MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this paper. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication. More marks were available than could be awarded for each requirement. This allowed credit to be given for a variety of valid points which were made by candidates.

General comments

The pass rate was lower than that experienced in recent examinations. Short form question (SFQ) 3 and questions 8.1 and 8.2 were the lowest scoring questions but candidates also performed poorly on SFQ 5 and questions 7.1 and 9.2. Answers to question 9.1 were of a mixed standard as some candidates demonstrated only limited understanding of the implications for audit reports in each of the scenarios. There were, however, a large number of excellent scripts submitted by stronger candidates. Although there was an increase in the number of candidates using note form to present their answers to the SFQs, a significant minority continue to present lengthy answers to these questions. There was some evidence that candidates had not adequately managed their time across the paper as there were some very brief or no answers to some questions, particularly on questions 8 and 9.

Question 1

Total Marks: 4

Failure to protect client data	**Marks**
Consequences • Breach of legal requirements/confidentiality • Reputational damage • Loss of clients • Litigation • Fines • Disciplinary procedures by professional body/loss of registered auditor status • Increased insurance premiums • Costs of reconstructing lost data • Negative impact on cash flow/going concern **Internal controls** • Implement data security policy • Procedures for reporting breaches of data security • Monitoring of procedures • Password protected laptops and files • Passwords changed regularly • Anti-malware/anti-virus software/firewalls • Secure storage of files • Staff training/disciplinary procedures.	
This question was well answered, particularly by those candidates who formatted their answers under the headings consequences and internal controls. Candidates scored more marks in respect of consequences than they did on internal controls. The points most commonly overlooked in respect of consequences were those relating to increased insurance premiums and reconstruction costs following the loss of data. The points most commonly overlooked in respect of internal controls were those relating to IT controls such as anti-malware software and passwords.	
Total possible marks	8½
Maximum full marks (½ mark per point)	4

Question 2

Total Marks: 3

Benefits of a voluntary external audit	**Marks**

• Better discipline over maintaining accounting records which:
  ○ reduces risks of material misstatement/errors
  ○ identifies fraud
  ○ reduces management bias
• May act as a deterrent to fraud:
  ○ eg, theft of cash, food and golf equipment
• More reliable business information:
  ○ leading to informed management decisions
• Enhances the credibility of the financial statements:
  ○ giving reassurance to third parties
  ○ eg tax authorities, lenders and suppliers
• Business is scrutinised by a professional:
  ○ reduces business risk
  ○ improves controls/identies deficiencies
  ○ improves efficiency/performance.	

Answers to this question were of a mixed standard. The points most commonly cited were those relating to credibility of the financial statements, assurance to third parties such as banks and recommendations in respect of internal controls. Surprisingly, only a minority of candidates identified the points relating to management bias, fraud and error. Few candidates considered the points relating to discipline over accounting records, more reliable business information and informed business decisions. A common error was to treat the entity as an incorporated body and cite irrelevant points such as ensuring that financial statements comply with the Companies Act provisions.	
Total possible marks Maximum full marks (½ mark per point)	7½ 3

Question 3

Total Marks: 3

Audit procedures to address the risk of management override of internal controls	**Marks**
• Substantiate journal entries • Investigate reconciling items • Use of data analytics to identify exceptions • Review significant accounting estimates and judgements for bias • Investigate transactions outside the normal course of business • Review 'whistle-blowing' arrangements • Review internal audit reports • Interview management to assess its attitude towards the control environment.	
This question proved to be the most challenging of the short-form questions. A significant number of candidates did not attempt this question and many of those who did attempt it scored zero marks. The points most commonly identified were those relating to journal entries, management's estimates, transactions outside the normal course of business and management's attitude towards the control environment. Weaker candidates often cited discussing the risk of management override with management. No mark was awarded for such statements. Few candidates considered the use of data analytics, whistle-blowing arrangements or internal audit reports. A common shortcoming was to list more than three procedures as stated in the requirement. Candidates should be aware that only the first three points listed were considered by markers.	
Total possible marks (marks were awarded for the first three points only) Maximum full marks (1 mark per point)	3 3

Question 4

Total Marks: 3

Request to provide a second opinion on a proposed auditor's report	**Marks**

Ethical issues
• Threat to professional behaviour
  ○ discredit the profession
  ○ may compromise/undermine the opinion of the existing auditor
• Client may be opinion shopping
  ○ may indicate lack of management integrity
• Threat to professional competence and due care
  ○ if firm is not in possession of all the facts
• Self-interest threat
  ○ to objectivity
  ○ firm may give the opinion the client desires to obtain future work
Response
• Obtain client's permission to contact the existing auditor
• Notify the auditor of the work to be undertaken
• If client refuses permission, consider whether it is appropriate to accept the engagement
  ○ must decline if ethical threats cannot be mitigated.	

This question was well answered as most candidates identified that the prospective client was opinion shopping and that this had implications for management's integrity and the self-interest threat to objectivity. A significant number failed to consider the fundamental principles of professional behaviour and professional competence and due care. Many overlooked the fact that the prospective auditor needed to obtain client consent to discuss the reason for the modification with the incumbent auditor. The point most commonly overlooked was that relating to the need to be aware of the same facts as the incumbent auditor.	
Total possible marks Maximum full marks (½ mark per point)	7 3

Question 5

Total Marks: 4

Reliability of an email as audit evidence and audit work that should be undertaken	**Marks**

Reliability
• The email:
  ○ should not be accepted at face value/must be critically challenged
  ○ does not provide sufficient evidence to support the going concern status
    ▪ Sunwac may not have the funds to support Aire
    ▪ Sunwac has not provided a timeframe for funding
  ○ was not sent directly to the auditors
  ○ could be forged
  ○ is not reliable
  ○ is not legally binding
Audit work that should be undertaken
• Request that a signed letter/direct confirmation/copy of Sunwac board minute pledging support is sent directly to auditors
• Consider whether Sunwac has the financial backing/resources to finance Aire
  ○ request access to and review the financial statements of Sunwac/undertake a credit check on Sunwac
  ○ request access to and review Sunwac's budgets/forecasts
  ○ confirm period of funding is for at least 12 months from the date the financial statements are approved.	

Answers to this question were disappointing. Most candidates correctly identified that the email was not sufficient or reliable evidence in respect of the going concern status of the audited entity and that direct confirmation from the parent company was required. However, only a small minority of candidates appreciated that such confirmations are not legally binding. Stronger candidates appreciated the need to assess whether the parent company was able to provide the funding and consequently the importance of establishing whether the funds would be available. A minority of candidates strayed beyond the requirement and wasted time discussing the implications for the auditor's report.	
Total possible marks	9
Maximum full marks (½ for comment on the reliability, 1 mark for audit work)	4

Question 6

Total Marks: 3

Request that an engagement partner continues beyond rotation threshold	**Marks**

• Sue may continue as engagement partner:
  ○ to maintain audit quality
• ES permits when there are unexpected changes in the structure of the client's business:
  ○ such as the acquisition of competing business
  ○ only for an additional 2 years/no longer than 7 years
• Expanded review of audit work required:
  ○ to mitigate the familiarity threat
• Facts and reasons to be disclosed to:
  ○ shareholders
  ○ those charged with governance
• If no disclosure, should refuse the request
• Ethics partner should be consulted.	

This question was well answered as most candidates identified that it was possible for the engagement partner to remain in post for an additional two years due to the change in business structure. Although most candidates appreciated that a review was required many of these failed to state that an **expanded** review was required under these circumstances. The points most commonly overlooked were those relating to the disclosures to shareholders. A small minority of candidates were unaware of the provisions of paragraphs 3.15/3.16 of the FRC Ethical Standard and, incorrectly, stated that the engagement partner must be rotated off the engagement immediately. These candidates scored no marks.	
Total possible marks	5½
Maximum full marks (½ mark per point)	3

Question 7

Total Marks: 40

General comments
The overall average mark on this question was the highest on the long-form questions. This was due to strong answers to 7.2, with many candidates obtaining maximum marks. A number of candidates may have lost some marks by not expanding the cells used to record their answer.

7.1 Outline the process set out by the ICAEW Code of Ethics that your firm should have undertaken to obtain professional clearance from LEL's previous auditors. List the reasons for this process.	**Marks**
The firm should explain to LEL that it has a professional duty to communicate with the previous auditor. It should also obtain written authority from LEL to discuss LEL's affairs with the previous auditor. Once written authority is obtained, the firm should communicate with the previous auditor seeking any information relevant to its decision to accept the appointment as auditor. All discussions with the outgoing auditor should be documented.	2½
Reasons The process as set out by the ICAEW Code of Ethics is designed to maintain client confidentiality and mitigate reputational risk for the audit firm. It also ensures that the audit firm is in full possession of the facts and able to make an informed decision. The reason for the change in appointment could be due to disagreements with management or issues around management integrity that may not be easily overcome. The response may also highlight issues around unlawful acts or unpaid fees.	7
The documentation of discussions provides evidence of the process if the firm's acceptance is questioned at a later date.	1
Answers to this question were of a mixed standard. Most candidates correctly outlined the process set out by the ICAEW Code of Ethics relating to professional clearance from the previous auditors. This included identifying the need to obtain the client's permission to contact the previous auditors, communicating with them and identifying any reasons why the firm should not accept appointment. Candidates also identified a range of relevant reasons for this process including compliance with the principle of confidentiality, ensuring the firm was in full possession of the facts and alerting the firm to potential issues such as doubts about management integrity, disagreements, unlawful acts by the client and unpaid fees. The most commonly overlooked points were: ○ explaining the firm's professional duty to the prospective client ○ recording discussions with the outgoing auditor in writing ○ providing evidence of the process if questioned; and ○ mitigating any reputational risk to the firm. Several candidates wrote at length about the steps that should be taken if professional clearance was not obtained from the outgoing auditor or if issues were identified during the process. These did not earn any marks as the firm had already accepted the audit engagement and therefore these points were not relevant in this scenario.	
Total possible marks Maximum full marks	10½ 6

<table>
<tr><td colspan="2">7.2 Justify why the items listed as (1) and (2) in the scenario have been identified as key areas of audit risk and, for each item, describe the procedures that should be included in the audit plan to address those risks. Your answer should include examples of specific data analytics routines that can be applied to the items listed as (1) and (2).</td><td>Marks</td></tr>
<tr><td>Trade receivables
Justification (6½ marks)
Trade receivables may be overstated because:

trade receivables days have increased from 31.1 in 2016 to 45.1 in 2017
REC is refusing to pay an invoice for £1.3m. This is 1.04% of revenue and therefore material
even if REC's balance is excluded, trade receivables days are 41.3 in 2017
this is inconsistent with the credit terms of 30 days
issues with the quality of components may indicate potential disputes with other customers.
</td>
<td>Procedures (12 marks)

Inspect contracts to ascertain if credit terms have changed
Obtain direct confirmation of trade receivables balances at the year end
Identify cash received from customers after 31 December 2017 which relates to trade receivables at the year end
Review the aged trade receivables analysis to identify overdue balances
Discuss with management the basis for any allowance against receivables. Recalculate the allowance against receivables
Inspect correspondence with customers and solicitors and review board minutes for evidence of any disputes
Inspect credit notes raised after the year end for evidence of amounts disputed at 31 December 2017 or goods returned after 31 December 2017
Assess the financial position of key customers
Vouch entries in the sales ledger with despatch documentation
Perform cut-off procedures
Use data analytics to identify items for further investigation, for example:

reproduce the receivables ageing analysis
three-way matches between sales orders, goods despatched records and invoices

(marks were awarded for any relevant examples of data analytic routines which could be used as an audit procedure).</td><td></td></tr>
<tr><td>Inventory
Justification (9 marks)

Inventory may be overstated because:

inventory days have increased from 47.4 in 2016 to 75.7 in 2017
the gross margin has increased from 40.8% in 2016 to 45.4% in 2017 which is inconsistent with higher prices charged by the new supplier
the annual update of the product range may result in some instruments becoming obsolete
there have been quality issues with components
there was over purchasing by the chief buyer
obsolete inventory will require write down to net realisable value
</td>
<td>Procedures (19½ marks)

Plan to attend an inventory count:

evaluate and test the controls over procedures
perform two-way test counts of inventory
identify slow-moving or obsolete items
obtain details of the last goods delivery and last despatch records

Follow up inventory count notes:

ensure provision is made for slow-moving or obsolete inventory identified at the count
reconcile inventory at the count date to the year-end figure

Review reports of previous inventory
</td><td></td></tr>
</table>

The standard costing system may be inaccurate and may not reflect up to date costs of components and labour. Production overheads may not reflect the normal level of activity. The inventory system may be recording incorrect balances due to inadequate controls over the interface between inventory and cost accounting systems. Foreign suppliers are paid in local currency and there is the potential for translation errors.	counts, evaluate the level of discrepancies and consider the implications for the reliability of the inventory system • Evaluate and test controls over updates to the cost accounting and inventory systems • Inspect aged-inventory analysis to identify slow-moving or obsolete items • For those items in inventory at the year end, check post year-end selling prices to determine whether net realisable value is less than carrying value • Review after date movements of over-ordered items • Discuss with management the basis of the provision for slow-moving or obsolete inventory: o ensure there is appropriate provision for Partco inventory o obtain written representation that all defective items are identified and written down • Obtain standard cost specifications for each instrument and for a sample of instruments: o discuss with management the basis of costings o agree the cost of components to suppliers' invoices o vouch labour costs to payroll o ascertain the basis of the overhead allocation o ensure the overhead allocation is based on normal levels of activity and that only production overheads are included o agree figures to management accounts o reperform calculations • For a sample of items purchased from overseas suppliers, recalculate the foreign exchange translation and check the rate used to a reliable independent source • Use data analytics to identify items for further investigation, for example, inventory items: o with negative margins (cost greater than selling price) o that are slow moving o with the highest discrepancies at inventory counts o with no recent cost price changes (marks were awarded for any relevant examples of data analytic routines which could be used as an audit procedure).	

General Justification (2 marks)	Procedures (1½ marks)	
This is a first-year audit and it may be difficult to obtain assurance over opening balances. LEL has applied for a bank loan and may seek to window dress the financial statements.	• Review the prior year auditor's working papers • Consider whether audit work in the current year provides evidence as to the reliability of opening balances • Consider whether opening balances reflect the application of appropriate accounting policies	

Answers to this question were of a good standard. Most candidates justified why trade receivables and inventory had been identified as key areas of audit risk and described relevant procedures to be included in the audit plan. Both areas of audit risk were addressed equally well.

A significant proportion of candidates also correctly identified points relating to the fact this was a first-year audit, and therefore the risk associated with opening balances was greater and the review of the audited financial statements by the bank increased the risk of window dressing.

Very few candidates explicitly addressed the requirement to include data analytics routines to address either of the key areas of audit risk.

Trade receivables
Most candidates correctly identified the risk of overstatement of trade receivables and correctly calculated the increase in receivable days, identifying that this was out of line with the client's payment terms. Whilst most candidates identified the specific risk relating to the balance due from REC, few went on to state that this balance was material to the financial statements. The most commonly overlooked justification related to the issues with the quality of components which may give rise to disputes with other customers.

Most candidates cited relevant audit procedures including:
- review of the aged receivables analysis for overdue balances
- inspection of correspondence for evidence of disputes
- obtaining evidence of amounts received after the year end
- direct confirmation of balances with customers
- review of post year end credit notes and ascertaining the basis and reasonableness of the year end allowance.

The most commonly overlooked procedures were:
- assessing the financial position of key customers
- inspecting contracts to ascertain if credit terms had changed
- vouching entries in the sales ledger with despatch documentation.

A significant number of candidates incorrectly identified translation errors relating to the sale of instruments around the world. This was not relevant as the scenario stated that the company invoiced its customers in sterling.

Some candidates suggested one appropriate data analytics routine to produce the aged receivables analysis. However, few other variations of data analytics routines were identified and many candidates failed to state any data analytics routines at all.

Inventory
Most candidates correctly identified the risk of overstatement and correctly calculated the increase in inventory days. Relevant justifications relating to the risk of obsolete inventory were also commonly identified, including:
- the quality issues with components
- the annual update of the product range
- over purchasing by the chief buyer
- translations errors due to purchases in foreign currencies
- the integration between the costing and inventory systems.

The most commonly overlooked justification related to the increase in the gross margin being inconsistent with the higher prices charged by the new supplier.

Procedures relating to inventory was the least well answered of this part of the question. Several candidates incorrectly questioned the client's use of a perpetual inventory system and inappropriately recommended the firm carried out a full year-end count or insisted on the client doing so. Where candidates correctly recommended attendance at inventory counts during the year they then generally earned the marks relating to the procedures that would be carried out during the firm's attendance such as observing the count procedures, performing two-way test counts and identifying slow-moving or damaged inventory. Fewer candidates earned the marks available for following up on the inventory count notes or performing a reconciliation between the inventory at the count date and the year end.

Other commonly correctly cited procedures included:

- reviewing post year-end selling prices
- reviewing the aged inventory analysis for slow-moving items
- ascertaining the basis for writing down inventory, including that in relation to inventory purchased from the supplier with quality issues.

Few candidates earned the marks available for considering the movement of over-ordered items post year end or obtaining a written representation from management that all defective items had been written down.

Except for reperforming foreign currency translations and checking the rates used to a reliable external source, few candidates earned the marks available for procedures relating to the cost accounting system. Stronger candidates correctly cited agreeing the cost of components to purchase invoices and labour costs to payroll or timesheets. However, few candidates earned the marks relating to calculation of production overheads.

As with trade receivables, few candidates identified specific data analytic routines except for a minority of stronger candidates who correctly cited comparison of the cost of instruments to their selling price.

Total possible marks	50½
Maximum full marks	21

7.3 For each internal control deficiency listed as (a) and (b) in the scenario, draft points for inclusion in your firm's report to those charged with governance and management at LEL. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address it.		**Marks**
Catalogue update **Consequences (3½ marks)** The sales staff may: • misunderstand the oral instructions • input incorrect prices • make unauthorised amendments. Instruments may be sold at sub-optimal prices leading to lower profits and an adverse effect on cash flow. Instruments maybe overpriced leading to loss of customer goodwill and reduced demand for LEL's products.	**Recommendations (3 marks)** • All amendments to be recorded on a standard form • The standard form should be signed by the sales director • A printout of amendments to be obtained and checked to the standard form and the printout should be signed as evidence of review • Periodic checking of all prices to the authorised price list	
Bribery prevention policies **Consequences (5½ marks)** The Bribery Act 2010 makes bribery or failing to prevent bribery a criminal offence. The Bribery Act is global in scope and holds the company responsible for the actions of its employees. The company is liable if employees or persons associated with the company offer, accept or bribe a foreign public official. The absence of policies means that employees may offer or accept bribes without realising the consequences or do not	**Recommendations (6 marks)** • Document and implement bribery prevention policies • Introduce a whistle-blowing policy and procedures for reporting bribery • Appoint a designated person responsible for compliance • The bribery policies should be communicated to all employees • Policies should be based on Government (Ministry of Justice)	

know what to do if they suspect bribery. The penalties for bribery or failing to prevent bribery are severe and include fines and imprisonment. The financial results of the company may be adversely affected. There could be additional expenses arising through the: • payment of bribes • cost of any fines or penalties imposed by the authorities • cost of legal fees to resolve any bribery issues. There may be regulatory investigations and adverse publicity leading to a reduction in sales. Ultimately, the going concern status may be threatened as the company may have its licence to trade revoked. Furthermore, external auditors have a duty to report suspicions of bribery to the National Crime Agency as required by the Proceeds of Crime Act.	guidelines which set out the following principles: ○ proportionate procedures to mitigate risks ○ top level commitment/anti-bribery culture ○ risk assessment to identify bribery ○ due diligence procedures ○ embedded culture of bribery prevention ○ making improvements to procedures when necessary.	

Answers to this question were of a mixed standard although candidates tended to perform better when outlining the consequences of each internal control deficiency compared with the recommendations to address them.

Amending prices in the online catalogue
Most candidates correctly identified that amending prices on the oral authority of the sales director might result in errors in pricing with customers being either over or under-charged and a subsequent negative impact on profit, cash flow and customer goodwill.

Most candidates correctly recommended that written authority should be obtained for any changes to catalogue prices. However, fewer candidates earned the marks available for extending their recommendations to include regular printouts of amendments, checking to the written authority and signing the printout as evidence that the review had taken place.

Bribery prevention policy
Most candidates correctly identified that the absence of a bribery prevention policy contravened the Bribery Act 2010 and increased the risk that bribery might take place. Most also went on to explain relevant consequences such as:

- regulatory investigation
- fines
- adverse impact on the company's reputation
- negative impact on profit and cash flow
- going concern risk.

Fewer candidates earned the marks for stating that:

- the Bribery Act 2010 is global in scope
- the company is responsible for the actions of its employees
- the auditors have a duty to report suspicions of bribery to the NCA under the Proceeds of Crime Act.

Most candidates earned marks for relevant recommendations such as documenting a bribery prevention policy, including whistle-blowing procedures, that should be communicated to all employees.

The recommendations most commonly overlooked were:
- appointing a compliance officer
- Ministry of Justice guidelines.

Total possible marks	18
Maximum full marks	9

7.4 **Explain the ethical issues arising in respect of the offer of the free use of a private box at a premier league football match and paid travel and hotel costs.**	**Marks**
There is a self-interest threat to objectivity and independence as the audit team may comply with the managing director's wishes to benefit from the hospitality offered. The offer is not trivial or inconsequential and is likely to be considered excessive by an independent third party.	2
There is a possible intimidation threat if the managing director exerts pressure on the audit team. The offer may represent an inducement and raises question over management integrity.	2
There is a threat to professional competence and due care and professional behaviour as the audit quality may be compromised to meet the deadline. Insufficient audit evidence may be obtained and an inappropriate opinion may be reached if a material misstatement is not highlighted.	3

Answers to this question were of a mixed standard although many candidates scored maximum marks. Most candidates correctly identified and explained the self-interest threat to objectivity as well as the fact that the offer may represent an inducement by the managing director which raised questions about management integrity.
A significant number of candidates also correctly identified the threat to professional competence and due care if the audit work was rushed and an inappropriate opinion issued because of the managing director exerting pressure on the audit team. Fewer candidates stated that insufficient audit evidence might be obtained.
Few candidates earned the marks for identifying that there was a risk of unprofessional behaviour which might discredit the profession. A significant number of candidates wasted time by stating the actions that the firm could take in response to the threats which was not required.

Total possible marks	7
Maximum full marks	4

Question 8

Total Marks: 20

General comments The average mark for this question was the lowest on the long-form questions. A number of candidates submitted very brief answers.	
8.1 Draft a response to Arnie which: **(a) lists the general representations that should be obtained from management as part of the assurance work on the cash flow forecasts and explains why such representations are required; and** (b) **explains the term moderate assurance and why a higher level of assurance cannot be provided as to whether the assumptions provide a reasonable basis for the preparation of the cash flow forecasts.**	**Marks**
(i) General representations The general representations that should be obtained are:	
The intended use of the forecast This is to ensure that the audit firm is aware of all users of the forecast and that there are no unforeseen users which could impact on the risk associated with the engagement. This representation reduces the extent of the reporting accountant's liability and exposure to claims for damages.	3½
The completeness of significant management assumptions Knowledge of the assumptions used to compile the forecast is largely confined to management. The reporting accountant cannot undertake the examination of the forecast unless all assumptions are adequately disclosed. The reporting accountant reports on the 'reasonableness' of assumptions and therefore needs confirmation, via a representation, that they are complete.	3½
Management's acceptance of its responsibility for the forecast The reporting accountant is not responsible for preparation of the forecast and is only responsible for examining and providing an assurance report on the forecast. This representation reduces the expectation gap i.e. any misunderstandings regarding the responsibilities of the respective parties.	2½
(ii) Moderate assurance A report on the examination of the cash flow forecast is a limited assurance engagement which provides moderate assurance as to the credibility of the financial information. Engagement risk is reduced to a level that is acceptable in the circumstances. The conclusion is expressed negatively in the form of "nothing has come to our attention that causes us to believe that the assumptions do not provide a reasonable basis for the cash flow forecast ……."	2
The examination of the cash flow forecast is based on assumptions and judgments about the future which are subject to uncertainty. Procedures used in the examination are restricted due to the lack of corroborative evidence about future events. For a higher level of assurance to be provided, a greater degree of verification and corroboration of the financial information would be required.	4
Answers to part (i) were disappointing. Candidates who were familiar with the contents of paragraph 25 of ISAE 3400 The examination of prospective financial information, often scored full marks as once they listed the required representations they demonstrated an understanding of why they were needed, particularly in respect of limiting the reporting accountant's liability and reducing the expectation gap. Weaker candidates answered in terms of the role of written representations in a statutory audit of financial statements or an engagement to review historical financial statements, instead of the examination of prospective financial information. Consequently, they listed the requirements of ISA 580 Written representations or paragraph 62 of ISRE 2400 Engagements to review historical financial statements for which no marks were awarded. Several candidates provided representations that were specific to the scenario. These answers scored no marks as the requirement was to list general representations.	

Part (ii) was well answered by most candidates who attempted this part of the question. Most candidates were able to explain the term moderate assurance and scored further marks for explaining why a higher level of assurance could not be provided. The points most commonly overlooked were those relating to engagement risk and the fact that forecasts were subject to uncertainty. Some candidates strayed into discussing reasonable assurance and the nature of testing, such as controls testing and tests of details that would be needed to achieve this.	
Total possible marks Maximum full marks	15½ 8

8.2 For the items listed (1) to (6) in the scenario, identify the specific matters you would consider when reviewing the reasonableness of the assumptions underlying each receipt or payment.	**Marks**
(1) Receipts from ticket sales	
Receipts from ticket sales should reflect the number of operational cinemas, as follows: • To June 2018, there are 22 cinemas • From July to December 2018, there are 20 cinemas (two cinemas are closed for sale) • In 2019, there are 10 unconverted cinemas (ten cinemas are closed for conversion) • In 2020, there are 10 converted cinemas (ten converted cinemas are operational but the remaining ten cinemas are closed for conversion) • In 2021, there are 20 converted cinemas.	2½
Receipts therefore decline until the end of 2019 and start increasing in 2020.	
The receipts should reflect that tickets prices increase by 10% and the number of seats increase by 5% on completion of the conversions.	1
The level of occupancy of cinemas should be considered taking into account the capacity of each cinema before and after conversion, market trends and any variations from city to city. Market research reports should be inspected. Proof in total calculations, for example using number of seats, occupancy levels and price of tickets will provide added assurance.	2½
(2) Payments for the conversion of cinemas, new seating and project management fees	
Payments for the conversion of cinemas should be based on the tenders received, which should be inspected. The payments should commence in January 2019 with the profile of the payments as set out in the tenders and should reflect any retentions (payments held back until a later date for any rectification work required).	2
Enquiries should be made of the directors as to how they arrived at the estimate of £150 for the cost of each cinema seat. The estimate should be compared to suppliers' price lists or quotes obtained for the new seating. The number of seats should be consistent with plans for the capacity of each cinema.	1½
The project management payments should be either fixed fee or a percentage of building costs and should be in line with market rates or the letter of engagement with Monroe and Co, if available.	1
(3) Proceeds from the sale of the two cinemas	
This should be a prudent estimate and in line with the market value of properties in the locality of each cinema. The estimate should be checked to a valuer's report, if available. Correspondence with the developer should be inspected for evidence of the likelihood that the sales will take place and any indication of the sales value and whether the sales are contingent on obtaining planning permission. The planning permission application to change the use from cinema to residential should be inspected as this will affect the market value if the planning application is successful. If the sale is contingent on obtaining planning permission and the proposed deal collapses, the ability to find another buyer should be	5½

considered. The forecast should reflect the timescales involved in obtaining planning permission. There should be consideration of whether the proceeds could be a lump sum or by instalments and should be net of selling costs.	
(4) Payments to the film distribution company	
The amounts in the cash flow forecast should reflect the level of ticket sales as shown in the profit forecast. The percentage fee should be as per the agreement with the film distribution company or market rates. The payments should reflect the three-month rent-free period followed by monthly payments in arrears.	2
(5) Payments to employees	
The amounts in the cash flow forecast should be consistent with the number of cinemas in use and reflect an increase of 60 employees in each year after conversions are complete (six extra employees in each of the ten cinemas converted). The cash flow forecast should include redundancy payments on closure of the cinemas for conversion and the sale of two cinemas. The minimum wage levels and statutory increases each year should be confirmed with government pronouncements. The profit forecast should be examined to see that bonuses shown in the cash flow forecast are consistent with the level of forecast profits.	3
(6) Receipts from and payments to the bank	
The amount of the loan should be sufficient to fund the conversion of the cinemas into multiplexes and allow the company to pay its debts as they fall due while staying within any overdraft facility. The receipt should precede the start of the building work.	1½
Prudent assumptions should be made regarding interest payments, for example, in line with market rates or consistent with those cited in any correspondence with the bank and should be based on the principal outstanding. Loan repayments should be consistent with those cited in any correspondence with the bank.	2
General	
The assumptions should take account of inflation and key variables should be subjected to sensitivity analysis.	1

Answers to this part of the question were disappointing and many candidates provided very brief answers that scored few marks or failed to provide any answer in one or more of the six sections. The consideration of the reasonableness of assumptions in assurance engagements has been identified by examiners in previous commentaries as an area where candidates struggle.

The following points were commonly overlooked:

- consideration of occupancy levels at cinemas
- payment profile for the cost of conversions
- examination of the correspondence with the developers
- inspection of the planning permission documentation
- consideration of redundancy payments
- whether the loan would be received prior to the conversions or if it would be sufficient to fund the conversions.

Most candidates failed to consider inflation and sensitivity analysis in their answers.

Many weaker candidates approached the question from the perspective of the firm conducting a financial statements audit, instead of consideration of the reasonableness of assumptions underlying receipts and payments in a cash flow forecast. For example, candidates discussed issues such as:

- the internal controls in operation for ticket sales and payroll
- agreeing ticket sales receipts to bank statements or till records
- the risk of fraud when ticket sales are in cash
- the review of timesheets
- the risks associated with the manipulation of the profit forecast to ensure the bonus is paid.
- the review of bank statements and bank reconciliations.

None of these points was relevant to the answer.

A large number of candidates digressed into whether the points described in the scenario were valid, for example was it feasible to convert 10 cinemas a year or whether a film distribution company would allow a rent-free period of three months. Candidates also digressed into areas that were not part of the requirement, for example, the payment of running costs and the payment of taxes and dividends.

Weaker candidates confused a cash flow forecast with a profit forecast and incorrectly discussed items such as depreciation and profit or loss on the disposal of the two cinemas. This matter has also been identified in previous examiners' commentaries on questions concerning the examination of cash flow forecasts.

The points commonly identified by stronger candidates were the:

- increase in ticket prices and the number of seats following conversions
- timeframe for the payments
- review of contract tenders
- comparison of the costs of seating to supplier's price lists
- market value of properties in the locality of each cinema to be sold
- payments to the film distribution company should reflect the level of ticket sales with payment in arrears and include a three month rent-free period
- payment to employees should be consistent with the number of operational cinemas.

Total possible marks	25½
Maximum full marks	12

Question 9

Total Marks: 20

General comments
Answers to this question attained the second highest overall average mark on the long-form questions. However there were a number of weak answers to both parts of the question.

9.1 For each of the situations described above, explain the implications, if any, for the auditor's report.	**Marks**
Foyle There will be no modification to the audit opinion. The loss of £0.2million cannot be offset against profits on other contracts and a provision therefore should be made. However, the loss is not material as it is only 2.06% of profit before tax and 0.24% of total assets. Even if the directors refuse to amend the financial statements in respect of the misstatement, the audit opinion will not be modified.	3
Ogmore As the disclosures in the financial statements regarding this matter are adequate, there is no material misstatement or limitation on scope. However, the firm has concluded that there are significant doubts as to whether Ogmore can continue as a going concern. Therefore, a modified auditor's report with an unmodified opinion will be issued. A paragraph headed 'Material Uncertainty related to Going Concern' will be included immediately after the opinion section. This should draw users' attention to the matter disclosed in the financial statements as the issue is fundamental to users' understanding of the financial statements. A statement that the opinion is not modified in respect of the uncertainty should be included.	4
Pattack A modified opinion should be issued which should be a qualified ("except for") opinion. As the managing director refuses to disclose the transaction there is a material misstatement. The amount of the transaction is not material by size as it is only 3.54% of profit before tax and 0.45% of gross assets. However, it is material by nature as it is a related party transaction because Clyde Ltd is owned by the brother of the managing director. It is not pervasive as it is confined to a specific item in the financial statements and is not fundamental to the users' understanding of the financial statements. There should be an explanation of the issue (reason and amount involved) in the "basis for qualified opinion'' section of the audit report.	6
Tyne The audit report should disclose that the firm has taken advantage of the exemptions of the Provisions Available for Small Entities and that a former engagement partner has joined Tyne, unless the matter is disclosed in the financial statements. The disclosure should be set out in a separate paragraph. However, the matter does not affect the audit opinion which remains unmodified.	3

Answers to this part of the question were of a mixed standard. There were some excellent answers in respect of the first three scenarios with many candidates scoring maximum marks. Candidates were less confident dealing with the final scenario and some candidates did not attempt this scenario. However, disappointingly, a significant minority of candidates demonstrated only limited understanding of the implications for audit reports in each of the scenarios. These candidates wasted time by listing a number of different answers in the hope that one or other of their answers was correct. These candidates often failed to perform any materiality calculations, or if they were attempted, reached an incorrect conclusion as to whether an item was material.

Foyle
This part of the question was generally well answered with many candidates scoring maximum or close to maximum marks. The point most commonly overlooked was that a provision should be made for the loss. Disappointingly, several candidates having correctly calculated the percentage effect of the loss on profit before tax and total assets decided that the matter was material and therefore concluded, incorrectly, that a modified report was required.

Ogmore
This part of the question was generally well answered. However, there were some very brief answers to this part of the question. Most candidates correctly identified that the opinion should be unmodified. However, a minority failed to consider the use of a paragraph headed 'Material Uncertainty related to Going Concern' to direct the users' attention to the note in the financial statements. In addition, many candidates failed to point out that the uncertainty surrounding going concern was fundamental to the users' understanding of the financial statements.

Weaker candidates strayed beyond the requirement and wrote at length about the implications for the financial statements and the auditor's report if the audited entity was not a going concern. These candidates failed to appreciate that the financial statements are still prepared on the going concern basis even if there is an uncertainty about the going concern status.

Pattack
Most candidates identified that the scenario represented the non-disclosure of a related party transaction (RPT) and that the RPT was material by nature but not by size. Stronger candidates identified that the matter was not pervasive and reached a correct conclusion on whether or not the opinion should be modified. Weaker candidates hedged their answers and discussed the possibility of the issue being pervasive, thereby demonstrating a lack of understanding of what constitutes a pervasive issue. A number of candidates having correctly calculated the materiality percentages, incorrectly concluded that the matter was material by size.

Tyne
Answers to this part of the question were generally disappointing. Candidates that were familiar with paragraphs 6.15 to 6.17 of the FRC Ethical Standard or paragraph 3.16 of Chapter 4 in the 2017 Audit and Assurance study manual scored maximum marks. Most candidates, who attempted this part of the question, scored some marks by stating that the matter should be disclosed in the audit report and that the opinion should be unmodified. Weaker candidates incorrectly stated that the audit opinion should be qualified or that the firm should not offer any opinion as an audit was not required or that the firm should resign as auditors. Several candidates digressed into the ethical threats associated with engagement partners joining audit firms which was not required.

Total possible marks Maximum full marks	16 12

	Marks
9.2 (a) Identify the parties to whom your firm may be liable for damages if an inappropriate audit opinion is issued. **(b) Outline the methods available to your firm to limit its liability to such parties.** **(c) Outline the quality control procedures your firm should implement to reduce the risk of issuing an inappropriate audit opinion.**	
Parties to whom your firm may be liable for damages The firm may be subject to professional negligence claims from the audited entity and its shareholders and/or third parties where it can be demonstrated that the auditor owed the party a duty of care, such as the company's bankers.	2
Methods available to your firm to limit its liability The firm could agree a liability cap which would stipulate the maximum amount payable in damages, such as a fixed amount or based on a formula, eg. a multiple of the audit fee. The liability cap must be fair and reasonable and approved by the shareholders. A proportional liability agreement could be set up whereby there is an agreement to apportion blame between the guilty parties. The firm may be protected by the inclusion of a disclaimer of liability (a Bannerman clause) in the audit report stating that the report is prepared for the company's members and no other party. Trading as a LLP (limited liability partnership) means that liability is limited to assets in the partnership and there is no individual responsibility for the actions of other partners.	6
Quality control procedures The firm should have robust procedures to ensure competent employees are recruited and subsequently trained.	1

The firm should allocate competent and experienced staff to each engagement team. Junior members of the team should be adequately briefed, prior to starting their work, and supervised throughout the audit. All team members' work should be subject to a review by a more senior member of the team. Consultation should take place on contentious issues and all such matters, including their resolution, should be documented.	2½
An engagement quality control review (EQCR) should be performed on audits of all listed companies and other audits where audit risk is considered higher than normal.	1½
The firm should undertake due diligence procedures, including the assessment of management's integrity, prior to accepting new clients and deciding whether to continue with existing clients.	1

Answers to parts (a) and (b) were generally of a higher standard than part (c).

Parties to whom your firm may be liable for damages
There were some good answers to this part of the question with many candidates scoring maximum marks. Most candidates correctly identified that the firm may be liable to the shareholders and the bank. Several candidates incorrectly stated that the audit firm would be liable to third parties who relied on the auditor's report. Audit firms are only liable where it can be demonstrated that the auditor owed the party a duty of care. Some candidates incorrectly cited that a duty was owed to organisations such as the Financial Reporting Council and the ICAEW.

Methods available to your firm to limit its liability
Most candidates correctly identified relevant methods of limiting liability such as liability caps, disclaimer of liability in the audit report and limited liability partnerships. Several candidates stated that the disclaimer of liability should be included in the firm's engagement letter. This earned no mark as the parties in question would not have access to the engagement letter. A significant minority of candidates failed to mention that the liability cap could be a fixed amount or based on a formula. Most candidates identified trading as a LLP but lost marks as they did not explain that liability is limited to assets in the partnership and there is no individual responsibility for the actions of other partners.

Quality control procedures
Answers to this part of the question were of a mixed standard. Most candidates identified review procedures including the use of an EQCR but did not expand their answers, for example, to explain that and EQCR should be performed on audits of all listed companies and other audits where audit risk is considered higher than normal. Few candidates identified due diligence or the consideration of management's integrity as a quality control procedure.

Total possible marks	14
Maximum full marks	8