MARK PLAN AND EXAMINER'S COMMENTARY

The marking plan set out below was that used to mark this question. 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 made by candidates.

General comments

Although there were a number of excellent scripts presented by candidates, overall, the quality of scripts deteriorated and the pass rate was therefore lower than that achieved in recent sittings. Questions 7b on planning and 9a on reporting scored the highest average mark. Short Form Questions (SFQ) 1, 3 and 4 on legal, professional and ethical issues were well answered. Previous examiners' commentaries have stated that some candidates struggle to identify the matters to consider when reviewing the reasonableness of the assumptions underlying receipts and payments in a cash flow forecast and, in this sitting, many candidates scored low marks on questions 8b and 8c. SFQ6 relating to the disclosure requirements for audit reports on the financial statements of listed companies required to apply the UK Corporate Governance Code was poorly answered. Although there was an increase in the number of candidates taking advantage of the facility to present their answers to the SFQs in note form, a significant number failed to do so and wasted time writing lengthy answers. A number of candidates left themselves short of time and, consequently, did not answer or presented very short answers to one or more questions.

Short Form Questions (SFQ)
Total Marks: 20

SFQ1

Rights and responsibilities, under the Companies Act 2006, in relation to a firm's resignation during its term of office.

Rights

- Outgoing auditors may request the directors to:
  - convene an extraordinary general meeting (EGM)
  - circulate a statement of circumstances to members
- Auditors can attend and speak at the EGM.

Responsibilities

- Submit a written notice of resignation
- Prepare a statement of circumstances
- Detailing the circumstances of resignation
  - to be deposited at Tahoe's registered office
  - and a copy sent to the Registrar of Companies
- Must state a disagreement over accounting policy
- As Tahoe is a listed company, there is no option to state there are no circumstances.

Although many candidates scored full marks on this question, a minority performed poorly as a result of failing to read the question carefully. These candidates wasted time writing about the rights of an audit firm when threatened with removal from office (e.g. a copy of the resolution to remove the firm) instead of the rights when a firm resigns during its term of office. Consequently, they failed to identify the right to request the directors to convene an extraordinary general meeting. Another commonly overlooked point was that as a listed entity there is no option to state, in the statement of circumstances, that there are no circumstances surrounding the auditor's resignation. Many candidates wasted time listing ethical requirements such as duty of confidentiality and communicating with the incoming auditor instead of the provisions of the Companies Act 2006 as required by the question.

Total possible marks	5½
Maximum full marks	2

SFQ2

Circumstances requiring the disclosure of confidential information by auditors

- Required by law
  - legal proceedings
  - suspected terrorist activities
  - suspected money laundering
  - suspected bribery
- Required to report to regulators
  - such as FSA and the charity commission
  - on regulatory breaches
- Required in the 'public interest'
  - providing not contrary to law or regulations
- Professional duty to disclose
  - comply with quality review by ICAEW or professional regulator
  - respond to enquiry or investigation by ICAEW or regulatory body
  - to protect professional interests in legal proceedings
  - comply with technical standards and ethics requirements.

Answers to this question were often disappointing, particularly in light of the availability of relevant information in the Open Book. The majority of candidates identified that an auditor can disclose confidential information without clients' permission when it is required by law. These candidates also provided relevant examples such as money laundering and, to a lesser extent, terrorist activities and bribery. However, many candidates wasted time describing the actions to be taken if money laundering was suspected. This was not required and no marks were awarded for these points. Most candidates also identified that an auditor may disclose confidential information when there is a professional right or duty and also provided relevant examples. The circumstance most commonly overlooked was that in respect of reporting to a regulator and, consequently, examples of such circumstances.

Total possible marks	7½
Maximum full marks	4

SFQ3

Identify and explain the ethical threats of proposing a fee below market rates

- Proposal represents "lowballing"
- Not prohibited by the Code of Ethics
- ES4 states that the audit fee must not be influenced by the provision of other services
- Threat to professional competence and due care
  - audit quality may be jeopardised
  - risk of audit failure/issuing an inappropriate audit opinion
  - impaired sceptism
- Self-interest threat
  - fear of not obtaining advisory work

If the advisory work is obtained there may be:

- Self-review threat
  - over reliance on colleagues' work during the external audit
  - reluctance to identify firm's errors to audited entity's management
- Management threat
  - may be expected to make decisions
  - too closely aligned with management.

This question was very well answered. Most candidates appreciated that the firm's policy represented lowballing and that such a policy has associated risks in respect of audit quality. However, many candidates failed to identify that this represented a threat to the fundamental principle of professional competence and due care. Although many candidates identified and explained the self-interest threat, a significant number overlooked the additional threats to objectivity that could arise if the audit firm succeeded in winning the lucrative advisory work. Weaker candidates wasted time writing at length about fee dependency and the fee thresholds. A minority of candidates wasted time citing safeguards for each of the threats which were not required.

Total possible marks	7½
Maximum full marks	4

SFQ4

Procedures to comply with firm's policy prohibiting partners and staff from owning shares in client companies

- Firm to maintain an up-to-date list of all clients
- Written confirmation by partners and staff of compliance with the firm's policies on independence
- Annual or more frequent confirmations
- New partners and staff required to provide confirmations on joining firm
- Regular training for partners and staff on the firm's policies and procedures on independence
- Monitoring of procedures
- Disciplinary action for breaches
- Procedures for prompt notification by partners and staff when shareholdings change
- E.g. shares inherited
- E.g. new client of the firm.

This question was very well answered as many candidates identified that partners and staff should sign a declaration of compliance with the firm's policy and that the declaration should be made at least annually. In addition, most candidates identified the need for training, monitoring and disciplinary action for non-compliance. The points most commonly overlooked were those relating to the maintenance of an up-to-date list of listed clients and procedures for prompt notification of a change in circumstance in respect of share ownership for partners and staff within the firm. A minority of candidates failed to appreciate that the firm's policy prohibited all partners and staff within the firm from holding shares in client companies and wasted time listing irrelevant safeguards such as not using personnel who held shares in a client company on that company's audit.

Total possible marks	7½
Maximum full marks	3

SFQ5

Matters that should be considered by the audit committee to monitor the performance of the internal audit function

- Audit committee to consider the internal audit function's:
  - planned programme of work
  - arrangements for direction and supervision of work
  - completed reports
  - independence and objectivity
- Establishment of performance indicators such as:
  - actual time compared to budget
  - actual work completed compared to planned work
  - number of recommendations accepted
  - feedback from users
  - numbers of qualified staff used
- Monitoring of performance indicators

Answers to this question were of a mixed standard. Those candidates who used their knowledge of internal audit and outsourcing to generate matters to be considered by the audit committee often scored full marks. The points most commonly identified were those relating to the objectivity of the internal audit function, the arrangements for planning, supervising and review of the function's work and, to a lesser extent, the review of completed reports. Few candidates appreciated the need for establishing and monitoring performance indicators and considering the planned programme of work. A minority of candidates did not attempt this question.

Total possible marks	11
Maximum full marks	3

SFQ6

Additional information to be included in the auditor's report of a company required to apply the UK Corporate Governance Code and the benefits to the users of the financial statements of having this information

Additional information

- A description of the assessed risks of material misstatement that had the greatest effect on:
  - the overall audit strategy
  - the allocation of resources in the audit
  - directing the efforts of the engagement team
- An explanation of how the auditor applied the concept of materiality in planning and performing the audit
- The materiality threshold for the financial statements as a whole
- An overview of the audit scope
- A description of how the assessed risks were addressed
- A statement on the audited entity's compliance with the ten provisions of the UK Corporate Governance Code.

Benefits to users

- Provides greater information as the audit report is specific to each company
- Narrows the expectation gap by giving greater information about the work of the auditors
  - E.g., identifying areas where the auditor made critical judgments.

Answers to this question were disappointing with a number of candidates failing to score any marks because they either did not attempt an answer or presented incorrect answers. Many candidates just listed, incorrectly, the information that is included in all auditors' reports instead of the **additional information** required for those companies applying the UK Corporate Governance Code. The disclosure requirements of audit reports on the financial statements of listed companies required to apply the UK Corporate Governance Code are covered in some detail in paragraphs 3.2.7, 3.2.12 and 3.2.13 of Chapter 13 of the 2015 Audit and Assurance Study Manual and are also set out in paragraph 19 of ISA 700. A number of candidates did not attempt this question.

Total possible marks	7
Maximum full marks	4

Question 7
Total Marks: 40

General comments
This was the highest scoring long-form question on the paper with a number of excellent answers to part (b).

Question 7a

Explain what is meant by the familiarity threat in the context of the external audit of Whistler and discuss the safeguards available to your firm in order to mitigate this threat.

Threat
A familiarity threat arises when the auditor is predisposed to accept or is insufficiently questioning of the audited entity's point of view, thereby impairing the objectivity of the auditor. This may occur where there are close personal relationships between the external audit team and client personnel. This threat arises in the case of Whistler because Lisa Lowry has been the engagement partner for 10 years and will have developed a relationship with the management of Whistler. Furthermore, Tom Turner, the former audit manager, was appointed as the finance director of Whistler in July 2015 and members of the audit team may be too trusting of their former colleague.

Safeguards
In respect of the engagement partner, the firm has the option to replace Lisa or leave her in place with safeguards. The firm should consider whether a reasonable and informed third party would consider objectivity to be impaired were Lisa to remain as the engagement partner. However, as there is a new audit manager with no previous experience of Whistler, it may be more appropriate to leave Lisa in place, with safeguards, so that the knowledge and understanding of the business is not lost. Where it is decided, after due consideration, that Lisa is not rotated after 10 years, ES 3 Long Association with the Audit Engagement requires the following safeguards:

- an independent review of the work done by the engagement partner and senior members of the team
- document the reasons as to why Lisa continues to participate in the audit
- communicate the facts to those charged with governance at Whistler.

ES 2 Financial, Business Employment and Personal Relationships, requires the firm to consider the composition of the engagement team to ensure that objectivity and independence are not impaired as a result of relationships between Tom and members of the audit team. However, the new manager may reduce the need to change members of the engagement team.

The ethics partner should be consulted on each of these issues

This part of the question was generally well answered. The vast majority of candidates provided a plausible explanation of the familiarity threat and then applied this to the scenario. Most candidates correctly identified that the familiarity threat at Whistler arose from two issues. Firstly, the audit engagement partner had acted for a prolonged period and secondly, the finance director at the audited entity had a relationship with the audit team having previously acted as the audit manager. However, some candidates focused on only one or other of these issues and so reduced the potential number of marks available to them.

A majority of candidates also identified a number of appropriate safeguards such as rotation of the engagement partner and consideration of the composition of the audit team. However, a significant minority of candidates failed to appreciate that partner rotation was not mandatory as Whistler was unlisted. Consequently, these candidates did not achieve the marks available for the safeguards, such as documenting reasons and communicating to those charged with governance, if the engagement partner was not rotated.

Very few candidates recognised that the appointment of a new audit manager might reduce the need to consider the composition of the team. Similarly, few candidates identified that the presence of a new audit manager would reduce the need for audit partner rotation so that knowledge and understanding of the business was not lost.

A number of candidates strayed into discussing intimidation threats although the requirement was limited to the familiarity threat.

Total possible marks	9½
Maximum full marks	6

Question 7b

Justify why the items listed as (1) to (4) have been identified as key areas of audit risk and, for each item, describe the procedures that should be included in the audit plan in order to address those risks.

Fee Income
Justification
 	
Fee income has increased by 6.5% compared to the prior year. This is out of line with the decline in fee income in the industry of 2% per annum. Gross margin has increased from 50.5% to 52.0%. This suggests an overstatement of fee income.
 	
The initial payment of 30% of the contract value may lead to inappropriate income recognition if the payment is recognised as fee income prior to the completion of the project. Consequently, fee income may be overstated because of cut-off errors.
 	
Some clients are invoiced in euro and there is the potential for translation errors.
	Procedures
	
	• Compare actual fee income to budget/by office/by month to identify any anomalies
	• Inspect post year-end management accounts to see if fee income is abnormally low
	• Evaluate and test the system for recording deferred fee income and transfers between deferred fee income and fee income
	• For a sample of contracts:
	  ○ vouch entries in deferred fee income to invoices/contracts
	  ○ confirm the assignment is complete by inspecting the report
	• For contracts in progress at the year end confirm that the 30% initial payment is recorded in deferred income
	• Match initial payments with bank statements
	• Inspect post year-end credit notes to ascertain if any relate to pre year-end
	• For a sample of invoices prepared in euro, reperform the translation and check the exchange rate to a reliable source.

Work in progress (WIP)
Justification
 	
WIP days have increased from 105.6 days to 127.8 days (an increase of 24.9%). This is not in line with the growth in fee income and this may indicate overstatement.
 	
The project costing system was replaced in September 2015 and may not be functioning correctly. Data could have been incorrectly transferred to the new system.
 	
Errors in the project costing system may arise from:
  ○ expenses recorded incorrectly
  ○ time recorded incorrectly
  ○ time or expenses recorded against incorrect project codes
  ○ incorrect charge out rate applied
  ○ time or expenses recorded in the incorrect accounting period.
 	
Standard charge out rates are used which may not reflect actual costs.
 	
Cost overruns on fixed-price contracts may result in losses. If losses are not provided for this will result in overstatement of work in progress because the net realisable value of WIP will be lower than cost.
	Procedures
	
	• Ascertain and test the controls over the completeness and accuracy of recording time and expenses in the project costing system
	• Discuss with management whether there have been any issues with the new system
	• Ascertain and test the controls in place over the transfer of data from the old to the new system (eg parallel run)/check a sample of balances transferred from the old system to the new system
	• Compare the charge out rates recorded on the system to independently held data
	• Vouch expenses to suppliers' invoices
	• Compare the contract price to estimated total costs for assignments in progress at the year end to ascertain whether provision for losses is required
	• Inspect the ageing of WIP to identify any unbilled/irrecoverable WIP
	• Review post year-end sales invoices to ascertain if WIP is billed soon after year end.

Trade receivables **Justification** Receivable days have increased from 40.6 days to 52.2 days (an increase of 36.9%) which is higher than the 30 days payment terms indicating possible overstatement or insufficient allowance against doubtful debts. The high level of disputes could lead to customers withholding payment.	**Procedures** **Unpaid invoices** • Vouch invoice entries in the receivables ledger with the final report or confirmation that the assignment is complete • Examine post year-end bank statements to see if receivables are paid after the year end • Review credit notes issued after year end • Direct confirmation of balances with customers **Bad debt allowances** • Obtain an aged receivable analysis and ascertain reasons for overdue balances • Ascertain the basis for the bad debt allowance and assess its reasonableness • Reperform the calculation of the allowance for receivables • Inspect customer correspondence and board minutes for evidence of disputes • Consider the impact of any dispute on the level of allowances.

Provision for claims
Justification
 	
The level of provisions has fallen from 3.3% to 2.0% of fee income (a decrease of 35.6%) despite an increase in fee income. Additionally, the insurer has reduced the scope of insurance cover in the current year. This suggests that provisions may be understated.
 	
The estimate for provisions is subjective as the outcome of claims made against Whistler is uncertain.
 	
Provisions are a material balance. A large claim could threaten the going concern status of Whistler.
	Procedures
	
	• Evaluate and test the system for identification of professional claims
	• Obtain the breakdown of the provision for claims and ensure that provision is made for uninsured costs including:
	  ○ any insurance excess
	  ○ claims that are outside the scope of insurance cover or over the maximum insurance cover
	• Discuss with management the basis of provisions and:
	  ○ review key assumptions for reasonableness
	  ○ check calculations
	• Seek legal advice or insurance specialist advice about the expected outcome of claims
	• Review insurance policy documents for terms and conditions
	• Consider the impact of those terms and the level of cover on the provisions made
	• Obtain direct confirmation from the insurer of the existence of insurance cover
	• Review a sample of correspondence and board minutes for evidence of progress in settling claims
	• Review bank payments after the year end for evidence of claims settled since the year end
	• Obtain written management representations on the completeness of provisions
	• Consider the financial strength of the insurance provider and whether there are sufficient assets available to honour the levels of cover provided
	• Review publicly available information for evidence of other claims that may exist.

General - Justification

- Whistler has submitted a bank loan application and may seek to window dress the financial statements

General - Procedures

- Discuss with management the reasons for changes in fee income/balances since the previous year
- Corroborate reasons given by management

Answers to this part of the question were of a very high standard. It was pleasing to note that the majority of candidates attempted to make some use of the financial information provided in the scenario, which has been identified in previous examiners' commentaries as a deficiency in answers. It was also pleasing to note that many candidates cited procedures to address audit risks that were adequately described and relevant to the justification of the audit risk. However, weaker candidates continue to cite vague audit procedures not linked to the audit risk, for example, "check systems" or "test controls" without specifying which systems or controls.

Fee income

The majority of candidates correctly identified that the increase in fee income was out of line with the industry average, that invoicing in euro may lead to translation errors and that the 30% initial payments may be incorrectly recognised on receipt rather than on completion of the report. A minority of candidates incorrectly challenged the accounting treatment for fee income, suggesting it should be recognised over the duration of the assignment and not on completion.

Candidates were also able to cite credible audit procedures to address the identified risks, such as:

- enquiring of management why fee income had increased
- checking a sample of foreign currency calculations using exchange rates from a reliable external source
- evaluating the system for recording deferred income and/or checking that initial payments received in respect of incomplete assignments were not included in fee income.

Only a minority of candidates considered procedures such as comparing fee income on a monthly or by office basis to identify any anomalies or inspecting post year-end management accounts to see if fee income was abnormally high. Other procedures that were commonly overlooked included:

- vouching entries in the fee income account to invoices or contracts
- inspecting reports for completed assignments
- matching initial payments to bank statements
- inspecting post year-end credit notes to ascertain if they relate to fee income recognised pre year-end.

Work in progress (WIP)

This was the least well answered section. The most cited justifications were the risk of overstatement, the risks associated with the replacement of the project costing system, including errors resulting from incorrect transfer of data, and errors due to incorrect inputting of time and expenses by consultants. The justifications most commonly overlooked were that fixed price contracts could lead to cost overruns and result in overstated WIP and that the use of standard charge out rates to value WIP may not reflect actual costs.

Candidates identified a range of appropriate procedures to address the risks identified such as evaluating the controls around the system, including the implementation of the new system, and vouching expenses recorded in the system to invoices. Few candidates earned the marks available for procedures to assess whether WIP was recorded at lower of cost and NRV, such as comparing contract price to estimated total costs to complete the assignment, inspecting the aging of WIP or reviewing post year-end sales invoices.

A small number of candidates incorrectly provided audit procedures in respect of inventory.

Trade receivables

The majority of candidates identified a range of points justifying the risks. The most commonly overlooked justification was the high level of disputes with customers that might lead to non-payment. Candidates were also able to cite a number of appropriate audit procedures to address the risk, such as:

- inspecting bank statements for post year-end receipts
- direct confirmation of balances with customers
- obtaining an understanding from management of the basis for the allowance for receivables
- obtaining a copy of the aged receivables analysis to identify overdue balances
- inspecting customer correspondence for evidence of disputes.

Provision for claims

Answers relating to the section on provision for claims were generally good although there was some evidence that candidates had not managed their time well resulting in shorter answers to this part of the question. The majority of candidates correctly identified the risk of understatement given that the level of the provision had fallen in relation to fee income and that the insurer had reduced the level of cover available compared to the prior year. Most candidates also correctly identified the subjective nature of the estimates involved.

Candidates were also able to cite some appropriate audit procedures to address the risk, such as discussing the basis of the provision and assumptions with management and assessing their reasonableness, reperforming calculations and seeking independent legal advice. There were a number of procedures that were commonly overlooked such as:

- assessing the system for identifying professional claims
- considering the impact of insurance cover on the provision
- obtaining a written management representation as to the completeness of the provision
- direct confirmation of the existence of insurance cover
- reviewing bank payments to settle claims after the year end.

Total possible marks	66
Maximum full marks	24

Question 7c

For each internal control deficiency listed as (i) and (ii), draft points for inclusion in your firm's report to those charged with governance and management at Whistler. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address it.

IT equipment ordered directly by consultants Unnecessary or duplicate expenditure may be incurred or equipment purchased which does not benefit Whistler. Equipment may also be purchased that is sub-optimal both in terms of quality and price. Consultants ordering equipment directly from the supplier increases the risk of fraud. For example, the consultants may receive kickbacks or hospitality from the supplier in return for their order or the supplier could be a relative or a friend who over-charges the company. There is a risk that the equipment is purchased for the consultant's personal use and not for business use. High volumes of unauthorised expenditure could leave the company financially overcommitted with budgets being breached and an adverse impact on profits and cash flow. The equipment may not be appropriately accounted for and the non-current asset register not updated in respect of the purchases.	**Recommendations** • Company policy over authorisation for capital expenditure should be re-communicated to all consultants • Regular monitoring of compliance with the company policy by senior management.
Bribery prevention policies **Consequences** The Bribery Act 2010 makes bribery or failing to prevent bribery a criminal offence. The Bribery Act is global in scope and makes 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 know what to do or how to proceed if they suspect bribery. The penalties for bribery or failing to	**Recommendations** • 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) guidelines which set out the following principles.:

prevent bribery are severe and include imprisonment. The risk of bribery is increased as Whistler is seeking to expand internationally and obtain government contracts which require interaction with foreign public officials. The financial results of the company may be adversely affected. There could be additional expenses arising through the payment of bribes, the cost of any fines or penalties imposed by the authorities and the cost of legal fees to resolve any bribery issues. There may be 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.	○ 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.

General marks applicable to both scenarios (award only once)
The following recommendations apply:

- Staff should acknowledge in writing that they understand and will comply with the procedures
- Disciplinary action should be taken against those employees who fail to adhere to company policy.

This was the least well answered part of this question.

IT equipment ordered directly by consultants
The majority of candidates correctly identified that direct ordering of IT equipment by consultants could have an adverse impact on profit and cash flows due to the company not obtaining the best price or quality of equipment or over-ordering taking place. Strong candidates also identified that consultants might order equipment for personal use or order from suppliers in return for hospitality or 'kick-backs'. Very few candidates identified that budgets might be breached. Whilst the majority of candidates correctly identified that company policy should be communicated to employees a significant proportion wasted time suggesting controls such as only allowing purchasing through a buying department. This was stated in the scenario as an existing company policy and therefore no marks were available for this.

Bribery prevention policies
The majority of candidates correctly identified that failure to implement a bribery prevention policy is a criminal offence and could lead to fines or imprisonment and that the absence of a policy was more likely to increase the risk of bribery occurring. Few candidates earned the marks available for stating that the Bribery Act 2010 is global in scope, thus failing to tailor their answers to the circumstances in the scenario, or that the company was responsible for the actions of its employees. The majority of candidates were able to describe some basic recommendations, such as documenting and communicating a bribery prevention policy and implementing whistle-blowing procedures. Very few candidates cited the six principles of the Ministry of Justice – proportionate procedures, top-level commitment, risk assessment, due diligence procedures, embedded culture and making improvements to procedures.

Total possible marks	17
Maximum full marks	10

Question 8
Total Marks: 22

General comments
This was the least well answered long-form question particularly in respect of parts (b) and (c). Disappointingly, a number of answers were very short, possibly indicating mismanagement of time across the paper.

Question 8a

(i) Identify the matters to be included in your firm's engagement letter for the examination of the cash flow forecasts in respect of:
- **management's responsibilities;**
- **the purpose and scope of your firm's work; and**
- **limiting your firm's liability.**

(ii) Explain why these matters should be included.

(i) Management's responsibilities
The engagement letter should state that management:
- is responsible for the preparation of the cash flow forecast and
- for the identification and disclosure of the assumptions on which the forecast is based
- will provide the reporting accountant with all relevant information used in developing these assumptions and written representations specifically on:
  - intended use of the forecasts
  - completeness of significant assumptions; and
  - its acknowledgement of its responsibility for the forecasts.

Purpose and scope of your firm's work
The engagement letter should state:
- that the reporting accountant will examine the cash flow forecast for the three years ending 31 December 2018
- that the examination will consider the reasonableness of assumptions and whether the forecast is properly prepared on the basis of those assumptions
- whether the engagement is to be conducted in accordance with the provisions of ISAE 3400
- that there could be differences between the forecast and actual performance due to unforeseen circumstances
- limited assurance will be provided by the reporting accountant expressed in a negative form ("nothing has come to our attention…") as to whether the assumptions provide a reasonable basis for the prospective financial information.

Limiting your firm's liability
The engagement letter should identify the intended users, that is, the management, bank and Denzil Dragon for the purpose of obtaining funding and that the report should not be shown to any other party without permission. A liability cap should be stated (that is the maximum monetary amount of damages payable by the reporting accountant).

(ii) Explanation
The reasons why these matters should be included in the engagement letter are to reduce the risk of any misunderstandings (bridge the expectation gap) and to make it clear that the examination of the cash flow forecast does not constitute an audit. By including the matters in respect of limiting liability, the firm limits the amount of damages to which it is exposed. By identifying the intended users, the firm reduces the risk of claims for damages by unforeseen third parties.

This part of the question was generally well answered. The most common error was that many candidates failed to demonstrate an appreciation that an engagement letter in respect of an examination of cash flow forecast would differ from an engagement letter in respect of a statutory audit. Consequently, they wasted time covering the matters to be included in an engagement letter for a statutory audit (for example responsibility for the prevention and detection of fraud). Candidates who focussed on an engagement letter for the examination of a cash flow forecast generally earned marks from each of the three sections specified in the requirement and the majority correctly identified that narrowing the expectations gap was a primary reason for including those matters in the engagement letter. Other reasons, such as making it clear that the engagement was not an audit and limiting the amount damages the firm may be exposed to, were frequently overlooked. Many candidates lost marks for failing to appreciate that the firm would owe a duty of care to the bank and incorrectly stated that a restriction on the distribution of the firm's report would limit the firm's liability to the bank. A minority of weaker candidates wasted time discussing other means of

limiting a firm's liability such as limited liability partnerships and professional indemnity insurance which was outside the scope of the question as they would not be included in an engagement letter.	
Total possible marks Maximum full marks	17 8

Question 8b

For the items listed (1) to (5), identify the specific matters you would consider when reviewing the reasonableness of the assumptions underlying each receipt or payment.

(1) Receipts from and payments to supermarkets for the sale of products

The contract with Terose expires in June 2016 so the final receipt for the sale of sauces should be reflected 75 days later. A rebate payable to Terose should be included in the cash flow forecast at the end of the contract only if the specified volume of sauces is forecast to be purchased by Terose. The contract with Terose should be examined to confirm the specified volume and the profit forecast checked to confirm the forecast volume sales of sauces to Terose.

The receipts from the new supermarkets should commence after June 2016 with a credit period of 30 days following the sale. The likelihood of obtaining four-year contracts with five new supermarkets should be considered through examination of correspondence and discussion with TSL management. The 30 days credit period should be checked to ensure that it is consistent with current negotiations or draft contracts. For sales transacted in foreign currencies, the assumptions used for the exchange rates should be discussed with management.

An increase in receipts should be reflected in June 2017 when soups are sold for the first time and, again, in June 2018 when curries are sold for the first time. It should be considered as to whether the length of the research and development phase is consistent with other new product development periods.

The seasonality of receipts should be reflected in the cash flow forecast as sales of sauces are higher in warmer months.

(2) Payments to Mixit

The payments to Mixit should start in June 2016 and should be consistent with the level of sales and purchases assumed in the profit forecast and should reflect a realistic and prudent gross margin. There should be cash payments in advance for the first 12 months and credit terms of 30 days thereafter. The terms should be checked to correspondence and any contract with Mixit.

The capacity of the Mixit facility should be considered to see that it is sufficient to fulfil the volume of orders assumed.

The financial position of Mixit should be ascertained to see if it can continue trading for the foreseeable future.

(3) Proceeds from the disposal of the manufacturing unit

This should be a prudent estimate and in line with the market value of similar properties in the locality. 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 sale will proceed and any indication of the sales value and whether the sale is contingent on obtaining planning permission. The planning permission application to change the use from industrial to residential should be inspected as this will affect the market value if the planning application is successful. The forecast should reflect the timescales involved in obtaining planning permission and the six months needed to decommission the manufacturing unit.

(4) Payments for the rented warehouse, office and research facility

These payments should reflect the six-month rent-free period followed by quarterly payments in advance. The rental payments will commence in 2017. The amounts in the cash flow forecast should be in line with the rental agreement or market rates and reflect any future rent increases.

(5) Receipts from and payments to Denzil Dragon.

The equity funding should be reflected in equal tranches in March and June 2016 and the repayment of

half of the equity funding should only be reflected in the cash flow forecast if the specified level of profit is reached in the forecast. The dates and amounts of the receipt and repayment of equity funding should be consistent with the shareholders' agreement and any correspondence. The profit forecast should be examined to check whether the specified level of profit is expected to be achieved. Dividends of one quarter of annual profits should be reflected in the cash flow forecast. Again, the profit forecast should be examined to see that dividends are one quarter of forecast profits.

General
The assumptions should take account of inflation and key variables should be subjected to sensitivity analysis.

Answers to this part of the question were disappointing and a number of candidates provided very brief answers that scored few marks. A significant number of candidates were unable to identify any matters to consider when reviewing the reasonableness of the assumptions underlying the receipt or payment. This matter has been identified by examiners in previous commentaries as an area where candidates struggle.

The following points were commonly overlooked:

- consideration of the likelihood of obtaining contracts with the five new supermarkets
- exchange rate considerations in respect of the new contracts
- seasonality of receipts
- the growth in receipts from the sale of soups and curries
- the link between payments to Mixit and the volume of sales receipts
- the capacity and financial viability of Mixit
- correspondence with the developer.

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

A number of 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:

- removing assets from the asset register
- vouching the cost of the manufacturing unit
- ensuring the correct accounting treatment was followed for the rent free period and the rebate to Terose
- the audit of the rebate payment
- the need to identify related party transactions
- the audit procedures that should be performed at inventory count attendances.

None of these points was relevant to the answer.

A number of 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 manufacturing unit. This matter has also been identified in previous examiners' commentaries on questions concerning the examination of cash flow forecast information.

Most candidates correctly commented on the timing of receipts and payments. Stronger candidates identified the terms of contracts, market value of properties similar to the manufacturing unit and the examination of the agreement or correspondence with Denzil Dragon to corroborate the equity funding receipt and its repayment.

Total possible marks	27½
Maximum full marks	10

Question 8c

State four key differences you would expect to see between the items included in the profit forecasts and the receipts and payments included in the cash flow forecasts prepared by the directors of TSL.

Profit forecasts are prepared using the accruals principle whereas cash flow forecasts are prepared using the cash basis of accounting. The key differences in the case of the forecasts prepared by the directors of TSL are:

- Items of expenditure such as purchases, rebates, rent, interest and tax are recorded in the profit forecast as costs when they are incurred. The cash flow forecast includes these transactions only when there is an expected outflow of cash
- Revenue is recorded in the profit forecast as income once it is earned. The cash flow forecast includes revenue only when there is an expected inflow of cash. Provisions for slow-moving inventories or for doubtful debts are included in the profit forecast but not in the cash flow forecast
- Capital expenditure is included in the cash flow forecast when there is an expected outflow of cash. Depreciation of assets acquired is included in the profit forecast but would have no cash flow implication
- Development expenditure is included in the cash flow forecast when there is an expected outflow of cash. Amortisation of development costs is included in the profit forecast but would have no cash flow implication
- Proceeds from the disposal of the manufacturing unit are included in the cash flow forecast when there is an expected inflow of cash. The profit forecast records the profit or loss on the disposal of the manufacturing unit
- The cash flow forecast includes the receipt and repayment of the equity finance from Denzil Dragon but this would have no impact on the profit forecast
- Value added tax (VAT) is included within the receipts and payments in the cash flow forecast. The profit forecast includes income and expenditure net of VAT.

Answers to this part of the question were disappointing. Stronger candidates were able to identify, from the list above, four key differences between the items included in the profit forecasts and the receipts and payments included in the cash flow forecasts and scored maximum marks. However, weaker candidates appeared confused by the concepts of a cash flow forecast and a profit forecast. As a result, many candidates were unable to state any key differences between the items in a profit forecast and the items in a cash flow forecast. A large number of candidates restricted their answers to a general discussion of the accruals basis used in the preparation of financial statements without providing any specific examples and failed to score any marks. The most popular key differences identified were in relation to proceeds from the disposal of the manufacturing unit and the profit or loss on its disposal. Few candidates identified the VAT difference. A significant number of candidates did not attempt this part of the question.

Total possible marks	8
Maximum full marks	4

Question 9
Total Marks: 18

General comments
This was the second highest scoring long-form question but this was mainly due to a number of excellent answers on part (a). There were a number of short answers to part b, possibly indicating mismanagement of time across the paper.

Question 9a

For each of the situations outlined above, state whether or not you would modify the audit opinion. Give reasons for your conclusions and describe the modifications, if any, to each audit report.

Mint
A modified opinion should be issued which should be a qualified ("except for") opinion due to limitation on scope as evidence reasonably expected to be available is not available. 7% of revenue is material but not pervasive as it is confined to specific elements in the financial statements. Reference to the limitation on scope should be made in the "basis for qualified opinion'' section of the audit report which should explain the reasons and state the amounts involved. The auditor should also report by exception under the Companies Act 2006 that:

- adequate accounting records were not maintained; and
- all information required for the audit was not obtained.

Coriander Ltd
There will be no modification to the audit opinion. The liquidation of the customer and subsequent sale of inventory is an adjusting subsequent event, providing additional evidence of the value of inventory at the year end. The inventory should be valued at net realisable value (NRV), because it is lower than cost. However, the difference between the cost and NRV is £300,000 and is not material as it is only 2.3% of profit before tax and 0.77% of total assets. Even if the directors refuse to amend the financial statements in respect of the misstatement over the accounting treatment, the audit opinion will not be modified.

Basil
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 0.25% of gross assets. However, it is material by nature as it is a related party transaction because Saffron is owned and managed by the husband of Basil's 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.

This part of the question was very well answered with a significant number of candidates scoring maximum marks.

Mint
Most candidates correctly identified that this scenario represented a limitation on scope and that it was unlikely to be pervasive. The points most commonly overlooked were those relating to the UK Companies Act requirement regarding proper accounting records and the availability of information required for the audit. A number of candidates incorrectly stated that the scenario represented a disagreement rather than a limitation on scope.

Coriander
The majority of candidates correctly identified that inventory should be included at its net realisable value (NRV) because it was lower than cost. However, some candidates failed to appreciate that it was the difference between the cost of inventory included in the financial statements and the NRV that should be considered for materiality purposes. Instead, they considered the materiality of the total inventory figure and consequently concluded that the amount was material when in fact the difference between cost and NRV was not material. As a result, these candidates reached the wrong conclusion in respect of the implications for the audit report.

Basil
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. Most of these 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 bets and discussed the possibility of the issue being pervasive, thereby demonstrating a lack of understanding of what constitutes a pervasive issue.

Total possible marks	15
Maximum full marks	11

Question 9b

Describe the possible consequences for your firm if an inappropriate audit opinion on financial statements is issued and outline the quality control procedures your firm should implement to reduce the risk of issuing an inappropriate audit opinion.

Consequences
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. Although damages awarded against the firm may be covered by professional indemnity insurance, the cost of future insurance will increase.

The firm may be investigated by the regulatory bodies, which may result in disciplinary action and penalties such as fines or withdrawal of registered auditor status.

The adverse publicity associated with legal claims and disciplinary procedures may result in the loss of clients and key staff may leave the firm. 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.

Quality control procedures
The firm should have robust procedures to ensure competent employees are recruited and subsequently trained.

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.

An engagement quality control review should be performed on audits of all listed companies and other audits where audit risk is considered higher than normal.

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.

The majority of candidates correctly identified a range of potential consequences for the audit firm. However, a significant number of candidates lacked an understanding of the quality control procedures required to reduce the risk of issuing an inappropriate audit opinion. Weaker candidates cited the objectives of quality control instead of the procedures to be exercised by the firm. A significant number of candidates stated, incorrectly, that forming limited liability partnerships, agreeing liability caps and including a Bannerman paragraph in the audit report would reduce the risk of issuing an inappropriate audit opinion. These candidates failed to appreciate that such actions would only reduce the auditor's exposure to damages in the event of an inappropriate opinion being issued and would not reduce the risk of issuing an inappropriate opinion.

Total possible marks	14½
Maximum full marks	7