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 higher than the December 2017 but lower than the other three sittings in 2018. Answers to question 1.1, 1.3 and 1.4 of the short-form questions (SFQs) and question 2.2 on the justification of audit risks and audit procedures were of a good standard. Answers to question 3.2 were disappointing as many candidates were unable to identify the deficiencies in an audit test of trade receivables balances. A large number of candidates did not recognise the money laundering scenario presented in question 1.6. It was disappointing to note that a significant minority of candidates disregarded the instruction on the front sheet of the exam and examiners' feedback on previous sessions and wrote lengthy answers to SFQs. There was some evidence that candidates had not adequately managed their time across the paper as there were some very brief or no responses to some questions, particularly parts of questions 1, 3 and 4.

Question 1.1

Total Marks: 2

Whether explanations for an improvement in the current ratio are plausible	Marks

(a) Refinancing
• plausible explanation
    o restructuring the loan would result in a reduction in current liabilities (denominator in the current ratio)
(b) Sale of freehold store
• plausible explanation
    o disposal of the non-current asset for cash would result in an increase in current assets (numerator in the current ratio).	

Full marks were awarded to those candidates who demonstrated an understanding that: • restructuring the loan would result in a reduction in current liabilities and consequently an increase in the ratio; and • disposal of the non-current asset for cash would result in an increase in current assets and consequently an increase in the ratio. The restructuring proved to be the more challenging part of the question. Weaker candidates failed to demonstrate an understanding that only part of the loan would be a current liability thereby significantly reducing the denominator in the ratio. A significant minority of candidates did not attempt this question.	
Total possible marks	3
Maximum full marks (½ mark per conclusion) (1 mark for full explanation)	2

Question 1.2

Total Marks: 4

Why the matter should be considered	Marks

• damages could be payable
    o may be material
    o may not be reflected in the financial statements
    o if probable
        ▪ provision required
    o if possible
        ▪ disclosure as a contingent liability	

• implications for management integrity/control environment • may affect going concern status • modified report may be required.	
Answers to this question were of a mixed standard. Those candidates who focused on the implications for the financial statements scored well on this question. The points most commonly identified were those relating to the possibility/probability of damages crystallising, the related accounting treatment, going concern risk and implications for the audit report. The point most commonly overlooked was that relating to management integrity. The most common misunderstanding was to assume that both companies were clients of the audit firm and, consequently, these candidates wasted time discussing a non-existent conflict of interest and listing the safeguards to be implemented to address this conflict. There was no indication in the scenario that Klingon was a client of the audit firm.	
Total possible marks Maximum full marks (½ mark for each point under damages) (1 mark for other points)	6½ 4

Question 1.3

Total Marks: 4

Differences between the conclusion expressed following an examination of prospective financial information and the opinion expressed in an audit report	**Marks**

Conclusion
• expressed negatively/'nothing has come to our attention……….'
• assumptions do not provide a reasonable basis for the forecast
• opinion that the forecast is properly prepared on the basis of the assumptions
Opinion
• expressed positively/true and fair view
• properly prepared in accordance with CA06
• opinion on consistency of information in directors'/strategic report with the financial statements
• matters to report by exception
Reasons for the differences
• examination provides limited/moderate assurance
• audit provides reasonable assurance
• examination defined by management/ISAE 3400
• audit defined by law/CA06/ISAs
• examination is on assumptions about the future
    o which are subject to uncertainty
• audit is on historical information
    o which can be verified to a greater degree
• examination reduces risk to a level that is acceptable
• audit reduces risk to an acceptably low level.	

Answers to this question were generally good with many candidates scoring maximum marks. The majority of candidates adequately described the differences between a conclusion expressed in an assurance report on forecast information and the opinion expressed in an audit report on financial statements. However, the reasons for the differences proved more challenging for some candidates. Strong candidates appreciated that prospective financial information is based on estimates and subject to uncertainty whereas financial statements are primarily based on historical data and can be verified to a greater degree. The points most commonly overlooked in respect of the conclusion on the forecast information were those relating to the assumptions as a basis for the forecast and the preparation of the forecast on the basis of the assumptions. The point most commonly overlooked in respect of the reasons for the differences were those relating to the level of risk. A significant number of candidates confused the examination of forecast information with a review of financial information. These candidates often incorrectly cited, as an example of negative expression of assurance, the wording that is used in the conclusion expressed following the review of historical financial statements or interim financial information.	
Total possible marks Maximum full marks (½ mark per point)	8½ 4

Question 1.4

Total Marks: 4

Implications for the auditor's report on financial statements	**Marks**

• material
    o 15.0% of profit before tax
    o 2.6% of total assets
• modify opinion
• qualified/except for opinion
• limitation on scope/unable to obtain sufficient appropriate evidence
• not pervasive
    o confined to specific element of the financial statements
• basis of qualified opinion paragraph
    o reasons for modification/qualification
    o immediately after the opinion section
• report by exception
    o not able to obtain all information necessary for the audit.	

It was pleasing to note that many candidates scored full marks on this question. Marks were commonly awarded for materiality calculations, limitation on scope and qualified opinion. The point most commonly overlooked was that relating to the matter to be reported on by exception. A small minority of candidates incorrectly concluded that a disclaimer of opinion should be expressed because the limitation on scope was imposed by management. These candidates failed to appreciate that at 2.6% of total assets, the amount did not represent a substantial proportion of the financial statements and, consequently, was not pervasive.	
Total possible marks Maximum full marks (½ mark per point)	6½ 4

Question 1.5

Total Marks: 3

Responsibilities of the ethics partner	**Marks**

• firm's policies and procedures regarding integrity, objectivity and independence
• firm's compliance with the FRC Ethical Standard (ES)
• communication of ethical matters to partners and employees
• ethical guidance to partners and employees
    o where difficult and objective judgement needs to be made
• ensuring policies and procedures are properly covered in training
• assessing implications of any breach of ES
• determining whether any safeguards can be put in place
    o or whether there is a need to resign from an engagement.	

This question was generally well answered as most candidates were familiar with the contents of paragraph 1.13 of the ES and consequently provided a range points – the most popular of which were those relating to policies, training, guidance and safeguards. The points most commonly overlooked were those relating to assessing the implications of any breach of the ES and considering whether there is a need to resign from an engagement. A tiny minority of candidates confused the role of the ethics partner with that of an engagement quality control reviewer.	
Total possible marks Maximum full marks (½ mark per point)	4½ 3

Question 1.6

Total Marks: 3

<table>
<tr><th>Actions to take, with reasons</th><th>Marks</th></tr>
<tr><td>
report to money laundering reporting officer (MLRO) within the firm
MLRO to report to National Crime Agency

represents proceeds of crime
no de minimis limit with money laundering
revenue 0.095 of 1%, profit 1.17%, not material by size

do not tip off

as this might prejudice legal proceedings

tipping off and failure to report money laundering are criminal offences
consider impact on other areas of the financial statements
reconsider assessment of management’s integrity.
</td><td></td></tr>
<tr><td colspan="2">Answers to this question were particularly disappointing with a number of candidates not submitting an answer. Those candidates who identified that the circumstances represented potential tax evasion/money laundering generally scored well on this question because they then proceeded to list the reporting and tipping off requirements. The points most commonly overlooked were those relating to the fact that there is no de minimis where money laundering is concerned, management integrity and the impact on other areas of the financial statements. A significant number of candidates failed to identify the money laundering implications and consequently were unable to benefit from the marks available for money laundering issues. However, most of these candidates did score a half mark for the materiality calculations.</td></tr>
<tr><td>Total possible marks
Maximum full marks (½ mark per point)</td><td>5
3</td></tr>
</table>

Question 2

Total Marks: 30

General comments
Answers to this question attained the highest overall average mark on the long-form questions. This was due to strong answers to both parts of the question.

2.1 Identify and explain the matters that your firm should have considered before accepting appointment as external auditor of Dragon.	**Marks**
Reasons why the previous auditor resigned and whether management gave permission to approach previous auditors • this may indicate disagreements with management, unpaid fees, illegal acts or a limitation on scope of the audit	2½ marks
Availability of staff resources, in particular • sufficient personnel and geographic coverage to perform the external audit competently • access to an engagement quality control reviewer	1½ marks
Availability of expertise, in particular access to personnel with • e-commerce skills • knowledge of requirements relevant to listed entities	1½ marks
Whether an appropriate audit opinion can be reached in the time available • the audit requires sign off by 31 December 2018 to meet the bank deadline	1 mark
Ethical issues • any threats to objectivity and independence • potential conflicts of interest or confidentiality issues as the firm already acts for competing clients in the same industry	2½ marks
Ability to implement safeguards • information barriers to protect against confidentiality breaches if acting for competing clients	1 mark
Whether the overall level of risk associated with the external audit is acceptable • as a new client, the firm lacks cumulative audit knowledge of Dragon and its directors • possible duty of care to the bank • going concern risk	2 marks
Management's integrity • bank reliance increases the risk of fraudulent reporting • adverse publicity may indicate a lack of management integrity • there may be a risk to the firm's reputation from association with Dragon • the results of background checks on management and the risk of money laundering	3 marks
Whether the engagement is commercially viable.	½ mark
Answers to this part of the question were generally of a good standard. Candidates were able to identify and explain a number of relevant matters that should have been considered by the audit firm prior to accepting appointment as external auditor. The most commonly cited matters were in relation to the: • reasons for the previous auditor's resignation • firm's level of expertise and ability to resource the engagement • level of risk in relation to reliance by the bank on the audited financial statements • going concern issues. The most commonly overlooked matters were: • whether an opinion could be reached in the time available • issues related to potential conflicts of interest and confidentiality • whether the firm would be able to implement effective safeguards • risks to the firm's reputation • the results of background checks • whether the engagement was likely to be commercially viable. Those candidates who scored low marks on this part of the question tended to restrict their answers to resourcing issues and professional clearance – often writing at length about the latter issue.	
Total possible marks Maximum full marks	15½ 7

2.2 Justify why volume-based supplier rebates and non-current assets have been identified as key areas of audit risk and, for each key area, describe the procedures that should be included in the audit plan to address those risks. You should present your answer using the following subheadings: • Volume-based supplier rebates • Non-current assets - delivery vehicles • Non-current assets - freehold distribution centres.	Marks

Volume-based supplier rebates
Justification (8½ marks)

This is a complex area with 100 suppliers offering rebate terms ranging from 1% to 10% of purchases under contracts that straddle Dragon's accounting year end. The calculation of rebates involves estimates and judgements.

At 3.8% of revenue the rebates are material. They have increased from 6.6% to 9.2% of cost of sales. This is very close to the upper end of the rebate range, as only principal suppliers offer rebates. All of this suggests a potential overstatement of rebates.

The in-house rebate management system may be unreliable. An earlier version of this system was replaced in September 2018 and data may not have been correctly transferred to the new system.

Procedures (14 marks)

- obtain forecasts used in the calculation of rebates
- reperform calculations
- match details used in the calculations (such as rebate rate, length of contract) to signed supplier contracts
- discuss assumptions used in the forecast with operations managers
- consider reasonableness of the assumptions used
- assess the reliability of forecasts by:
  - comparison with post year-end management accounts
  - comparison of previous rebate estimates with actuals
- compare rebates recognised to post year-end receipts from suppliers
- discuss with the directors the reasons for the increase in supplier rebates in the year
- ascertain if Dragon is using more suppliers with higher rebates
- use data analytics (for example, to identify any suppliers with rebates outside of the range 1% to 10%)
- test controls over the:
  - rebate management system
  - transfer of data to the new system
- obtain management representations regarding the appropriateness of the assumptions used in preparing the sales forecast
- obtain direct confirmation from suppliers of volumes and contract terms.

Non-current assets - delivery vehicles
Justification (6½ marks)

The carrying amount of delivery vehicles has increased by 19.0%. The loss on sale of the delivery vehicles has increased by 80.0% and indicates that useful lives may be too long or the estimate of residual values too high. The carrying values of delivery vehicles may fail to recognise any impairment. The cost and accumulated depreciation on disposals may not be correctly eliminated from the non-current asset register.

The depreciation charge for the year of 7.1% of the net book value of delivery vehicles compared to the previous year of 9.9% seems low. This suggests an understatement of depreciation.

Delivery vehicles may be overstated due to capitalisation of inappropriate employee costs or routine maintenance costs.

Procedures (10 marks)
 	
• obtain a schedule of capitalisation costs and ensure all costs capitalised meet the relevant recognition criteria
• for a sample of additions in the year vouch amounts to the purchase invoice
• vouch employee time/costs to timesheets/payroll records
• in respect of disposals, inspect
    o the non-current asset register to check that delivery vehicles disposed of have been removed from the register
    o disposal documentation
• consider whether every addition has triggered a disposal
• select a sample of delivery vehicles on the asset register and
    o physically inspect
    o confirm delivery vehicles are still in use and not impaired
• confirm with management how residual value is assessed
• recalculate depreciation charge
• inspect evidence of impairment reviews undertaken by management	

Non-current assets - freehold distribution centres
Justification (2 marks)
 	
The distribution centres valuation involves judgement by the valuer.
 	
Revaluation adjustments may not be accounted for or disclosed correctly in the financial statements and depreciation may not be calculated correctly. Depreciation should be based on the building element only (excluding land).
 	
Only half of the distribution centres have been revalued (accounting standards require all properties in the same class to be revalued).
 	
Procedures (11½ marks)
 	
• obtain a copy of the valuer's report
• consider the basis of the valuation and assess its reliability
• consider the valuer's
    o independence and objectivity
    o qualifications
    o experience/expertise
    o reputation/credibility
• compare to the value of other similar properties in the locality
• physically inspect the distribution centres and confirm their condition
• inspect the title documents of the distribution centres
• consider the use of an auditor's expert valuer
• reperform the calculation of the revaluation adjustments and ensure correct accounting treatment
• ensure that depreciation is based on the building element only of the revalued amount
• recalculate depreciation
• inspect the notes to financial statements to ensure appropriate disclosures
• request management to revalue all assets in the class	

General
Justification (1½ marks)

Errors may arise due to:
- misstated opening balances – the firm did not audit the prior year financial statements
- possible window dressing of financial statements due to the bank requiring the audited financial statements in support of the loan application

Procedures (1½ marks)

- review predecessor auditor's working papers
- check balances have been brought forward correctly and consider if further substantive procedures are required

Answers to this part of the question were generally of a good standard. The majority of candidates made a reasonable attempt at addressing all three areas of audit risk identified in the scenario. Many candidates also correctly provided justifications and procedures relating to the fact this was a first-year audit and that opening balances may be misstated, and that the bank's reliance on the financial statements increased the risk of window dressing.

Volume-based supplier rebates
Most candidates correctly identified the risk of overstatement given the significant increase in rebates relative to the increase in cost of sales. Some candidates lost marks by incorrectly comparing the increase in rebates to the increase in revenue, failing to appreciate that rebates would be a function of purchases. Stronger candidates calculated rebates as a percentage of cost of sales and some then went on to earn the additional marks for appreciating that the current year percentage of 9.2% was unrealistically close to the upper end of the rebate range (1-10%).

Most candidates correctly identified factors which made rebates more complex, such as:
- the volume of different rebate schemes
- the range of rebate percentages
- contracts straddling the year end
- the subjectivity associated with the forecasts.

Most candidates also correctly identified that the replacement of the rebate system posed a risk. However, fewer candidates went on to explain that the new system might be unreliable or that data may not have been correctly transferred from the previous system.

Candidates also provided a range of plausible audit procedures. The most commonly cited procedures were:
- evaluating and testing the controls over the new rebate system
- obtaining forecasts and reperforming the rebate calculations
- inspecting rebate contracts and agreeing the rebate rates
- comparing post year-end information such as cash receipts and management accounts to support the estimates included in the financial statements.

Procedures commonly overlooked were:
- testing controls over the transfer of data to the new system
- ascertaining the basis of the assumptions used in the forecasts and considering their reasonableness
- discussing with directors the reasons for the increases, such as using more suppliers with higher rebate percentages
- obtaining a management representation regarding the appropriateness of the assumptions
- obtaining direct confirmation of volumes and rebate terms from suppliers.

Non-current assets – delivery vehicles
Most candidates correctly identified the risk of overstatement and calculated the correct percentage increase in the carrying amount and decrease in the depreciation charge for the year. However, only stronger candidates earned the higher marks available for calculating the effective charge for the current and prior year. Most candidates also correctly identified that the 80% increase in loss on sale might indicate that the useful life of the assets was not reliably estimated. Fewer candidates earned the marks

for identifying that the increase in the loss may also be due to residual values being too high, disposals not being correctly eliminated, or impairments not being fairly reflected. Many candidates also correctly identified that certain costs may be inappropriately capitalised.

Candidates provided a range of relevant audit procedures. Those most commonly cited were:

- checking capitalised costs met the relevant recognition criteria
- vouching additions to invoices and employee costs to payroll records
- physical inspection of delivery vehicles
- confirming the basis for the depreciation policy with management and considering its reasonableness
- reperforming the depreciation calculation.

Procedures most commonly overlooked were:

- ascertaining whether assets were correctly removed from the register on disposal
- inspecting documentation relating to disposals
- inspecting evidence of impairment reviews undertaken by management.

Freehold land and buildings

Most candidates correctly identified that the valuation of the freehold land and buildings involved judgement and a significant number correctly stated that all ten buildings should be revalued. Fewer candidates earned the marks available for stating that revaluation adjustments might not be accounted for correctly or that the depreciation charge should be based only on the building element.

Candidates provided a number of relevant audit procedures. Those most commonly cited were:

- considering the independence, qualifications, experience and reputation of the external valuer
- comparing the valuation to the value of similar properties in the locality
- considering the use of an auditor's expert
- recalculating depreciation.

Procedures commonly overlooked were:

- obtaining a copy of the valuer's report and considering the basis of the valuation
- physically inspecting the condition of the buildings and verifying the title documents
- ascertaining whether depreciation was based on the building element only
- requesting management to revalue all assets in this class
- reperforming the calculation of the revaluation adjustments
- inspecting the notes to the financial statements for the relevant disclosures.

Total possible marks	55½
Maximum full marks	23

Question 3

Total Marks: 28

General comments
The overall average mark on this question was the lowest on the long-form questions. Several candidates did not attempt one or more parts of the question.

<table>
<tr><td>3.1 Explain why issue (1) above was identified by the independent partner and outline the matters that should have been discussed with the audit team at a briefing meeting.</td><td>Marks</td></tr>
<tr><td>Issue 1 - Audit briefing meeting not held

Why identified
It is a requirement of ISA 220 that a briefing meeting is held prior to starting audit fieldwork. The meeting reduces the risk of issuing an inappropriate opinion as it allows juniors the opportunity to raise questions and understand their role in the audit. The issues discussed at the meeting should be documented.

Matters that should have been discussed
• background information about the client and its industry, including any applicable laws and regulations
• relevant ethical requirements including the importance of independence and objectivity
• the importance of professional scepticism
• areas of key audit risk, including any:
    o susceptibility to misstatement due to fraud and how fraud might occur
    o going concern considerations
    o points forward from the prior year
• business risks and how they impact on the financial statements
• objectives of the work to be performed
• how the audit plan addresses the risks identified
• materiality / performance materiality thresholds
• how the audit work is to be assigned to members of the audit team and how to raise issues, arising
• changes in financial reporting requirements
• the timetable for completion of audit work.</td><td>3 marks

7 marks</td></tr>
<tr><td colspan="2">Answers to this part of the question were disappointing. Very few candidates were able to satisfactorily explain why an audit briefing meeting was required. However, most candidates were able to outline some relevant key matters that should be discussed at a briefing meeting. The points most commonly identified were those set out in paragraph A13 of ISA 220 Quality Control for an Audit of Financial Statements including:
• the objectives of the audit work
• the nature of the entity’s business
• risk related issues
• the audit approach and addressing any problems that may arise.

Few candidates mentioned the importance of professional scepticism or the risk of misstatement due to fraud. A number of candidates wasted time by digressing into matters to consider when an engagement team is assigned to an audit, such as the competence and capabilities of the proposed team. A small number of candidates incorrectly outlined the matters to consider when reviewing the work of junior members of an audit team or incorrectly identified the matters to be discussed at a planning meeting with client management. A tiny minority of candidates did not answer this part of the question.</td></tr>
<tr><td>Total possible marks
Maximum full marks</td><td>10
5</td></tr>
</table>

3.2 Explain why issues (2) and (3) above were identified by the independent partner and for each item, list the additional procedures that should have been undertaken by your firm.	Marks
Issue 2 - Direct confirmation of trade receivables	
Why identified Insufficient work has been completed and therefore, the firm is not in a position to form any conclusion on the trade receivable balances. In respect of non-replies, confirming balances to sales invoices is not a reliable procedure, as the sales invoices are internally generated. All items in a sample must be verified, including the balances that individually are not material. Any errors identified must be followed up and reasons for the error identified. When relevant the sample size must be increased and the error extrapolated and transferred to the summary of audit differences. The error of £150,000 when extrapolated is £2.25m which is material. Finally, the incorrect conclusion casts doubt on the adequacy of review procedures.	9 marks
Additional procedures The firm should make further enquiries to understand why the error of £150,000 occurred and extend the sample if needed. In respect of non-replies to the confirmations, alternative procedures must be undertaken such as, agreeing the balance to the billings schedule in the contract or valuations. All immaterial balances in the sample should be verified.	6 marks
Issue 3 - Engagement quality control review (EQCR)	
Why identified It is a requirement of ISA 220 that an EQCR must take place on or before date of the auditor's report for audits of listed clients.	2 marks
Additional procedures An EQCR requires: • discussion of significant matters with the engagement partner • review of financial statements and proposed audit report • review of judgements • evaluation of conclusions • evaluation of the firm's independence • consideration of whether appropriate consultation has been undertaken on contentious matters.	3½ marks

Answers to this part of the question were disappointing. Most candidates struggled to explain the issues around receivables testing in respect of issue (2). Generally, candidates provided better answers in respect of issue (3).

Issue 2 - Direct confirmation of trade receivables
Although much of the audit testing was flawed, many candidates were unable to identify any deficiencies. Most candidates did not identify that agreeing balances to sales invoices provides insufficient audit evidence. Very few candidates noted that any errors identified arising from testing of the sample must be followed up to ascertain the reason for the error and, when relevant, extrapolated and transferred to the summary of audit differences. Very few candidates noted that insufficient work would cast doubt on the adequacy of review procedures. Many candidates incorrectly digressed into discussing materiality levels and whether the sample size was large enough. In respect of the additional procedures, many candidates restricted their answer to identifying that the immaterial items must be verified but often incorrectly concluded that this should be by agreeing to sales invoices for which no marks were awarded.

Issue 3 - Engagement quality control review (EQCR)
Most candidates were able to explain why an EQCR was required. Those candidates familiar with the contents of sections 20/21 and 23 of ISA 220 tended to score well. The points most commonly identified in respect of the EQCR were those relating to significant judgements made and conclusions reached by the audit team. The point most commonly overlooked was that relating to appropriate consultations having taken place.

Total possible marks	20½
Maximum full marks	7

3.3 In respect of issue (4), describe the audit procedures that should have been undertaken to address the going concern risk.	Marks

Issue 4 – Audit procedures to address the going concern risk
 	
The work that should have been undertaken by the audit team is as follows:
 	
• obtained profit and cash flow forecasts for at least one year from the date of the financial statements (per ISA 570) or from the date of approval of the financial statements (per ISA UK 570)
• assessed the assumptions for reasonableness, in particular, the assumptions regarding loan repayments
• performed sensitivity analysis on key components of the forecast such as revenue, exchange rates and interest rates
• reviewed the cash flow forecasts to see if Gremlins
  o can pay its debts as they fall due
  o will comply with bank covenants
• obtained the reorganisation plan and assessed whether profit and cash flow forecasts are consistent with the plan
• obtained written representation from management regarding their future plans and the feasibility of those plans
• ascertained management's contingency plans for alternative sources of finance should the bank overdraft be withdrawn
• inspected bank correspondence for evidence of the banking relationship
• inspected bank covenants and assessed Gremlins' ability to comply with covenants
• reviewed post year-end management accounts and assessed company performance
• reviewed board minutes for evidence of funding issues
• inspected legal correspondence for evidence of claims against the company.
	12 marks

Answers to this part of the question were of a mixed standard. Most candidates identified some relevant procedures to address the going concern risk. Stronger candidates tailored their answers to the scenario such as identifying procedures in respect of loan covenants and the banking relationship. The procedure most commonly overlooked was that relating to sensitivity analysis on key components of the forecast such as revenue, exchange rates and interest rates. A number of candidates made a number of general points such as discussing various modifications to the auditor's report, the importance of professional scepticism, risk assessment procedures and discussing subsequent events in general terms for which no marks were awarded.	
Total possible marks Maximum full marks	12 6

3.4 Assuming that your firm should have concluded that Gremlins was not a going concern, state whether you would have modified the audit opinion if the financial statements of Gremlins for the year ended 30 June 2018 were prepared: (a) on a break-up basis with adequate disclosure included in the notes to the financial statements; or (b) on a going concern basis. Give reasons for each conclusion and describe the modifications, if any, to the auditor's report.	Marks
On a break-up basis with adequate disclosure An unmodified audit opinion should have been issued. There is no misstatement as appropriate disclosures have been made and no limitation on scope as sufficient evidence is available. The use of the break-up basis of accounts preparation is fundamental to the user's understanding of the financial statements and therefore, the audit report should be modified to include an "emphasis of matter" paragraph after the opinion section. It should draw users' attention to the disclosures in the notes to the financial statements and state that the opinion is not modified in respect of this matter.	4½ marks

On a going concern basis A modified audit opinion should have been issued. There are misstatements as the financial statements have been incorrectly prepared on a going concern basis. The matter is material and pervasive as it is not confined to specific elements of the financial statements. An adverse opinion should be issued. A paragraph describing the matter giving rise to the modification should be included, after the opinion section, and headed “basis for adverse opinion”.	4 marks

Answers to this part of the question were generally of a good standard. Weaker candidates gave short answers with insufficient detail.

On a break-up basis with adequate disclosure
Most candidates correctly identified that the opinion should be unmodified and identified that an ‘emphasis of matter’ paragraph was required in accordance with paragraph A27 of ISA 570 and ISA 706. The points most commonly overlooked were those relating to the positioning of the “emphasis of matter” paragraph and that this paragraph should state that the opinion is not modified in respect of this matter. A number of candidates recommended modifying the auditor’s report with a paragraph headed “Material Uncertainty Related to Going Concern”. These candidates did not appreciate that the financial statements were prepared on the break-up basis and the directors had therefore agreed that the company was no longer a going concern and had made adequate disclosures. A small number of candidates incorrectly stated that there should be an 'unmodified report, but modified opinion'.

On a going concern basis
A significant number of candidates correctly identified that the matter was material and pervasive as it is not confined to specific elements of the financial statements and that an adverse opinion should be issued. These candidates then scored extra marks for stating that a paragraph describing the matter giving rise to the modification should be included, headed “basis for adverse opinion”. The point most commonly overlooked was that the basis for adverse opinion paragraph should follow the opinion section. Weaker candidates wasted time hedging their bets by stating that the opinion could either be qualified or adverse depending on whether the misstatement was pervasive. Several candidates incorrectly stated that a disclaimer of opinion should be given. A number of candidates incorrectly stated that there should be a report by exception that not all information and explanations had been provided.

Total possible marks Maximum full marks	8½ 6

3.5 List the possible consequences for your firm if an inappropriate auditor’s report had been issued.	**Marks**
The firm may be subject to professional negligence claims from the audited entity and its shareholders and/or third parties (such as the company’s bank) where it can be demonstrated that the auditor owed a duty of care. Although damages awarded against the firm may be covered by professional indemnity insurance, the cost of future insurance will increase.	2½ marks
The firm may be investigated by the regulatory bodies (such as the ICAEW and the FRC), which may result in disciplinary action and penalties including fines or withdrawal of registered auditor status.	2 marks
The adverse publicity associated with legal claims and disciplinary procedures may result in the loss of reputation, clients and key employees. There will be an increase in costs for the firm as a result of greater scrutiny. In extreme cases this could lead to the financial collapse of the firm. Ultimately there could be criminal prosecutions for the partner or the firm where the auditor’s report is deemed to have been issued in a reckless manner.	4 marks

Most candidates answered this part of the question well with many scoring maximum marks. However, some candidates discussed irrelevant issues usually relating to how an audit firm may attempt to mitigate the consequences of issuing an inappropriate auditor’s report, and suggested actions such as the inclusion of a 'Bannerman' paragraph, having indemnity insurance, and setting a liability cap. These points were outside the scope of the question and did not score any marks. The point most commonly overlooked was that the firm could be investigated by the FRC.

Total possible marks Maximum full marks	8½ 4

Question 4

Total Marks: 22

General comments
Answers to this question attained the second highest overall average mark on the long-form questions. Several candidates did not attempt one of more parts of the question. A number of answers were very short, possibly indicating mismanagement of time allocation across the paper.

4.1 For each internal control deficiency listed as (a) and (b) in agenda item (1), outline what should have been included in the report to those charged with governance regarding the possible consequence(s) of the deficiency and the recommendations to address the deficiency.	Marks
(a) No comparison of actual against budgeted costs **Consequences** Cost overruns and projects falling behind schedule will not be identified and result in management remedial action being delayed. There will be customer dissatisfaction and penalty clauses for late completion could be triggered. Work in progress may be overvalued if provisions for losses are not recognised resulting in unreliable management information. This reduces the ability of Yeti to price future contracts on a profitable basis. There will be an adverse impact on cash flow and profitability.	5 marks
Recommendations • comparison of budget against actual to be evidenced by signature • all significant variances to be investigated • progress reports to be prepared for senior management • review of all contracts to identify any additional provisions for losses.	2 marks
(b) Failure to book airfares and hotels through the website **Consequences** There is increased scope for fraud and Yeti may not get the best rates for airfares and hotels. Manual expense claims are inefficient and there could be loss of employee goodwill as the website is not user friendly. Liabilities for airfares and hotels are not known until an expense claim is made. Non-use of the website could leave Yeti exposed to breach of contract and be liable for damages. There will be an adverse impact on cash flow and profitability.	4 marks
Recommendations • investigate why consultants claim that the system is not user friendly and follow up with Zombie • commission Zombie to improve the website • carry out user acceptance testing • do not process any expense claims that have bypassed the website.	2½ marks
General marks applicable to both scenarios (2 marks, awarded once only) The following recommendations apply: • communication of procedures and training • employees should acknowledge in writing that they understand and will comply with the procedures • disciplinary action if procedures are not followed and • regular monitoring of procedures by senior management.	2 marks (awarded once only)
Answers to this part of the question were disappointing. Generally, candidates were better at identifying the consequences of the internal control deficiencies than providing recommendations. Most candidates were able to outline a range of possible consequences and provide some suitable recommendations in both scenarios. The most common omissions in scenario (a) were those relating to the penalty clauses and the investigation of variances. The most common omissions in scenario (b) were those relating to the possible breach of contract and liability for damages.	
Total possible marks Maximum full marks	15½ 8

4.2 In respect of agenda item (2), identify and explain the threats to Griffin's objectivity and state, with reasons, how Griffin should respond to the proposal that Nicola Canvey continues as audit engagement partner.	**Marks**
Threats Nicola Canvey has worked continuously as the audit partner for Yeti for five years. The close association of Nicola with Yeti represents a familiarity threat as she may be too trusting and insufficiently sceptical of Yeti's financial statements. A reasonable and informed third party may consider the firm's independence and objectivity to be impaired. Additionally, there are self-interest and self-review threats as Nicola may be reluctant to identify prior-year misstatements which subsequently come to light.	3½ marks
Response Nicola may continue as engagement partner, for up to two years, to maintain audit quality. This is permitted by the ES when there are unexpected changes in the structure of the client's business such as the retirement of the chief executive. However, the following safeguards are required: • an expanded review of the audit work • the facts and reasons to be disclosed to shareholders and those charged with governance. • the ethics partner should be consulted.	3½ marks
This part of the question was well answered. Most candidates identified the familiarity threat and that it was possible for Nicola to remain in post for an additional two years due to the retirement of the chief executive. Although most candidates appreciated that a review of audit work was required many of these failed to state that an expanded review was required. The points most commonly overlooked were those relating to the perception of a reasonable and informed third party and the disclosures to shareholders and those charged with governance. A small minority of candidates were unaware of the provisions of the ES and incorrectly stated that the engagement partner must be rotated off the engagement immediately.	
Total possible marks Maximum full marks	7 4

4.3 For each invitation to provide non-audit services listed as (a) and (b) in agenda item (3), draft notes that identify and explain the threats to Griffin's objectivity. State, with reasons, how Griffin should address those threats.	**Marks**
Recruitment of a new chief executive **Threats** A familiarity threat arises if the firm plays a significant role in the recruitment of the chief executive as the firm is less likely to be critical of information provided by the new chief executive. A management threat also arises as the firm may become too closely aligned with management and be required to make decisions about which candidate to select.	2½ marks
How to address the threats The firm must decline to assist with the recruitment of a new chief executive. The ES expressly prohibits audit firms from undertaking an engagement to provide recruitment services in relation to key management positions of a listed company. However, the service can be provided in less formal ways such as the provision of salary surveys and interviewing candidates and advising on a candidate's financial competence.	3 marks
Provision of payroll services **Threats** The self-review threat arises because payroll information will be reflected in the amounts included or disclosed in the financial statements. External audit staff may be reluctant to identify shortcomings in their colleagues' work or may place too much reliance on that work without checking it. A management threat arises if members of the firm are expected to make decisions on behalf of management. The firm may become too closely aligned with the views and interests of management. The regular fee income may give rise to a self-interest threat and the firm may be reluctant to modify the auditor's report.	4½ marks

How to address the threats Your firm must refuse to provide the payroll services. The ES expressly prohibits audit firms undertaking payroll services for listed clients.	1½ marks
Answers to this part of the question were of a mixed standard. Most candidates provided better answers on the identification of the threats but were weaker on how the threats should be addressed. **Recruitment of a new chief executive** Most candidates correctly identified and explained the management threat but fewer candidates identified the familiarity threat. Stronger candidates recognised that the work must be declined as the ES prohibits recruitment services for listed clients and were awarded extra marks for highlighting that the service can be provided in less formal ways such as the provision of salary surveys and interviewing and advising on a candidate's financial competence. Weaker candidates incorrectly concluded that the firm could assist with the selection of a new chief executive. **Provision of payroll services** Most candidates correctly identified and explained the self-review and management threats but fewer candidates identified the self-interest threat. Some candidates incorrectly identified and explained the familiarity threat. Weaker candidates incorrectly concluded that the firm could undertake the payroll services providing safeguards were in place and then wasted time by listing irrelevant safeguards. The firm's response should have been to decline the engagement as the ES prohibits the provision of payroll services to listed companies.	
Total possible marks Maximum full marks	11½ 7

4.4 In respect of agenda item (4), outline the procedures that Griffin should implement to address the potential conflict of interest.	**Marks**
Obtain consent to act from both clients. Once obtained, separate teams should be used for each client with information barriers between the teams. There should be a system of confidential and secure data filing. Teams should be physically separated and staff from different offices used. The firm should have clear guidelines for members of each engagement team on issues of security and confidentiality. Employees and partners of the firm should sign confidentiality agreements. Procedures should be in place for dealing with any need to disseminate information beyond the barrier. There should be a regular review of safeguards by an independent person.	5½ marks
This part of the question was generally well answered with most candidates identifying a range of relevant points. Weaker candidates strayed beyond the requirement to "outline the procedures to address the conflict of interest" and wasted time explaining the threat to the fundamental principle of confidentiality. The points most commonly identified were those relating to separate teams, information barriers and confidentiality agreements. The points most commonly overlooked were those relating to the dissemination of information beyond the barrier and the independent review of the application of safeguards. Although many identified the need for an independent review, they failed to appreciate that it was the application of safeguards that had to be reviewed.	
Total possible marks Maximum full marks	5½ 3