AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 2019

NOTES:
SECTION A: Answer Question 1, and
SECTION B: Answer any **two** from Questions 2, 3 and 4.
Should you provide answers to more questions than required in Section B, you must draw a clearly distinguishable line through the answer not to be marked. Otherwise, only the first two answers provided will be marked.

Time Allowed
3.5 hours, plus **20 minutes** to read the paper.

Examination Format
This is an open book examination. Hard copy material may be consulted during this examination, subject to the limitations advised on the Institute's website.

Reading Format
During the reading time you may write notes on the examination paper, but you may not commence writing in your answer booklet.

Marks
Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

Answers
Start your answer to each question on a new page.

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

Answer Booklets
List on the cover of each answer booklet, in the space provided, the number of each question attempted. Additional instructions are shown on the front cover of each answer booklet.

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Time allowed: 3.5 hours plus **20 minutes** to read the paper.
Section A: Answer Question 1 **and**
Section B: Answer any **two** from Questions 2, 3 and 4.

Section A: Question 1 is compulsory.

Case study : Crystal Hotel Group Ltd. (Crystal Group)

1. You are an audit manager in Morgan & Co. Certified Public Accountants and Registered Auditors. The audit engagement partner, John Morgan, has called you into his office to discuss a new audit client. You have been assigned as the audit manager of Crystal Hotel Group Ltd. (Crystal Group) for the year ended 31 December 2018. The Group operates a chain of luxury hotels across Ireland. However, as part of a continuing growth strategy, it has acquired a new hotel in Paris. You are very excited about auditing this luxury group of hotels, and are hoping that you may get to stay in one of the hotels during the audit.

It is now January 2019, and you have recently had a planning meeting with John Morgan, Paul Wilson, the managing director of Crystal Group, and Lisa Gribben, the finance director of Crystal Group. From detailed discussions with them, you note the following information:

<u>Background information:</u>
Crystal Group owns five hotels in Ireland (Dublin, Cork, Kerry, Monaghan and Belfast) and one hotel in Paris, which was acquired in September 2018. Each hotel operates through a separate legal entity, and Crystal Group owns 100% of each entity. The Group prepares consolidated financial statements on an annual basis. The Head Office is located in Dublin. In 2018, the Crystal Group had total revenues of €90 million (2017: €80 million), and operating profits of €8,500,000 (2017: €11,000,000). Lisa Gribben explained that all the hotels have been performing well over the last year, with the exception of the hotel in Belfast (see Appendix 1).

<u>Information Technology (IT)</u>
Lisa Gribben highlighted that the Crystal Group relies heavily on the use of information technology (IT) and noted that approximately 96% of bookings are made online via its website. The Group invested significantly in IT over the last six months, which resulted in an extensive upgrade of its website and the development of a user-friendly app. Paul Wilson said, "we have spent a significant amount of money developing our IT systems and ensuring they are secure, as the rapid increase in cybercrime in Ireland is frightening."

<u>Finance team</u>
Each hotel has a finance team, including a financial controller. At the end of every month, a reporting pack is prepared by the financial controller, including a copy of the management accounts, key completed reconciliations and detailed commentary on how the hotel has met key performance indicators for that particular month. Each reporting pack is submitted to the head office in Dublin, and the group financial controller reviews them and performs additional reconciliations. The group financial controller also prepares the year-end consolidated financial statements. Lisa has, however, informed you that the group financial controller resigned in November 2018 because he could not cope with the pressure of the job. She has not yet been able to find a suitable replacement. Lisa has asked if your firm would be able to help with the finalisation of the consolidated financial statements for the year ended 31 December 2018, as her team is currently struggling to find the time needed.

<u>New acquisition</u>
The hotel in Paris (Paris Ltd.) was acquired in September 2018 for €8,500,000, and will be included in the consolidated financial statements at 31 December 2018. The purchase of the hotel was financed by a bank

loan. Paul Wilson explained this was a significant investment for the Crystal Group and that a further €2 million has since been spent on capital expenditure to ensure it meets the exceptionally high standards of the Group. Paul Wilson has invited the entire audit team to travel to Paris for the opening of the hotel in March 2019 as his guests. He has also assured the team will be treated very well while there.

<u>Valuation of the hotel properties</u>

The group policy is to value Land and Buildings at fair value. The calculation of fair value and the allocation of fair value to Land and Buildings requires significant judgement. Paul Wilson confirmed professional valuation experts were appointed to value Land and Buildings at 31 December 2018. Land and Buildings at that date were valued at €110 million, representing a revaluation increase of €12 million.

<u>Loans and Borrowings</u>

During the financial year to 31 December 2018, the Group borrowed €10,500,000 in order to finance the purchase of the new hotel in Paris, and to complete the renovation work required. The loan is repayable over 10 years and the Group must adhere to strict loan covenants. The bank requires the Group to provide management accounts on a quarterly basis: if a loan covenant is breached, the loan may be due for repayment immediately. Lisa Gribben has informed you that the group is also struggling to ensure management accounts for the quarter ended 31 December 2018 will be submitted within the allocated timeframe.

Appendix 1: Hotel in Belfast

Overview:

- The hotel in Belfast is one of the biggest in the Group, and contributes 25% of total revenue.
- Although revenue has increased in 2018, profit has fallen significantly due to a number of "special offers" in both accommodation rates and the restaurant. Paul Wilson believes the main causes for this fall are reduced gross margins (due to the successful uptake of the various special offer promotions during the year) and increasing costs (mainly driven by payroll). The number of special offers were approved by management in a bid to counter the tough economic environment within which the hotel operates and thereby increase revenue.
- During the year, a new bonus scheme was introduced for both managers and directors in order to increase revenue. The bonus is directly linked to revenue.
- The hotel has four main revenue streams, as outlined below.

1. **Accommodation income:**

   The hotel has 350 rooms, with average room rates of £225. Paul Wilson informed you that occupancy rates average 75% throughout the year, with almost 100% occupancy during the summer months.

   In the latter six months of 2018, it was difficult to achieve occupancy targets, as three new hotels were opened in the city centre in May 2018. A further two hotels are expected to open next month.

2. **Restaurant income:**

   The hotel has one restaurant which is open daily for breakfast, lunch and dinner. Paul Wilson explained the restaurant incurred significant losses during 2018, due to increased competitor offerings.

3. **Bar income:**

   There are two bars in the hotel and a wide range of drinks is available to both residents and non-residents. In April 2018, the hotel opened a wine bar, which has proven to be very profitable.

4. **Function room income:**

   The hotel has a large function room which is ideal for weddings, small conferences and business meetings. The function room was renovated in March 2018, and the hotel hosted a wedding fair in April 2018. Due to the success of the wedding fair, supplemented with advertising in various media outlets, almost all Fridays and Saturdays in 2019 and 2020 have been booked. The average cost of a wedding in the hotel is £15,500 and a deposit of £2,000 is required for each booking.

REQUIREMENT:

(a) Draft a memo to the audit partner that outlines FIVE key audit risks in respect of Crystal Group, and recommend an appropriate approach to test each highlighted risk.

Note: *You may ignore cybercrime and the revenue streams pertinent to the hotel in Belfast as these are examined separately in parts (b) and (d) below.*

(21 marks)

(b) In accordance with ISA 315 - *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, discuss the key procedures which should be performed to assess the risk of cybercrime to the Crystal Group.

(5 marks)

(c) Describe the additional audit procedures required in relation to engaging the services of a property expert to value Land and Buildings.

(4 marks)

(d) In relation to the hotel in Belfast (Appendix 1), propose the substantive tests that should be performed to gain comfort over each of the four revenue streams.

(12 marks)

(e) Prepare an email to the audit partner assessing any ethical concerns an auditor should have in respect of the Crystal Group audit engagement and recommend appropriate safeguards.

(8 marks)

[Total: 50 Marks]

SECTION B - ANSWER TWO QUESTIONS ONLY

2. You are the audit manager in L&M Certified Public Accountants and Registered Auditors. The below situations below have arisen in three unrelated external audit clients of your firm. It is now 1 April 2019 and the year end in each case is 31 December 2018.

IT Supplies Ltd. (ITS):
During the year, ITS was engaged by a customer to test its resilience to a cyber-attack. The customer alleges that ITS "brought its system down", resulting in three days of lost trade. The customer has initiated legal proceedings against ITS for negligence. You have reviewed correspondence in relation to the claim and have discussed the incident with the solicitor engaged by ITS. The solicitor has stated it is very likely the customer will win the case, and has estimated the loss to be within the range of €1,500,000 to €1,600,000. The directors of ITS have not recorded a provision in the year-end financial statements, as they believe ITS will win the case. ITS has presented a profit before tax of €12,000,000 in the financial statements, and materiality has been calculated at 10% of profit before tax.

Natural Slate Company Ltd. (NSC):
NSC is reliant on the continuing support of its bank to fund operations. The current loan facility expires on 30 September 2019. However, the directors expect to be able to renew the facility on similar terms, although they have no binding agreement with the bank. The directors have prepared cash-flow forecasts for the year ended 31 December 2019, based on the assumption that the facility will be renewed. These forecasts indicate that the company will be able to meet its liabilities as these fall due. The directors have agreed to include a note to the financial statements which fully discloses the situation. The audit report is due to be signed on 30 June 2019.

Central Building Supplies Ltd. (CBS):
CBS maintains continuous inventory records and, consequently, the company does not perform a physical count at the year end. On 5 February 2019, a fire in the office at the CBS warehouse destroyed the company's inventory and despatch records. The physical inventory was not damaged. There were no satisfactory alternative audit procedures which could be performed. The company has included an estimated closing inventory figure of €805,000 in the financial statements. This estimate represents 5% of total assets and 20% of profit before tax.

REQUIREMENT:

(a) Assess the THREE situations outlined above and state whether the audit report should be modified. Justify your conclusions and outline the modifications, if any, to each audit report.

(15 marks)

(b) Recommend additional procedures that should be undertaken with regards to Natural Slate Company Ltd.'s cash flow forecasts prior to signing the audit report.

(10 marks)

[Total: 25 Marks]

3.

(a) In order to ensure that new trainees are aware of the high standards expected of auditors, the audit partner responsible for staff training has asked you to prepare some training material on the importance of quality control procedures.

REQUIREMENT:
Prepare a memorandum for the audit trainees, which critically discusses the importance of quality control procedures in audit engagements.

(10 marks)

(b) A&B Ltd. manufactures and supplies windows. You are the audit senior on this audit engagement, and are currently working on the audit of trade receivables for the year ended 31 December 2018. Materiality has been calculated at €75,000.

A sample of three trade receivable balances was selected at random, and a confirmation was requested for each of the three customers below.

Trade receivable	**Balance per trade receivables listing**	**Balance per the confirmation**	**Comments**
A&L Morgan Ltd.	€315,100	£235,939	Note 1
JT Construction Ltd.	€565,000	€385,000	Note 2
Top Class Timber Ltd.	€479,000	€414,000	Note 3

The results of the confirmation process are set out in Notes 1 to 3 below:

Note 1:
During the confirmation process, it was noted that A&L Morgan Ltd. is invoiced and pays in £ sterling. The amount confirmed, £235,939, includes invoices for products received to 31 December 2018 worth €315,100 less payments made on 28 December 2018 of €50,000 (£44,500). The payment of €50,000 (£44,500) was received by A&B Ltd. on 4 January 2019. The balance of £235,939 represents the €265,100 retranslated at the FX rate of Euro/GBP: €1/£0.89 at 31 December 2018.

Note 2:
The difference relates to invoices raised by A&B Ltd. for €180,000 in respect of services in November 2018-February 2019. There was a delay in sending these invoices and consequently the invoices were recorded by JT Construction Ltd. in February 2019. The €180,000 was recognised by A&B Ltd. in revenue for the year ended 31 December 2018.

Note 3:
The date on Top Class Timber Ltd.'s confirmation was the 6 January 2019 which showed credit notes received during the first week of January for €65,000. These credit notes were recorded in the accounting records of A&B Windows Ltd. in January 2019, but relate to goods returned in November 2018.

REQUIREMENT:
In respect of the A&B Ltd. trade receivables confirmation process for the year ended 31 December 2018:

(i) Outline key audit procedures that should now be performed in relation to each of the above THREE trade receivable balances.

(9 marks)

(ii) Prepare a proposed schedule of journal adjustments in respect of the above matters. (6 marks)

[Total: 25 Marks]

4.

(a) Reliance on technology in today's society has led to a substantial increase in cybercrime. In turn, the impact of cybercrime on organisations is becoming increasingly significant in relation to financial statement audits.

REQUIREMENT:
Critically discuss the above statement. (10 marks)

(b) You are the senior in charge of the audit of South Ltd. (South) for the year ended 31 May 2019. South owns and manages a chain of ten gourmet sandwich outlets. Sandwiches are prepared on demand for customers, from a range of fresh ingredients that local suppliers deliver on a daily basis.

You are aware that the directors of South are currently discussing opportunities for expansion and are pursuing a listing on the stock exchange. The listing rules of the stock exchange require compliance with corporate governance principles, and the directors have indicated that they are fairly confident they are adhering to best practice. You have documented the following in relation to corporate governance in South:

<u>*Corporate Governance*</u>

- *The board comprises six directors; four executives who originally set up the company and two non-executive directors who recently joined South.*
- *Each director has a specific area of responsibility and only the finance director reviews the financial statements and budgets.*
- *As the board is relatively small, and to save costs, the chief executive officer, Tom McBride, has recently taken on the role of chairman.*
- *Tom McBride, originally set up the audit committee and he sits on this sub-committee along with the finance director and the non-executive directors.*
- *The finance director and the chairman make decisions regarding the appointment and remuneration of the external auditors.*
- *To save costs, an internal audit function has not been established to monitor internal controls.*
- *The executive directors' remuneration is proposed by the finance director and approved by the chairman. They are paid an annual salary, as well as a generous annual revenue-related bonus.*

The audit is nearing completion, and the audit manager is currently drafting the management letter to communicate relevant audit matters to those charged with governance.

REQUIREMENT:

(i) ISA 265 - *Communicating Deficiencies in Internal Control to those Charged with Governance and Management*, requires external auditors to communicate significant deficiencies in internal controls identified during the audit to those charged with governance.

Identify and explain the attributes that are required to ensure such communications are effective. (5 marks)

(ii) Discuss FIVE corporate governance weaknesses faced by South Ltd., and provide recommendations to address each weakness in order to ensure compliance with corporate governance principles.
(10 marks)

[Total: 25 Marks]

END OF PAPER

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 2019

SOLUTION 1

(a) Memo – Audit risks and testing approach
Client: The Crystal Hotel Group Limited
Year end: 31 December 2018
To: John Morgan, Audit Engagement Partner
From: Audit Manager
Date: January 2019
Subject: Audit risks and testing approach

Audit risk	Reasons for choosing	Proposed testing approach
First year audit	- Lack of cumulative audit knowledge and experience.	- Read the most recent financial statements and auditor's report. - Conduct thorough planning and research to gain an understanding of the business. - Use more senior and experienced staff to carry out work on risky and subjective areas. - Ensure sufficient staff are made available to complete audit work. - Request to review the prior year auditor's working papers in order to gain assurance over opening balances. - Perform substantive procedures on opening balances if they cannot be verified by other means. - Determine whether the opening balances reflect the application of appropriate accounting policies.
Revenue recognition	- Driven by the pressures to maintain revenues in tough economic conditions/introduction of bonus scheme, linked to revenue/cash based business. - Revenue is a key risk area to ensure sales are not being artificially inflated or sales made at a loss.	- Perform substantive analytical review procedures by disaggregating revenue by hotel and each of the revenue streams (e.g. accommodation, restaurant etc) - Discuss any significant movements with management, and obtain appropriate explanations. - Select a sample of sales from the general ledger to till reports

		and payments made by customers. - Review post year end credit notes/refunds issued for evidence of window dressing. - Consider fraud due to revenue recognition.
Fraud (ISA 240)	- Introduction of bonus scheme linked to revenue creates incentive to manipulate revenue.	- Perform substantive analytical review procedures by disaggregating revenue by hotel and each of the revenue streams (e.g. accommodation, restaurant etc) - Discuss any significant movements with management, and obtain appropriate explanations. - Select a sample of sales from the general ledger to till reports and payments made by customers. - Review post year end credit notes/refunds issued for evidence of window dressing. - Review sales nominal ledger for evidence of any unusual journal entries posted. - Inspect the last five sales invoices in the accounting period, and the first five sales invoices in the next accounting period to ensure cut-off is correct. - Ensure revenue has not been overstated in respect of the function room income. Ensure that revenue has been recognised in the appropriate periods, and any deposits received have been included within deferred income. - Inspect documentation of how each bonus is calculated.
Group financial controller resigned in November 2018, and has not been replaced.	- The group financial controller left in November 2018 and the reporting packs from each hotel have not been reviewed since October 2018 – this increases control risk. - Also the consolidated financial statements have not been prepared for the year ended 31 December 2018.	- The audit team should remain alert throughout the audit for misstatements due to error or fraud. - Discuss with the managing director, and finance manager whether they will be able to provide the information required during the audit, in the absence of the group financial controller. - Also as this is a first year audit,

	- The increased workload in the head office (after acquiring a new hotel in Paris) and the loss of an experienced and important staff member increase the risk of material misstatement.	perform controls testing at both the head office and the hotels to ensure that good controls are in place.
The Land & Buildings at 31 December 2018 were valued at €110 million, with a revaluation increase of €12 million.	- The group has a policy of revaluing its land and buildings and these valuations have been carried out at the year end. - Land and Buildings could be under or over valued if the recent valuation has not been carried out in accordance with IAS 16 Property, Plant & Equipment and adequate disclosures may not have been made in the financial statements.	- Discuss with management the process adopted for undertaking the valuation of Land & Buildings. This process should be reviewed for compliance with IAS 16. - In accordance with ISA 620 *"Using the Work of an Auditor's Expert*" ensure the expert has the appropriate skills, qualifications and expertise for carrying out the valuation. It is also important to ensure they are independent. - Ensure the assumptions used when carrying out the valuation were appropriate. - Compare the valuation of Land & Buildings to similar properties in the area. - Ensure the depreciation is based on the revalued amount. - Review the disclosures of the revaluation in the financial statements for compliance with IAS 16. - Ensure all assets are revalued. (i.e. no cherry picking)
Paris Limited was acquired in September 2018 and will be included in the consolidated financial statements at the year end.	- It Is important that the entity has been included within the consolidated financial statements in accordance with IFRS 3 – Business Combinations. - In addition as the hotel was acquired part way through the accounting period, only the activity from September 2018 – December 2018 should be included within the consolidated statement of comprehensive income. - As the hotel was only opening in March 2019, after a period of renovation, we would not	- Inspect the legal documents of the purchase of the hotel to ensure it has been acquired by the Crystal Group, and the date the hotel was acquired. (Existence, Rights & Obligations). - Vouch the consideration paid for the hotel to the supporting bank statements/loan statements. - Calculate if there was any goodwill on acquisition, and if this was calculated accurately and treated appropriately in the financial statements. - Check if there was any impairment of goodwill in accordance with IAS 36 at the

	expect to see any trading activity in the period ended 31 December 2018. - In addition it is important to check if any goodwill was recognised in relation to the acquisition, and if it had been recognised appropriately.	year end. - Review the financial statements for the four month period (September – December), to ensure no trading activity was included within the financial statements, as the hotel was being renovated, and not due to open until March 2019. - Ensure that the capital expenditure, has been capitalised appropriately within the financial statements in accordance with IAS 16. - Ensure the acquisition has been fully disclosed in the notes to the financial statements.
Capital expenditure of €2 million has been carried out in the current year in relation to the hotel in Paris.	- It is important that the capital expenditure has been capitalised appropriately in accordance with IAS 16, and has not been included within expenditure in the financial statements.	- Obtain a breakdown of the capital expenditure of €2 million. - Select a sample of items, and vouch the expenditure to purchase invoices/contracts and to payment from the bank. Ensure the expenditure has been capitalised appropriately in accordance with IAS 16. - Ensure the expenditure that has been capitalised has not been depreciated in the current year, as the hotel is not due to open until March 2019. - Review a breakdown of the repairs & maintenance expenditure incurred during the year, and ensure there is no capital expenditure. - Select a sample of repairs & maintenance expenditure incurred during the year, and vouch the expenditure to purchase invoices, and payment from the bank. In addition, ensure the expenditure is not of a capital nature.
Breach of loan covenants	- The loan has bank covenants attached to it which, if breached, would result in the loan becoming repayable in full immediately. - The directors will therefore be keen to ensure the financial statements are presented in such a way as	- Plan to pay specific attention to more subjective and judgemental areas of the financial statements such as revaluation of Land & Buildings, cut-off and revenue recognition. - Recalculate bank loan covenants based on the loan agreement to determine if the covenants are at risk of being

	to satisfy the loan covenants. - Also, from discussion with Lisa, they are struggling to have the management accounts for the quarter ended 31 December 2018 to the bank on time.	breached. - Inspect correspondence with the group's bank to ascertain whether any issues have arisen in respect of the bank covenants or loan repayments. - Inspect board minutes for evidence of any conflict with directors' personal interests.
Hotel in Belfast - Foreign exchange risk	- There is a risk that foreign currency balances on the Statement of Financial Position are valued at the incorrect FX rate or that transactions during the year are translated at an incorrect FX rate in respect of the hotel in Belfast.	- In line with IAS 21, the statement of comprehensive income and statement of financial position should be presented in the consolidated financial statements at the appropriate rates. - Agree the foreign exchange rates used by the client to supporting documentation and ensure they are appropriate. - Using the appropriate rates, re-calculate the balances included within the consolidated financial statements for the hotel in Belfast. - Ensure the gain/loss on foreign exchange is treated appropriately in line with IAS 21.
Going concern	- Despite the increase in group's revenue during the current year of €10 million there has been a decrease in profit on €2.5 million. - The Belfast Hotel is the largest hotel in the group and accounts for 25% of the group's revenue. - In the Belfast hotel there is an increase in sales, but a decrease in gross profit margins – the key risk is that sales are being made at a loss which will impact the going concern of the business if margins continue to fall and this trend cannot be supported in the long term by the business. - There has been a decrease in occupancy rates in the Belfast hotel, and increase in competition. Three new hotels opened in May 2018, and another two	- Review the post year end management accounts for the hotel in Belfast after the year end to assess the financial results. - Perform an analytical review to a similar company to assess how the hotel in Belfast is performing against the industry average. - Review cash flow forecasts for 12 months from the date the audit report will be signed to ensure sufficient banking facilities. - Review post year end board minutes.

	hotels are expected to open next month. - In addition, the restaurant in the Belfast hotel incurred significant losses during the current year, due to an increase in competitors.	
Misstatement of payroll/bonus costs	- Driven to increase revenues to increase bonus payments will not increase profitability of the Crystal Group. - The key risk area is inflating sales to increase bonus will not take into account whether the sale is at a loss. - In addition increasing payroll costs has resulted from increasing revenue which needs to be supported by staff – reducing profitability of the Crystal Group.	- Review controls over the payroll function, select a sample of employees to recalculate the payroll amount. - Select a sample of bonuses and test back-up workings to ensure that they are in line with the terms of the bonus scheme.
Deposits received in advance for all events (weddings, conferences).	- There is a risk that revenue may be overstated, and the full amount of income expected for the particular event may be included in revenue. - For example, when a £2,000 deposit is received upon booking a wedding, the total cost of the wedding may be included in revenue (approx. £15,500). - In addition, the deposit may be included in revenue, rather than deferred income.	- For a sample of events booked in advance at the year end, check that the deposit received has not been included in revenue. - Recalculate the deferred income and ensure this has been treated appropriately in the financial statements. - Also check a sample of events that occurred during the year, to ensure the deposit paid in advance, was released from deferred income to revenue in the appropriate period.

91 mark for identifying each audit risk, 1 mark for explaining each audit risk, and 2 marks for identifying an appropriate response for each audit risk x 5 = 20 marks)
(Format & Presentation 1 mark)

(b)

- As 96% of the accommodation bookings are made online and there is a significant reliance on IT, there is a high risk of cybercrime.
- It is important that the entity is using appropriate accounting systems and technology that is up to date and can reduce the risk of cyber-crime.
- It is important that the organisation is able to restrict access to sensitive information by unauthorised individuals. The audit will check the IT controls the organisation has in place (such as usernames, passwords, how often the passwords are reset) to ensure they are appropriate.
- The auditor should assess how the organisation protects the data it holds (this is extremely important in the Crystal Group as 96% of their bookings are made online). It is important that the organisation complies with GDPR.
- The auditor should check the IT policies that are in place, and ensure they are being abided by all employees.
- It is important that the auditor is made aware of any cyber attacks the organisation has faced, and if a breach of data protection has occurred. The auditor may be able to find out this information through management inquiries, a review of board minutes and media attention.
- The auditor may bring in an expert to conduct and audit on the IT systems the client operates.
- It a breach of data protection has occurred, the auditor will have to consider the financial implications of the breach and whether a provision has been recorded within the financial statements in accordance with IAS 37. In addition, depending on the extent of the breach, the auditor may have to consider if there is any impact on the going concern of the organisation in accordance with ISA 570, Going Concern.

(1 mark for each valid point to a maximum of 5 marks)

(c)

- ISA (Ireland) 620 “Using the Work of an Auditor's Expert”sets out additional procedures arising when planning to use an expert:
- Evaluate the competence, capabilities and objectivity of the expert (ISA 620, para.9) using (ISA 620, Para. A15):
    - Personal experience with previous work of the expert;
    - Discussions with that expert;
    - Discussions with other auditors or others who are familiar with that expert’s work;
    - Knowledge of that expert’s qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition;
    - Published papers or books written by that expert;
    - The auditor’s firm’s quality control policies and procedures.
    - Other relevant matters may include (ISA 620, Para. A17):
    - Relevance of the auditor’s expert’s competence to the matter for which that auditor’s expert’s work will be used;
    - Their competence with respect to relevant accounting and auditing requirements, for example, knowledge of assumptions and methods.

(1 mark for each valid point to a maximum of 4 marks)

(d)

SOLUTION 2

Income stream	Substantive tests
Accommodation income	- Review accommodation income for the current year and the prior year and enquire as to any significant changes in total income and occupancy rates. - Using analytical procedures prepare a month by month comparison of accommodation income for the current year and the prior year. - Discuss any significant movements with management, and obtain appropriate explanations. - Compare the occupancy and room rates with the industry average. - Perform a substantive analytical procedure using the average room rate and occupancy rates to calculate the expected accommodation revenue for the current year. Compare the actual revenue to the expected revenue calculated and enquire into any differences. - Select a sample of sales from the general ledger, and agree this to supporting invoices and customer receipts (existence/occurrence) - Select a sample of receipts lodged to the bank and trace them back to the accommodation sales invoices, and the general ledger. (completeness) - Review a list of the last 5 overnight stays in the hotel in the current year, and the first 5 overnight stays in the hotel in 2019. Trace the overnight stays back to supporting documentation, e.g. sales invoices, and ensure that revenue has been included in the appropriate accounting period. (cut-off).
Restaurant income	- Review restaurant income for the current year and the prior year. - Using analytical procedures prepare a month by month comparison of restaurant income and gross profits margins for the current year and the prior year. - Discuss any significant movements with management, and obtain appropriate explanations. - In the current year, there was an increase in revenue due to the uptake of special offers, however there was a decrease in gross profit margins – ensure the special offers introduced in the

	restaurant are not loss-making. - Ensure there are appropriate controls in place over the revenue process in the restaurant. In addition, ensure there are adequate controls in place over bank and cash. - Take a sample of till receipts, and agree them to sales invoices, and the bank statements (occurrence). In addition, ensure the sale has been recorded to the correct nominal code in the general ledger (accuracy). - For a sample of receipts received during the year into the bank, agree the receipt to the supporting sales invoices, the general ledger and till receipts. (completeness).
Bar income	- Review bar income for the current year and the prior year. - Using analytical procedures prepare a month by month comparison of bar income and gross profits margins for the current year and the prior year. - Discuss any significant movements with management, and obtain appropriate explanations. - Ensure there are appropriate controls in place over the revenue process in the bars. In addition, ensure there are adequate controls in place over bank and cash. - Take a sample of till receipts, and agree them to sales invoices, and the bank statements (occurrence). In addition, ensure the sale has been recorded to the correct nominal code in the general ledger (accuracy). - For a sample of receipts received during the year into the bank, agree the receipt to the supporting sales invoices, the general ledger and till receipts. (completeness).
Function room income – weddings/conferences	- Review function room income for the current year and the prior year. - Using analytical procedures prepare a month by month comparison of function room income and gross profits margins for the current year and the prior year. - Discuss any significant movements with management, and obtain appropriate explanations. - Ensure initial deposits are included in deferred income until it is appropriate to recognise in revenue. - For a sample of events booked in

	advance at the year end, check that the deposit received has not been included in revenue. - Recalculate the deferred income and ensure this has been treated appropriately in the financial statements. - Select a sample of items posted to the nominal ledger during the year, and ensure the event occurred during the year, and the income has been recorded appropriately. - Also check a sample of events that occurred during the year, to ensure the deposit paid in advance, was released from deferred income to revenue in the appropriate period. - Obtain details of the number of events which took place during the year, and the average cost of each event. Using the above information perform a substantive analytical procedure over income, and compare this with the actual income received.

[1 mark for each appropriate substantive test identified up to a maximum of 3 marks for each revenue stream] x 4 to a maximum of 12 marks

(e)

Email:
To: John Morgan, Audit Engagement Partner
From: Audit Manager
Date: January 2019
Subject: The Crystal Hotel Group Limited – Ethical concerns

Hi John,

Please see below, two ethical concerns I have identified in respect of the Crystal Hotel Group Limited including appropriate safeguards I have recommended:

Ethical concern	Ethical Standard	Threats	Appropriate safeguards
The managing director has invited the entire audit team over to Paris for the opening of the hotel in March 2019 free of charge. He has also ensured the audit team will be treated very well.	Section 4 – Fees, Remuneration and Evaluation Policies, Gifts and Hospitality, Litigation	Self-interest threat	- The audit partner will need to determine the value of the free trip, however assuming that it will cost a significant amount of money, the audit partner should decline the offer. - If it is necessary to go over to the hotel ensure that the audit firm pays all of the expenses

			incurred.
The Finance Manager, Lisa Gribben has asked if your firm would be able to help with the preparation of the consolidated financial statements for the year ended 31 December 2018.	Section 5 – Non Audit Services	Self-review threat Self-interest threat	- If the audit firm were to prepare the financial statements, and then audit them, this would pose a self-review threat. It may also pose a self-interest threat depending on the fees received for carrying out the work. The audit firm should decline the work for preparing the financial statements, or else decline the audit.

Please let me know if you have any concerns.

Kind regards
Audit Manager

[1 mark for each ethical concern identified, 1 mark for identifying the correct ethical standard, 1 mark for identifying the ethical threats, and 1 mark for identifying appropriate safeguards] x 2 up to a maximum of 8 marks

(a) IT Supplies Limited (ITS)

IAS 37 states a provision should be booked where the following 3 criteria are met:

1. There is a present obligation arising from a past event – The incident took place during the year, therefore this is a past event. In addition there appears to be an obligation whereby ITS does appear liable.
2. Probable that an outflow of resources will be required to settle the obligation – From the information provided, the solicitor is confident the customer will win the case, and has estimated the amount to be within the range of €1,500,000 to €1,600,000.
3. Reliable estimate can be made of the obligation: The solicitor has estimated the claim will be within a range of €1,500,000 to €1,600,000. Although there is a difference in the range of €100,000, this is not material.
   - As all of the above criteria have been met, a provision of approximately €1,550,000 (mid-point) should be recorded in the financial statements according to IAS 37.
   - As the client is not willing to record the provision, this will result in a modified audit report due to a disagreement with the client.
   - The provision is material, as materiality has been calculated at €1,200,000, however the provision is not pervasive.
   - The auditor will therefore issue a qualified opinion “except for”, as the journal has resulted in a disagreement with the client, and the amount is material but not pervasive.

Natural Slate Company Ltd (NSC):

- Modify the audit report, but not the opinion.
- As the directors are willing to include a note fully disclosing the matter and they have prepared cash flow projections, there is no disagreement or limitation of scope.
- There is a significant uncertainty about the going concern, which is fundamental to user’s understanding of the financial statements.
- Per ISA 570, if adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor’s report shall include a separate section under the heading “Material Uncertainty Related to Going Concern”.
- The section should draw attention to the note in the financial statements that discloses the matters; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern and that the auditor’s opinion is not modified in respect of the matter.

Central Building Supplies Limited (CBS):

- Modify the report and the opinion due to the inability to obtain sufficient appropriate evidence on which to base the opinion (limitation of scope).
- The amount of inventory is material as it is greater than 5-10% of profit before tax and 1-2% of total assets.
- Consequently the possible effects on the financial statements of undetected misstatements, if any, could be material.
- The issue is unlikely to be pervasive as it is confined to specific elements in the financial statements and any error in inventory is unlikely to represent a substantial proportion of the financial statements.
- The opinion should be qualified and there should be a paragraph explaining the reasons for the inability to obtain sufficient appropriate audit evidence.

(1 mark for each valid point to a maximum of 5 for each company x 3 up to a maximum of 15 marks)

(b) The sufficiency of previous work on cash flow forecasts is set out below:

- Prior work considered forecasts to the year ended 31 December 2019. Going concern (ISA 570) must be evaluated for 1 year from the date the financial statements are approved;
- In this instance, this would require the auditor to consider the period to 30 June 2020;
- Typically, we would expect management to extend their forecasts beyond 31 December 2019, for another 6 months to 30 June 2020;
- The auditor should review these forecasts and consider the following:
  - o Compare forecasts performance against prior year actual;
  - o Compare key working capital ratios per the forecast against prior year actual (e.g. trade receivable days, trade payable days, inventory days);
  - o Check mathematical accuracy of the forecast;
  - o Agree the opening cash position to the bank statement or audited financial statements;
  - o Perform sensitivity analysis – e.g. “what if” revenue fell by 10%?
- Consider the impact of any subsequent events which may require an adjustment to the cash flow forecasts, e.g. loss of customers, fire etc.

(1 mark for each valid point up to a maximum of 10 marks)

SOLUTION 3

(a) Memorandum
To: Audit trainees
From: Audit senior
Subject: Importance of quality control procedures

- In order to ensure all assurance engagements are carried out efficiently and effectively it is important the auditor carries out quality control procedures.
- ISA 220 Quality Control for an Audit of Financial Statements, paragraph 12 states that:
  "The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate."
- Each registered auditor is required to establish and maintain quality control procedures appropriate to its circumstances.
- The firm's programme of quality assurance inspection has, as its main objective, to ensure that all engagements are conducted in accordance with the relevant policies and procedures.
- It is important they meet user's expectations/provide a reliable service.
- The work undertaken is performed to a high standard/provides value for money/in an efficient and cost-effective manner.
- The requirements of the Inspection Units/Auditing Standards are satisfied.
- They enhance the reputation of and increase confidence in the profession.
- To protect the assurance provider against negligence claims and disciplinary procedures.
- To ensure that engagements are only accepted for services for which the firm has the necessary competencies.
- To ensure that the predecessor auditors have been contacted to ensure there was no unusual circumstances surrounding their removal or resignation from their position of auditor.

(1 mark for each valid point up to a maximum of 9 marks)
(Format & Presentation 1 mark)

(b)

(i) Note 1: - Confirm trade receivable invoiced in sterling (£)
- Retranslate €265,100 using independent FX rates as at date of invoice.
- Agree payment of €50,000 (£44,500) to remittance and follow through to the bank statement.
- Ensure €50,000 (£44,500) payment related to pre-period end invoice.
- Confirm that payment was received by A&B Windows Limited post year end
- Ensure balance is correctly recorded at year end rates.
- Ensure that FX gains/losses are correctly calculated and included in income statement.

Note 2: Agree amounts to invoices
- Verify the period of the invoices for November & December 2018.
- Verify that sale of products occurred in this period.
- Understand why there is a delay in sending these invoices and consider wider implications.
- If sales occurred evenly through 4 month period – cut off adjustment required at 31 December 2018.

Note 3: Agree amounts and details to credit notes
- Confirm that these credits relate to pre-period end sales.
- Confirm goods were returned in November 2018 – agree to signed goods received notes.
- Confirm posting of these credit notes in January 2019.
- Inquire with management why delay in recording credit notes.

(3 marks for each trade receivable balance x 3 up to a maximum of 9 marks.)

(ii) JT Construction Ltd:

Journal to correct the cut off errors on sales:

DR Sales	90,000	
CR Trade receivables		90,000

Top Class Timber Ltd:

Journal to correct the sales returns not appropriately recorded:

DR Sales returns	65,000	
CR Trade receivables		65,000

(3 marks for each correct journal entry proposed– maximum of 6 marks)

SOLUTION 4

(a) Importance of cyber security

- Today, there is a significant increase in cybercrime due to the reliance on technology in all aspects of life.
- According to the National Cyber Security Centre, "Cyber risk is now one of the most commonly talked about topics as the impact of cybercrimes reaches an all-time high."
- It is vital that all businesses today, invest in cyber-security in order to protect themselves and their customers.
- This is an extremely important topic for management in all organisations, due to the increase in regulations and reporting requirements.
- In May 2018, the EU introduced GDPR (General Data Protection Regulation), and now organisations can be faced with fines up to 20 million euro or 4% of annual global turnover for non-compliance with the regulations.
- As most people in today's society rely on technology in all aspects of life (laptop, iPad, iPhone), there sometimes can be a fine line between work and their personal life, which significantly increases their vulnerability to a cyber-attack.
- As cyber-attacks are becoming increasingly sophisticated, it is important that organisations have appropriate IT security in place.
- Although the technology is extremely important in preventing a cyber-attack, it is vital that staff have received training in order to be aware of the processes to be implemented, and how to identify when they are coming under threat.
- If an organisation does not have appropriate measures in place, they may also suffer non-financial costs such as damage to their reputation and loss of trade – this may impact on going concern.

Role of the auditor

- In accordance with ISA 315, *'Identifying and assessing the risks of material misstatement through understanding the entity and its environment',* the auditor is required to carry out various risk assessment procedures in order to gain an understanding of the entity and its environment.
- The auditor should consider the following factors:
  - o Accounting systems and technology – it is important that the entity is using appropriate accounting systems and technology that is up to date and can reduce the risk of cyber-crime.
  - o General IT controls – it is important that the organisation is able to restrict access to sensitive information by unauthorised individuals. The auditor will check the IT controls the organisation has in place (such as usernames, passwords, how often the passwords are reset) to ensure they are appropriate.
  - o Data Protection – the auditor should assess how the organisation protects the data it holds (this may be increasingly important where the entity has online sales). It is important that the organisation complies with GDPR.
- It is important that the auditor is made aware of any cyber attacks the organisation has faced, and if a breach of data protection has occurred. The auditor may be able to find out this information through management inquiries, a review of board minutes and media attention.
- If a breach of data protection has occurred, the auditor will have to consider the financial implications of the breach and whether a provision has been recorded within the financial statements in accordance with IAS 37. In addition, depending on the extent of the breach, the auditor may have to consider if there is any impact on the going concern of the organisation in accordance with ISA 570, *Going Concern*.

(Importance of cyber security - 1 mark for each valid point] x 5 = maximum 5 marks)
(Role of the auditor – 1 mark for each valid point x 5 = maximum 5 marks)

(b)

(i)
- The report should be communicated in a timely manner to allow the management to take appropriate action promptly.
- The report should be communicated in writing in a clear language to avoid any confusion or misunderstandings.
- Communicated to those charged with governance to ensure that there is appropriate authority to take corrective action.
- Include a description of each deficiency, possible implications and recommendations to ensure there is sufficient information to understand and correct the deficiency.
- The extent, form and frequency of the report should be appropriate to the size, type and nature of the organisation. Points included should be of sufficient importance to ensure information provided by the auditor is useful and can be acted upon.

- Include any management comments, indicating if the point raised is accepted by management to aid the understanding of those charged with governance.
- Include a disclaimer to reduce the likelihood that third parties seek to rely on the report.

(1 mark for each valid point x 5 = maximum 5 marks)

(ii)

(1 mark for each weakness up to a maximum of 5 marks and 1 mark for each recommendation up to a maximum of 5 marks.– Maximum 10 marks)

Weakness	**Recommendation**
There are only two non-executive directors which is less than half. This is clearly not an appropriate balance to ensure board decisions are questioned, ultimately taken in the interests of the shareholders and prevent executives pursuing their own interests.	Two more non-executives should be appointed so that there is an equal amount of executive and non-executive directors.
Only the finance director reviews the financial statements and budgets. These should be presented and explained to the whole board since the financial results of previous decisions should be known and these results will impact on the future decisions made by the board.	Financial statements and budgets should be presented to the board to allow directors to understand the financial position and performance. This will facilitate informed decision making.
Tom McBride is both Chairman and CEO. There should be a clear division of responsibilities at the head of South Ltd and Tom McBride should not be allowed to occupy both positions, remaining unchallenged and able to abuse his power.	Someone else should be appointed as chairman and in accordance with corporate governance best practice, this should be an independent non-executive.
The CEO/Chairman set up the audit committee and the finance director sit on it. This committee should consist of non-executive directors to maintain independence from the executive board members who have a self-interest.	The audit committee should be reformed to only consist of non-executive directors. Tom McBride and the finance director should resign from the committee.
Tom McBride and the finance director decide the remuneration and appointment of auditors. This should be decided by an audit committee consisting of independent non-executives.	An audit committee consisting of non-executives should be responsible for the appointment of auditors and for setting their remuneration.
There is no internal audit department on the basis it would be too expensive. This decision should only be taken by an independent audit committee once the need to have an internal audit function has been assessed, taking into account both financial and non-financial benefits and drawbacks.	The newly formed independent audit committee should assess the need for internal audit taking both financial and non-financial factors into account. If it is decided that an internal audit function is not needed, the need for one should be assessed annually.
Tom McBride and the finance director decide the remuneration for all directors. Directors should not set their own remuneration due to them having a clear self interest which may prompt them to award themselves excessive pay packages.	The remuneration policy should be fair and transparent. The non-executives should set the executives' pay and the finance director could set the non-executives' pay.
The annual revenue related bonus could encourage a short-term view and ineffective decisions for the purposes of maximising long term shareholder wealth.	The remuneration of the executives should be restructured to include an appropriate proportion linked to the long-term performance of the company. For example, awarding shares or share options instead of bonuses may encourage a longer term view.