax profit, total assets, total equity, or total revenue; and
 - (ii) Qualitative factors. [1 mark] Such as errors including fraud and irregularities, breach of contractual obligation, change in earning trends etc.
- (2 marks)
- (h) Audit risk has three components:
- (i) inherent risk; [1 mark]
 - (ii) control risk; and [1 mark]
 - (iii) detection risk. [1 mark]
- "Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. [1 mark]
- "Control risk" is the risk that a misstatement could occur in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes, and would not be prevented or detected and corrected on a timely basis by the accounting and internal control systems. [1 mark]
- "Detection risk" is the risk that the auditors' substantive procedures would not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes. [1 mark]

(6 marks)

(Total: 25 marks)

- C2. (a)** Generalizations about the reliability of audit evidence are:
- (i) Audit evidence is more reliable when it is obtained from independent sources outside the entity.
 - (ii) Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
 - (iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
 - (iv) Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
 - (v) Audit evidence provided by original documents is more reliable than by photocopies or facsimiles.

(Any 4 items, 1 mark each, maximum 4 marks)

- (b)** Inspection of Tangible Assets
Inspection of tangible assets consists of physical examination of the assets. **[1 mark]**

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, **[1 mark]** but not necessarily about the entity's rights and obligations or the valuation of the assets. **[1 mark]** Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.

(3 marks)

- (c)** Observation
Observation consists of looking at a process or procedure being performed by others. **[1 mark]** Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, **[1 mark]** but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. **[1 mark]**

(3 marks)

- (d)** Inquiry
Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, throughout the entity or outside the entity. **[1 mark]** Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditors with information not previously possessed or with corroborative audit evidence. **[1 mark]** Alternatively, responses might provide information that differs significantly from other information that the

auditors have obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

The auditors perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.
[1 mark]

(3 marks)

(e) In determining whether the auditors should use external confirmations to obtain sufficient appropriate audit evidence to support certain financial statement assertions, they would consider the following factors:

- (i) The materiality of the assertions.
- (ii) The assessed level of inherent risk.
- (iii) The assessed level of control risk.
- (iv) The number and size of the individual accounts.
- (v) The effectiveness of confirmation as audit evidence.
- (vi) The availability of other audit evidence.

(Any 5 items, 1 mark each, maximum 5 marks)

(f)

	Computer audit procedures	General controls
(i)	Review the documentation of a sample of application systems to determine if systems development and modification policies and procedures are being followed.	(5) Application system acquisitions, development, and maintenance controls [1 mark]
(ii)	Review the CIS department's disaster recovery plan.	(4) System security controls [1 mark]
(iii)	Ask CIS personnel about the types of systems software and whether any modifications have been made to the programs.	(3) Hardware and system software acquisition and maintenance controls [1 mark]
(iv)	Review controls over work flow and error correction procedures.	(2) Data centre and network operations controls [1 mark]
(v)	Review job descriptions of key CIS personnel to ensure that there are no incompatible duties.	(1) Organisational controls [1 mark]

(5 marks)

- (g) The continuity of the computer operations of a business organization has to be ensured to prevent business disruption or excuse for any financial loss. **[1 mark]**

The control procedures to mitigate this threat include:

- (i) sufficient back up and recovery procedures.
- (ii) offsite storage of data and computer programmes and the storage facility should be secure and housed in a suitable environment to ensure that the archived files are not damaged.
- (iii) enough protection against fire, theft, loss and destruction.
- (iv) alternative processing facilities.

[Any one item, 1 mark each, maximum 1 mark]

(2 marks)

(Total: 25 marks)

- C3. (a)** The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:
- (i) Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; **[1 mark]**
 - (ii) Selecting and applying appropriate accounting policies; and **[1 mark]**
 - (iii) Making accounting estimates that are reasonable in the circumstances. **[1 mark]**
- (3 marks)**
- (b)** The auditor's report should state that the audit was conducted in accordance with Hong Kong Standards on Auditing. **[1 mark]** The auditor's report should also explain that those standards require that the auditor comply with ethical requirements **[1 mark]** and that the auditor plan and perform the audit to obtain reasonable assurance **[1 mark]** whether the financial statements are free from material misstatement. **[1 mark]**
- (4 marks)**
- (c)** An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, **[1 mark]** in all material respects **[1 mark]**, in accordance with the applicable financial reporting framework. **[1 mark]**
- (3 marks)**
- (d)** The two components forming the aggregate of uncorrected misstatements are:
- (i) Specific misstatements identified by the auditors including the net effect of uncorrected misstatements identified during the audit of previous periods; and **[1 mark]**
 - (ii) The auditors' best estimate of other misstatements which cannot be specifically identified (i.e. projected errors). **[1 mark]**
- (2 marks)**
- (e)** If the aggregate of uncorrected misstatements identified are considered material to the financial statements to ensure that the audit risk can be maintained at a low level, the auditors may consider:
- (i) To extend audit procedures when the uncorrected misstatements are material as compared with the preliminary materiality level, or **[1 mark]**
 - (ii) To request the directors to adjust the financial statements when misstatements are material, or **[1 mark]**
 - (iii) To qualify the audit opinion when misstatements are material. **[1 mark]**
- (3 marks)**

- (f) Auditors may not be able to express an unqualified opinion in certain matters. For matters that do affect the auditor's opinion, the auditors may give one of the following opinions:
- (i) Qualified opinion, **[1 mark]**
 - (ii) Disclaimer of opinion, or **[1 mark]**
 - (iii) Adverse opinion. **[1 mark]**
- (3 marks)**
- (g) Knowledge management systems (KMS) are:
- (i) knowledge-based information systems **[1 mark]**
 - (ii) support the creation, organization, and dissemination of business knowledge **[1 mark]** within the enterprise. **[1 mark]**
- (3 marks)**
- (h) Benefits of knowledge management system (KMS) are as follows:
- (i) Sharing of valuable organizational information.
 - (ii) Improved communication among people.
 - (iii) Reacting quickly to changes in the internal or external environment.
 - (iv) Avoiding re-invention of the wheel, reducing redundant work.
 - (v) Retaining intellectual property after the employee leaves, if such knowledge codified.
 - (vi) Decreasing staff turnover by lessening employee frustration.
 - (vii) Providing consistent service to internal and external customers.
 - (viii) Providing employees with potential for increased success, and giving employees more time to be innovative and proactive.
- (Any 2 items, 1 mark each, maximum 2 marks)**
- (i) Limitations of knowledge management system (KMS) are as follows:
- (i) Inefficient processes for capturing knowledge
Organisations are good at capturing basic transaction data and summarising this data for management use. However, data on knowledge can be more difficult to obtain or simply capture but not be adequately cross-referenced.
 - (ii) Failure to appreciate the knowledge
If a knowledge worker is unaware of the existence of this data then it will not be used. Some form of central knowledge registry may be required to keep track of all the organisation's knowledge.

- (iii) Difficulty of measuring intangible benefits
Measuring the costs of implementing a new information system is relatively easy, as they tend to be tangible. However, many of the benefits, especially in the area of increased product quality or better customer service, tend to be intangible. Attributing some value to these benefits may be guesswork and not show the true value of those benefits.
- (iv) Information overload
Care is needed in planning information systems to ensure that only the required “quality” output is produced, rather than producing reports simply because they are available resulting in information overload for the recipient of that information.

(Any 2 items, 1 mark each, maximum 2 marks)

(Total: 25 marks)

[END OF SUGGESTED ANSWERS]