



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

# **Professional Bridging Examination**

## **Pilot Examination Paper**

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### **Paper III PBE Auditing and 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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# Professional Bridging Examination

## Paper III PBE Auditing and Information Systems

### Pilot Paper (Questions)

Time Allowed	3 hours
Examination Assessment Allocation	
• Section A – The One question is compulsory	40 Marks
• Section B – Answer 3 out of 4 questions	60 Marks



## **SECTION A (COMPULSORY) (Total: 40 marks)**

*Answer ALL questions in this section. Marks are indicated at the end of each question. Together they are worth 40% of the total marks for this examination.*

### **CASE**

Mabel Lee is a technical manager of a CPA firm, ABC & Co. Recently, Mabel was requested by her firm to be the manager in charge of an existing client, Natural Beauty Limited (“NBL”), a private company engaging in the operation of eight beauty salons. A general manager, a district manager and an accountant work in the head office which is located in one of the beauty salons.

The personnel arrangement in each beauty salon is as follows:

- 1 shop manager
- 1 receptionist
- 5 – 7 beauticians

NBL was established by Ms Cheung about 10 years ago and has been growing steadily since then. NBL provides facial beauty treatments to its customers. In addition, NBL also sells over 100 beauty and skincare products to its customers. Facial beauty treatments are sold to customers by the beauticians in packages of ten treatments per course with an expiry period of one year. Beauty and skincare products are also sold by beauticians.

According to last year’s audit working papers, all the records of NBL are prepared manually. When a customer purchased a facial treatment course or skincare product in cash or by credit card, a pre-numbered receipt is issued by the receptionist to the customer and a copy is kept by her. The receptionist, who also performs the role of cashier, updates the daily sales report, which records in detail all of the cash transactions including the credit card receipts, such as receipt number, customer number, the number of treatments purchased, and name and code of skincare products purchased. An exceptions report will be prepared if there is any cancellation of receipts. The receptionist locks the daily cash received in the safe at the end of the day and banks the cash the next morning. In addition to the daily sales report, the receptionist also updates the skincare products inventory record.

An individual customer record states the number of times facial treatments are purchased, consumed, as well as those remaining, and the name of beautician who provides the service. After the customer has had a facial beauty treatment, the beautician who provides the service will record it on the individual customer record and the customer will sign it to confirm the completion of one facial treatment.

The skincare products inventory record shows the detailed information of units, codes and names of the skincare products purchased and sold each day as well as the remaining quantity of each skin care product.

The skincare products are counted by a beautician and recounted by the shop manager every week. The beautician will then prepare the stock ordering list which will be authorised by the shop manager.

Every six months, the shop manager is responsible for the identification and disposal of expired or damaged stock. The stock discrepancies, as well as the obsolete and damaged

stock written-off report are prepared by the shop manager and submitted to the head office.

The receptionist also prepares a daily staff activities report which shows the treatment courses sold, services provided and goods sold by each beautician. At the end of the day, this report is checked and signed by all the beauticians. The salary of a beautician is comprised of the basic salary and the commission earned from the services rendered and skincare products sold by the beautician.

The shop manager will check the daily sales report against the cash in hand and the credit card vouchers, and she will also verify that the receipts are listed in the daily sales report with reference to the sequential number and the exceptions report. Moreover, the manager will check the daily staff activities report against the daily sales report, the individual customer records and the skincare products inventory record. The daily sales report, the exceptions report and the daily activities report is then authorized by the shop manager and passed to the accountant in the head office.

At the end of each month, the receptionist will prepare the deferred income list (i.e. advanced receipts from customers) based on all the individual customer records to prepare the deferred income list. The deferred income list is checked and authorized by the shop manager.

The deferred income list will then be sent to the accountant at the head office. The accountant prepares the monthly service revenue analysis report and the monthly skincare products sales report and may request explanations from the shop manager when there is significant change in the monthly service revenue or skincare product sales revenue.

NBL has a year end of 31 December. Mabel intends to do audit planning in September and to conduct an interim audit for control study and testing.

**Question 1 (40 marks – approximately 72 minutes)**

- (a) **The understanding of the nature of the entity and the entity’s selection and application of accounting policies enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.**

**What are the key matters of NBL limited’s operation that are relevant to the auditor?**

**(5 marks)**

- (b) **“For auditing the service revenue of NBL Limited, the auditor should audit the cash receipts and the deferred income.” Explain the make up of revenue from services.**

**(2 marks)**

- (c) **State six substantive procedures for auditing deferred income (advanced receipts from customers) and state the audit objectives for the procedures.**

**(12 marks)**

- (d) **What are control activities? List four types of control activities and state an example for each one of them from NBL's accounting system regarding revenue.**  
(10 marks)
- (e) **State four tests of controls procedures for auditing the cash receipts of service revenue from customers.**  
(8 marks)
- (f) **What are the most important uses of the results of the October interim audit? If the results of the interim audit are satisfactory, do you agree that no more control tests are required for the remaining two months? Explain the rationale behind your opinion.**  
(3 marks)

\* \* \* END OF SECTION A \* \* \*

**SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)**

Answer any **THREE** questions in this section. Each question carries 20 marks. Together they are worth 60% of the total marks for this examination.

**Question 2 (20 marks – approximately 36 minutes)**

Many investors believe that audits should provide absolute assurance that there are no material misstatements or fraud in the financial statements.

An extract from the audit report of XYZ Limited is given below:

“We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the accounts are free from material misstatement.”

**Required:**

- (a) Explain the concept of reasonable assurance. Explain why an auditor cannot obtain absolute assurance. (6 marks)
- (b) The concept of materiality is fundamental to the work of auditors.
- (i) Explain the concept of materiality in the context of auditing. (4 marks)
- (ii) The auditors of XYZ Limited found that the amount of inventory of XYZ Limited is overstated by \$400,000. In addition, some of the goods with a cost of \$1,000,000 were sold to a shareholder for \$2,000, this transaction is not disclosed in the financial statements. The total assets of the company and the income before tax of the company are \$100,000,000 and \$1,000,000 respectively. The audit trainee believes that no adjustment to the financial statement is necessary as the misstatement of the inventory only accounted for 0.4% of the total assets and the invoice amount of the related party transaction is immaterial too. Comment. (8 marks)
- (iii) The auditor may, in planning the audit work, intentionally set an acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. What is the rationale for this? (2 marks)

**Question 3 (20 marks – approximately 36 minutes)**

You have worked on the audit for Company A for a few years and this year you are in charge of the audit. A newly recruited accounting graduate who has no practical experience is assigned as your assistant. You have already conducted tests of controls for the transaction cycles and control risks are assessed as relatively low for these cycles. You decide the first task to set for your assistant is the verification of cash at bank and in hand. A lead schedule stating all the bank balances and cash in hand balance of the current and last years, bank statements and bank reconciliation statements are provided by the client.

**Required:**

(a) **The balance of cash account is relatively small compared to the balances of other assets. Why is the audit of cash an important part of the audit?**  
(4 marks)

(b) (i) **List the audit objectives and related management assertions for cash at bank and in hand.**  
(4 marks)

(ii) **List the audit procedures that should be performed on the bank reconciliation statements. The items which appeared in the bank reconciliation statements are mainly unrepresented cheques and deposits in transit.**  
(7 marks)

(c) **To confirm the amount of the bank balances, bank statements are a reliable source of audit evidence and no more further audit procedure is required.**

**Evaluate this statement by considering the circumstances under which evidence gathered is in general considered to be reliable in accordance with HKSA 500 *Audit Evidence*.**

(5 marks)

**Question 4 (20 marks – approximately 36 minutes)**

HKSA 560 (revised) requires that:

The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for and adequately disclosed in the financial statements.

**Required:**

- (a) **The following events occurred after the balance sheet date but before the audit report was prepared:**
- (i) **declaration of a share dividend;**
  - (ii) **determination by the Inland Revenue Department of additional income tax due for a prior year;**
  - (iii) **disposal of fixed assets at a substantial profit; and**
  - (iv) **a lawsuit was filed against the audit client. In the opinion of legal counsel, there is a danger of a significant loss to the client.**

**Explain how each of the items might have come to the auditor's attention.**  
(8marks)

- (b) **What is an unqualified opinion in the auditor's report?**  
(2 marks)

- (c) **An auditor may not be able to express an unqualified opinion in the following circumstances:**

- (i) **an auditor was initially appointed by XYZ Limited on 1 February 2008 which was subsequent to the year end. In consequence, the auditor was unable to carry out audit procedures necessary to obtain adequate assurance regarding the quantities and condition of inventories and work in progress (\$1,000,000) which appeared in the balance sheet at the year end date; and**
- (ii) **subsequent to the date of the financial report as part of his audit procedures after the balance sheet date, an auditor learned of the bankruptcy of a client's debtor; the client has no security for this debt (\$1,000,000). The newspapers described the event in detail. The client did not make any provision for this debt.**

**What kind of audit opinion will be expressed in these circumstances?**  
(4 marks)

- (d) **If the auditor disagrees with the amount of provision for doubtful debts which is considered as material in the financial statements, what are the key elements that would be included in the opinion section of the auditor's report?**  
(6 marks)

**Question 5 (20 marks – approximately 36 minutes)**

Information systems (“IS”) have become increasingly important. IS often involve complex and dynamic interaction between people both inside and outside an organization. Communication between those people is of vital importance for the success of an organization, and the IS department provides user support in a variety of ways and users actively participate in IS development.

**Required:**

- (a) To what extent should the external auditor be involved in the systems development and analysis phase of the system development life cycle? (6 marks)**
- (b) What are the user supports provided by an IS department? (4 marks)**
- (c) Why is user participation important for developing successful IS? (6 marks)**
- (d) How do system analysts collect information for IS development? (4 marks)**

\* \* \* END OF EXAMINATION PAPER \* \* \*



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# Answers

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Paper III  
PBE Auditing and  
Information Systems  
(Pilot Paper)

**SECTION A (COMPULSORY) (Total: 40 marks)**

**Answer 1(a)**

- (i) nature of revenue source – the company is a retailing company which provides facial beauty treatments to its customers and sells beauty and skin products to the customers.
- (ii) key customers – the company has a large number of customer accounts
- (iii) products or services and markets – the company has rather a high volume of transactions from the provision of services and selling of products with expiry dates and it is facing keen competition as more and more beauty salons are established nowadays.
- (iv) conduct of operations – the company adopts a prepayment system for the selling of facial beauty treatments
- (v) alliances, joint ventures, and outsourcing activities – no indication that there are such kinds of activities
- (vi) transactions with related parties – no indication that related party transactions are extensive
- (vii) employment – there are approximately 70 staff in the company, the salaries of the beauticians consist of basic salaries and commissions.
- (viii) geographical dispersion and industry segmentation – there are eight beauty shops located in different districts in Hong Kong.
- (ix) Research and development activities and expenditures – the company may buy new facial beauty treatment equipments to cope with the fast changing technology
- (x) Other relevant answers

**Answer 1(b)**

Opening deferred income + cash receipts – closing deferred income = revenue for the year.

**Answer 1(c)**

Audit procedures for deferred income:

- Obtain the deferred income list from the client to ensure the existence, completeness, and accuracy of the liability
- Agree the deferred income list with the trial balance to ensure the correct amount is stated
- Check the sequence of the card number of individual customers on the list in order to ensure completeness of the deferred income liability
- Select samples of individual customers from the list and check the individual customer records to ensure the existence, right and obligation of the liability
- Select samples of the individual customer records, recalculate the amounts and match with the amounts stated on the list to ensure the accuracy of the liability

- Carry out analytical procedures by comparing this year's figures with prior year's figures to ensure the existence, completeness, and accuracy of the liability
- Review the list for large and unusual items and verify to ensure the existence and accuracy of the liability
- Review the basis for deferring income, ensure that it is valid, complete and has been correctly and consistently applied with the prior year and GAAP
- Other relevant procedures

#### **Answer 1(d)**

Control activities are the policies and procedures that help ensure that management directives are carried out. Examples of specific control activities are as follows:

- Authorization, the stock ordering list is authorized by the shop manager.
- Performance review, the accountant prepares the monthly service revenue analysis report and the monthly skincare products sales report, and requests explanations from the shop manager when there is any significant change.
- Information processing, numerical sequential checking of receipts listed in the daily sales report and manual follow-up of exceptions report.
- Physical control, the inventories are counted by a beautician and recounted by the shop manager at the end of each week.
- Segregation of duties, the beauticians are responsible for the selling of goods and facial beauty treatments and the cash is received by the receptionist.
- Other relevant examples

#### **Answer 1(e)**

Procedures include:

- (i) Inquiry of management for the results of performance review performed, or the follow up on unusual sales fluctuation
- (ii) Inspection of documents such as evidence of checking and authorization of the daily sales report and exceptions report
- (iii) Observation of the procedures performed by staff such as physical count of cash, to ensure the system is consistent with the auditor's understanding
- (iv) Reperformance of the checking of the daily sales reports against the exceptions report and matching with the bank in slips
- (v) Other relevant procedures

#### **Answer 1(f)**

The most important uses of the results of the October control tests are the evaluation of the control risks and the planning of the nature and timing and extent of further audit procedures to be performed during the final audit.

Although some tests of controls are performed in October and the results are satisfactory, it does not necessarily mean that no more control tests are required for the remaining two months. For example, procedures which are in place in the first ten months of the year and tested as effective may be discontinued in the two months prior to the end of the year.

\* \* \* END OF SECTION A \* \* \*

**SECTION B (ANSWER THREE QUESTIONS ONLY) (Total: 60 marks)**

**Answer 2(a)**

Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

An auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as:

- The use of testing;
- The inherent limitations of internal control (for example, the possibility of management override or collusion); and
- The fact that most audit evidence is persuasive rather than conclusive.

**Answer 2(b)(i)**

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The assessment of what is material is a matter of professional judgment.

**Answer 2(b)(ii)**

Materiality should be considered by the auditor when evaluating the effect of misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be considered.

For the misstatement of inventory, we have to consider its effects on the misstatement of the balance sheet as well as the income statement because of the double entry system. Although the effect on the balance sheet is immaterial, the effect on the income statement is material. The income before tax of \$600,000 is misstated as \$1,000,000. The gross profit margin is misstated as well. Such misstatements could influence the economic decisions of users.

For the omission of disclosure of the related party transaction, it does not comply with accounting policy. The nature of this non-disclosure matter will have significant effects on the financial statement which in turn could influence the economic decisions of users.

**Answer 2(b)(iii)**

Setting the acceptable materiality level at a lower level can help reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

**Answer 3(a)**

The audit of cash is considered an important part of an audit mainly due to two reasons. Firstly, almost all business transactions will be ultimately settled through the cash accounts, the audit of cash accounts also assists in the verification of other asset and liability accounts.

Secondly, cash is the most liquid asset in a company and it is an area of high inherent risk since there is a relatively high risk of misappropriation.

**Answer 3(b)(i)**

To establish that all bank balances and overdrafts have been included at the correct amount. Related assertions are completeness, rights and obligations, and valuation and allocation.

To ensure that bank balances and overdrafts are correctly disclosed. Related assertions are presentation and disclosure.

To ensure that cash balances are genuine and have been included at the correct amount. Related assertions are existence, rights and obligations, and valuation and allocation.

To confirm that all necessary disclosures concerning bank and cash balances have been made and that the information is presented and described appropriately.

Related assertions are presentation and disclosure.

**Answer 3(b)(ii)**

- (i) Check the bank balance per book to the general ledger.
- (ii) Check balance per bank statement to the bank confirmation and the bank statement.
- (iii) Check casting of the reconciliations.
- (iv) Trace the amount of the deposits in transit to the Cutoff bank statements and to the cashbook.
- (v) Trace a sample of unpresented cheques to the Cutoff bank statements and subsequent bank statements.
- (vi) Obtain reasons where any item has taken longer than expected to clear.
- (vii) Obtain explanations and substantiate other adjustments on the bank reconciliations.

### **Answer 3(c)**

According to HKSA 500 -

- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly
- Audit evidence is more reliable when it is obtained from independent sources outside the entity.

Although bank statements are third party evidence as they are issued by banks, bank confirmations obtained by auditors directly from the banks are more reliable than bank statements.

### **Answer 4(a)**

- (i) Declaration of a share dividend:
  - Reading the minutes of the meetings of the board of directors subsequent to the balance sheet date
  - Confirmation with the independent stock registrar
  - Inquiring of management as to whether the issue of new shares has been made
- (ii) Determination by the Inland Revenue Department of additional income tax due for a prior year:
  - Reading the minutes of the meetings of the board of directors
  - Examining the correspondence with the Inland Revenue Department
  - Confirmation with a solicitor near the end of the field work
  - Through discussions with the management
- (iii) Disposal of fixed assets at a substantial profit:
  - Reading the minutes of the meetings of the board of directors
  - Examining correspondence files
  - Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports
  - Inquiring of management as to whether sales of assets have occurred or are planned
- (iv) A law suit was filed against the audit client. In the opinion of legal counsel, there is a danger of a significant loss to the client:
  - Reading the minutes of the meetings of the board of directors
  - Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims
  - Inquiring of management as to whether there have been any developments regarding the law suit case

#### **Answer 4(b)**

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

#### **Answer 4(c)**

In the first circumstance, there is a limitation on the scope of the auditor's work.

A **qualified opinion** should be expressed when the auditor concludes that an **unqualified opinion cannot be expressed** but that the effect of any limitation on scope is **not so material and pervasive** as to require a disclaimer of opinion.

A **disclaimer of opinion** should be expressed when the possible effect of a limitation on scope is **so material and pervasive** that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

In the second circumstance, there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures

A **qualified opinion** should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion.

An **adverse opinion** should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

#### **Answer 4(d)**

The qualified opinion should be expressed as being "except for" the effects of the impairment of doubtful debts to which the qualification relates.

A clear description of all substantive reasons giving rise to the disagreement and a quantification of the possible effects on the financial statements.

#### **Answer 5(a)**

The external auditor should be involved in systems development and analysis phase:

- to ensure the system is auditable. The external auditor should see that there is an adequate audit trail.
- to contribute to better accounting controls that would be installed in the new system
- to enable the auditor to use better evidence – gathering techniques, as a result of his/her better knowledge of the system
- other relevant points

**Answer 5(b)**

The IS department's user support includes:

- preparing the user manual
- establishing standards of hardware
- advising on the purchase of hardware, software and application packages
- establishing software, testing and documentation standards
- managing software upgrades
- enforcing security procedures
- training in the use of new programmes or software
- assist users to exploit corporate data resources
- ensuring that new systems developed are compatible with the existing systems within the organisation
- other relevant points

**Answer 5(c)**

User participation is important for developing successful IS, the rationale is as follows:

- Participation allows the individuals who must use the systems to protect their own interests.
- Participation provides the means through which individuals can use the system as a basis for a redesign of their jobs and working environment.
- Participation reduces opposition to the new systems.
- Participation of the users acts as a motivator. Users are willing to use systems which were designed by themselves and this leads to higher productivity and greater efficiency.
- Participation permits the various skills and knowledge of the individuals who will use the systems to be incorporated into them.

**Answer 5(d)**

System analysts collect information for system development by the following methods:

- interviews
- facilitated users workshops
- existing records review
- observations
- questionnaires
- special purpose records, eg. computer logs
- prototyping
- existing system specification reviews

\* \* \* END OF EXAMINATION PAPER \* \* \*