



UNIVERSITY OF BOLTON
BUSINESS & CREATIVE TECHNOLOGIES
ACCOUNTANCY PATHWAY BY DISTANCE LEARNING
HONG KONG – CED (INTAKES 35 & 37)
SEMESTER ONE EXAMINATION 2009/2010
ADVANCED AUDITING PRACTICE
MODULE NO: ACC3010

Date: Saturday 26th June 2010

Time: 2.00 pm - 5.00 pm

Duration: 3 hours

INSTRUCTIONS TO CANDIDATES:

There are FIVE questions on this paper.

Answer FOUR questions in total.

This is a closed book examination

Candidates are advised that the examiners attach importance to legibility of writing and clarity of expression

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Question 1

With a view to expanding the product mix, Giant Limited entered into a research and development agreement with a Chinese Medicine Research Institute in July 2000 to develop three new products, including Beauty Essence, Lady Essence and Super Essence.

Budgeted research and development fees in aggregate amount to RMB15,000,000. Up to 31 December 2008, Giant had paid the research institute RMB5,000,000 in aggregate, out of which RMB3,000,000 was incurred in 2008. All the payments had been included as a prepayment in Giant's financial statement for the year ended 31 December 2008, and the total payments made in the year ended 31 December 2009 amount to RMB10,000,000.

Giant capitalized the total expenditure of RMB15,000,000 as an intangible asset in its financial statements for the year ended 31 December 2009. It is the Giant's accounting policies to amortize product development costs on a straight-line basis over a period of 5 years.

The engagement team, including the engagement partner, is not comfortable with the capitalization of the RMB15,000,000 development cost as intangible asset in Giant's financial statements.

Required

With reference to the appropriate auditing pronouncements, critically evaluate:

(a) The responsibilities of the engagement team (including the engagement partner) in dealing with this contentious issue.

(9 marks)

(b) The role of an engagement quality control review under the audit of Giant's financial statements for the year ended 31 December 2009.

(16 marks)

Total 25 Marks

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Question 2

ABC Limited (“ABC”) is a company incorporated in Hong Kong. ABC’s business was very successful during the period 2005-08, and most of its customers are financial institutions based in the US.

Mr. Kwok is a CPA (Practising) and has just started planning the audit of ABC’s financial statements for the year ended 30 June 2009. Ms. Chan, the Chief Executive Officer of ABC, has discussed the following matters with Mr. Kwok:

1) Notwithstanding the recent US sub-prime mortgage crisis, Ms. Chan does not think customers in the US will have any difficulties in settling trade debts. However, a general allowance at 1% of the outstanding balances has been maintained as a contingency reserve against losses from bad and doubtful debts.

2) Ms. Chan provides certain figures from ABC’s accounting records to Mr. Kwok as follows:

	Unaudited	Audited
	Year ended 30 Jun 2009	Year ended 30 Jun 2008
	\$’million	\$’million
Trade receivables from customers in the US	27	20
Trade receivables from other customers	<u>6</u>	<u>5</u>
Total trade receivables	33	25
Sales to customers in the US	110	100
Sales to other customers	<u>55</u>	<u>50</u>
Total sales	165	150

3) Ms. Chan expects ABC to be ready for listing on the Hong Kong Stock Exchange in the near future in order to stay competitive.

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Question 2 cont'd...

4) Ms. Chan explains that ABC has recently changed the remuneration package for senior managerial staff linking it more directly to ABC's sales.

5) Ms. Chan explains that ABC has recently established an affiliated entity in the US to provide certain support services for ABC's main products.

Required

(a) Evaluate the auditor's responsibility in respect of the assessment of risk of fraud in financial statements.

(8 marks)

(b) Define fraud risk factors and critically appraise the main fraud risk factors identified from the audit of ABC's financial statements for the year ended 30 June 2009.

(9 marks)

(d) Analyze how Mr. Kwok may identify any unusual or unexpected relationships amongst the figures provided by Ms. Chan.

(8 marks)

Total 25 Marks

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Question 3

Hong Kong Manufacturing Company Limited and its subsidiaries ("HKM") are principally engaged in the manufacture and distribution of garment and apparel products. All HKM's production facilities are located in Mainland China.

The draft summary of the financial position of HKM as at 31 December 2008 is as follows:

	2008 HK\$m	2007 HK\$m
Intangible assets	150	50
Property, plant and equipment	547	446
Other non-current assets	42	86
Inventories	486	282
Trade and other receivables	704	479
Equity	1,903	1,556
Bank balances and cash	580	567
Other current assets	106	36
Total Assets	2,615	1,948
Long-term bank loans	14	7
Taxation payable	79	49
Bank overdrafts	68	11
Trade and bills payable	377	228
Accruals and other payables	174	97
Total Equity and Liabilities	2,615	1,948

**Question 3 continued over...
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Question 3 cont'd...

During the year, HKM acquired the brand name of “Best” from Best Name Company Limited. Best Name is engaged in the manufacture and retail of a wide range of “Best” products in Hong Kong and major cities in China under.

For the purposes of accounting, the fair value of the brand name “Best” has been determined at HK\$100 million by Mr. Yu, finance director of HKM. Mr. Yu adopted a valuation model using discounted cash flow. Mr. Yu provided you with a number of assumptions used in the valuation model, and has agreed to include these assumptions in the letter of representation.

Included in HKM's accruals and other payable of HK\$174,000,000 at 31 December 2008 is an estimate of losses from a personal injury claim against the company in the amount of HK\$4,305,200. You are checking the adequacy of this provision.

You are a manager at XYZ & Co., HKM's auditor since its listing in 2006. You are the manager-in-charge of the audit of HKM's financial statements for the year ended 31 December 2008.

Required

Based on an evaluation of the above scenario:

- (a) Suggest how you would assess whether the assumptions used by Mr Yu in valuing the brand name “Best” are realistic or not.

(12 marks)

- (b) Explain and analyse the three main approaches to auditing the adequacy of the HK\$4,305,200 provision, referring to the relevant auditing standard where applicable.

(13 marks)

Total 25 Marks

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Question 4

One of your clients is Number One Limited (NOL). Since January 2009, a major customer of NOL, Financial Difficulty Company limited (FDC), has stopped settling trade debts with NOL.

NOL later learned from various sources that FDC was having severe financial difficulty after suffering an unexpected loss of a significant amount from a lawsuit in January 2009. Unless FDC is able to find new sources of finance within the next few months, it is highly probable that it will be liquidated by its bankers. Based on the latest financial statements of FDC available to NOL, it is not likely that NOL would get anything from FDC if it is to be liquidated.

FDC accounted for roughly 20% of NOL's total turnover, and had an outstanding trade receivable balance of approximately HK\$10 million in the books of NOL as at 31 December 2008. The outstanding trade balance of HK\$10 million with FDC was approximately 10% of NOL's total asset, 20% of NOL's total current asset, 50% of NOL's net current asset and 20% of NOL's equity at 31 December 2008. Profit after taxation in the draft income statement for the year ended 31 December 2008 of NOL was HK\$20 million.

You are an audit manager of XYZ & Co. Your team became aware of the situation of FDC a few days before NOL's directors approve the financial statement. In your firm's opinion, the uncertainty about FDC's financial position and the recoverability of the trade receivable due from FDC should be disclosed in the notes to financial statements of NOL. However the directors of NOL consider that the uncertainty was not fundamental and refuse to disclose such information.

Required

- (a) Compare and contrast inherent uncertainty and fundamental uncertainty, and critically evaluate whether either type of uncertainty exists in the current situation of NOL.

(13 marks)

- (b) Suggest how you would modify the auditors' report, if you are in the opinion that NOL is in the position of inherent uncertainty and fundamental uncertainty respectively.

(12 marks)

Total 25 Marks

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Question 5

Your CPA firm is engaged in the audit of China World Limited (“CWL”) for the year ended 31 December 2009. CWL is a company incorporated in Hong Kong and is principally engaged in the operation of five department stores selling over 10,000 different types of merchandise.

You are responsible for the audit of inventories, which is a material balance sheet item. CWL uses the periodic inventory system. All inventories are carried at invoice cost and are valued at lower of cost and net realizable value. All inventories will be counted at year-end and inventory records will be adjusted to reflect the actual quantity counted.

Inventory records are maintained by computer. The inventory records contain the following specific items of information:

- a. Product code
- b. Product description
- c. Date acquired
- d. Date of last sale
- e. Quantity on hand
- f. Unit cost
- g. Provision for obsolescence (if necessary)
- h. Net unit cost
- i. Total value (Quantity on hand x Net unit cost)
- j. Quantity sold this month
- k. Quantity sold year-to-date
- l. Physical count variance

Required

- (a) Discuss and critically evaluate the impact of the use of information technology on the audit process. **(15 marks)**

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Question 5 cont'd...

(b) You have reviewed the internal controls on CWL's inventory and performed all the tests of control you considered necessary. On the assumption that you are satisfied with and will rely on the internal controls on the inventories, determine specific substantive procedures using computer-assisted audit techniques ("CAATs") that could be applied to verify CWL's ending inventory balance.

(10 marks)

Total 25 Marks

END OF QUESTIONS