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 which were made by candidates.

General comments
The pass rate was lower than that achieved in recent sittings. Question 7 scored the highest average mark on long-form questions and short-form questions (SFQ) 3, 4, 5 and 6 were particularly well answered. Generally, candidates demonstrated strengths in the areas of the justification of key audit risks and the procedures to address those risks. There was a drop in the standard of candidates' answers to the audit reporting question, an area where candidates have performed strongly in the past. The question 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. It was pleasing to note the high number of candidates who presented their answers to SFQs in note form. However, many candidates continue to waste time writing lengthy answers to the SFQs thereby leaving themselves short of time for the long-form questions. Consequently, a number of candidates presented short answers to the final question.

Short Form Questions (SFQ)
Total Marks: 20

SFQ1

Proposed office lease

- Appropriate to lease
- Business relationships are permitted under ES2 if:
  - in the ordinary course of business
  - on an arm's length basis
  - not material to either party
  - clearly inconsequential to either party
- Leasing properties is in the ordinary course of business for both parties
- Proposed lease is at the market rate
- Both parties are large
  - Run is a large UK property company
  - the firm has 100 offices in Europe
- The transaction is unlikely to be material to either party.

Answers to this question were of a mixed standard. The candidates who listed and then applied the criteria to be satisfied in respect of business relationships, set out in paragraph 29 of Ethical Standard 2, to the circumstances described in the question scored full marks. A significant number of candidates stated, incorrectly, that such a business relationship was inappropriate and proceeded to justify why it was inappropriate. A minority of candidates wasted time by hedging their bets and presented two answers - one specifying why the relationship was appropriate and another specifying why it was not appropriate.

Total possible marks	6
Maximum full marks	3

SFQ2	
Audit procedures to address the risk of management override of internal controls • Substantiate journal entries • Investigate reconciling items • Review significant accounting estimates and judgements for bias • Investigate transactions outside the normal course of business • Review 'whistle-blowing' arrangements • Review internal audit reports • Interview management to assess its attitude towards the control environment • Review minutes of management meetings.	
Answers to this question were generally disappointing. Many candidates ignored the requirement to list the procedures to be included in the audit plan and, instead, listed procedures that should have been undertaken prior to acceptance of an engagement as part of due diligence. Very few candidates scored full marks on this question and many were awarded zero marks. The points most commonly identified were those set out in paragraph 32 of ISA 240 and paragraph 6.1 of chapter 7 of the Audit and Assurance Study Manual relating to journal entries, management estimates and transactions outside the normal course of business. The other points in the answer were rarely identified.	
Total possible marks Maximum full marks	8 3

SFQ3	

Consequences of an inappropriate audit opinion
• Professional negligence claims
    o from the bank
    o if a duty of care owed
    o damages may be payable
    o legal costs incurred
    o firm may be protected by a Bannerman paragraph or
    o emphasis of matter paragraph regarding the going concern uncertainty
    o professional indemnity insurance premiums may rise
• Subject to greater scrutiny by the regulators (eg ICAEW)
    o disciplinary procedures
    o fines or withdrawal of registered auditor status
• Loss of reputation
    o loss of clients and key staff
    o in extreme cases financial collapse of the firm
• Criminal proceedings if audit report was issued recklessly (Companies Act 2006).	

This question was generally well answered with a significant number of candidates scoring full marks. The majority of candidates identified the possibility of legal action by the bank and investigation by regulators. Most of these candidates then proceeded to list the possible outcomes relating to these actions such as damages awarded against the firm, disciplinary procedures and reputational issues. The points most commonly overlooked were those relating to increased costs of professional indemnity insurance and the inclusion of an emphasis of matter paragraph regarding the going concern uncertainty in the audit report.	
Total possible marks Maximum full marks	7½ 4

SFQ4

Assistance with the preparation of financial statements
Explanation of threats to objectivity

- Management threat
  - firm is expected to make decisions
  - firm becomes too closely aligned with the views and interests of management
- Self-review threat
  - results of a non-audit service are reflected in the amounts included or disclosed in the financial statements
  - such as calculations
  - audit team reluctant to identify shortcomings in their colleague's work or
  - may place too much reliance on that work.

Safeguards

- Refer to ethics partner
- Not prohibited in UK as company is not listed
- Limit the length of time for which assistance is provided
- Informed management in place
  - management makes all decisions requiring the exercise of judgement and
  - has prepared the underlying accounting records
  - staff member does not initiate transactions or
  - make decisions
  - services provided are of a technical, mechanical, informative nature
- Audit documentation demonstrates that management has made all decisions
- Responsibilities set out in engagement letter
- Staff member must have no involvement in the audit of the financial statements
- Independent partner review of:
  - audit work
  - accounting services.

This question was generally well answered with a significant number of candidates scoring full marks. As in previous exams, many candidates cited incorrect threats. For example, many candidates cited the self-interest threat resulting from fee dependency and wasted time detailing the fee thresholds. There was no indication in the question that this was likely to be a recurring engagement and, in addition, one of the criteria to be satisfied for the engagement to be acceptable, is that it is for a short period of time. A significant minority of candidates stated, incorrectly, that information barriers would be required.

Total possible marks	11½
Maximum full marks	4

SFQ5

Revision of terms

- Any indication that the entity misunderstands the objective and scope of the audit
- Any revised or special terms of the audit engagement
- Significant change in ownership
- Recent change in management
- Significant change in nature or size of the entity's business
- Change in:
  - legal or regulatory requirements
  - the financial reporting framework
  - other reporting requirements
  - the engagement partner or structure of the audit firm.

Those candidates who were familiar with the contents of paragraph A28 of ISA 210 scored full marks. However, a significant number of candidates failed to make use of the open book and as a result only cited one or two points. The point most commonly cited by these candidates was in respect of narrowing an expectation gap. A common error was to state that a change in the provision of non-audit services would require revised terms of an audit engagement. These candidates failed to appreciate that these services should be the subject of a separate engagement letter.

Total possible marks	4½
Maximum full marks	3

SFQ6

Actions to take, with reasons

- Report to money laundering reporting officer (MLRO) within the firm
- MLRO to report to National Crime Agency
  - represents proceeds of crime
  - criminal offence if auditor does not report
  - no de minimis limit with money laundering
  - appears to be disguising within accounting records
- Do not tip off
  - as this might prejudice legal proceedings
  - tipping off is a criminal offence
- Consider impact on other areas of the financial statements
- Reconsider assessment of management's integrity.

This question was generally well answered as the majority of candidates identified that the situation described in the question represented money laundering. Consequently, most candidates proceeded to cite the reporting responsibilities of the audit junior and the firm. Only a minority of candidates identified that tipping off might prejudice legal proceedings and that there was no de minimis in respect of amounts relating to money laundering.

Total possible marks	5½
Maximum full marks	3

Question 7
Total Marks: 35

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

Question 7a

Set out the benefits and limitations of using analytical procedures at the planning stage of an external audit.

Benefits
The benefits of using analytical procedures at the planning stage of an external audit are that they are used to:
- obtain an understanding of the audited entity and its environment
- identify risk areas or areas of potential material misstatement
- identify areas requiring more resources
- indicate areas where detailed testing can be kept to a minimum.

Limitations
The limitations of using analytical procedures at the planning stage of an external audit are that:

- substantial knowledge and understanding of the business is required to interpret the results
- sufficient knowledge and understanding may be absent in the first year of an external audit
- an experienced member of staff is required to interpret the results
- the consistency of results from one year to another may hide a material error
- they may be performed mechanically without the application of professional scepticism
- they rely upon good quality information which may not always be available
- they are of limited use if a business is changing (such as rapid growth or decline).

Answers to this part of the question were of a mixed standard. In respect of benefits, the points most commonly identified were those relating to risk and the targeting of resources to risk areas. In respect of limitations, the points most commonly identified were those relating to the requirement for knowledge of the business and experienced staff to interpret the results of analytical procedures. The points most commonly overlooked were those relating to areas where detailed testing can be minimised and mechanical performance without the application of professional scepticism. A number of candidates focused on the benefits and limitations of analytical procedures as used at other stages of the audit, which did not address the question and therefore did not score marks. A small number of candidates restricted their answers to setting out the benefits of analytical procedures and did not provide any limitations.

Total possible marks	11
Maximum full marks	5

Question 7b

Justify why the items listed as (1) to (3) in the scenario have been identified as key areas of audit risk and, for each item, describe the procedures that should be included in the audit plan in order to address that risk.

Volume-based supplier rebates

Justification

This is a complex area with 350 suppliers offering rebate terms ranging from 1% to 15% and contracts that straddle Hutton's accounting year end. The calculation of rebates involves many estimates and judgements.

At 7.9% of revenue the rebates are material.
They have increased from 7.1% to 12.9% of cost of sales. This is very close to the upper end of the rebate range, as only principal suppliers offer rebates. The increase in the level of rebates is inconsistent with the fall in cost of sales of 3.6% and the decline in revenue of 16.3% resulting from difficult trading conditions. All of this suggests a potential overstatement of rebates.

Spreadsheets are used to collate the information and these could be subject to manual error.

(Note credit was given to those candidates who calculated the expected rebate figure based on the previous year's average rebate rate. This is:
Expected 7.1% x 1,434 = 102
Actual = 185
Difference = 83).

Procedures

- Obtain spreadsheets and sales forecasts used in the calculation of rebates

<u>For a sample of calculations</u>

- Check calculations for accuracy
- Match details used in the calculations (such as rebate rate, length of contract) to signed supplier contracts

<u>For a sample of sales forecasts</u>

- Discuss assumptions used in the forecast with sales and purchases managers
- Consider reasonableness of the assumptions used
- Consider whether assumptions are consistent with the expected decline in the number of stores
- Assess the reliability of forecasts by comparison with post year-end management accounts
- Compare rebates recognised to post year-end receipts from suppliers.

<u>Other procedures</u>

- Discuss with the directors the reasons for the increase in supplier rebates in the year
- Ascertain if Hutton is using more suppliers with higher rebates
- Test controls over the:
  - management of spreadsheets
  - preparation of sales forecast (such as any finance department input)
- 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.

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Inventory
Justification
Inventory days have increased from 53.9 to 77.8 (inventory is up by 39%). This is inconsistent with the planned reorganisation involving the closure of stores indicating a potential overstatement of inventory.

Inventory includes smartphones which are susceptible to rapid technological change and soft furnishings which are susceptible to changes in fashion. Trading conditions are difficult and planned store closures may mean inventory items need to be discounted in order to sell. There may be obsolete inventory requiring write down to net realisable value.

The smartphones are desirable items subject to pilferage and the loss may not be reflected in the inventory records.

The inventory system may be recording incorrect balances as a result of:

website issues
integration issues with the EPOS system
inadequate controls over updates to the system for the results of inventory counts

The cost of inventory is adjusted to reflect any volume-based supplier rebates.

Foreign suppliers are paid in local currency and there is the potential for translation errors.
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Procedures

Evaluate the work of the internal audit function to assess if its work can be relied upon
Review reports of internal auditors' attendance at inventory counts

Evaluate the level of discrepancies identified at inventory counts
Consider the implications for the reliability of the inventory system

Plan to attend the 19 June 2015 inventory counts

Determine coverage of branches following evaluation of internal audit work
Evaluate and test controls over inventory count procedures
Perform two-way test counts of inventory
Identify slow-moving or obsolete items

Follow up inventory count notes to ensure provision is made for slow-moving or obsolete inventory identified at the count
Review and vouch key movements in inventory between 19 June and year end
Evaluate and test controls over updates to the perpetual inventory records from feeder systems
Match despatch and goods received records with entries in the inventory records to test cut off
Evaluate and test controls over the preparation of aged-inventory analysis
Review aged-inventory analysis to identify slow-moving or obsolete items
For those items in inventory check post year-end selling prices to determine whether net realisable value is less than carrying value
Discuss basis of provision for slow-moving or obsolete inventory with management
Sample test cost of inventory to suppliers' invoices
Review rebate adjustments and consider if they are consistent with spreadsheet calculations
For a sample of items purchased from overseas suppliers, recalculate the foreign exchange translation and trace the rate used to a reliable independent source.

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Intangible assets
Justification
Website development costs have increased 181.8%. At 1.3% of revenue, the costs are material.

Costs may be capitalised inappropriately resulting in overstatement of costs. For example, training costs associated with the new system or scrapped/abortive costs may be incorrectly included.

The cost of time spent by Hutton's own employees has been estimated by the IT director and there may be insufficient audit evidence to support the estimate. This indicates a potential misstatement of costs.

The determination of the useful life of intangible assets is an accounting estimate and susceptible to misstatement.

Amortisation may not have commenced when the system was ready for use or may not have been appropriately pro-rated for part of the year leading to an incorrect amortisation charge.

The asset may be impaired due to issues with the replacement website.

The prior year balance of £11m may not have been written down.

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Procedures
• Obtain a breakdown of costs and ensure all costs capitalised meet recognition criteria
• Vouch capitalisation of external software costs to contract or purchase invoices
• Ascertain the basis of the IT director's estimate for internal staff costs and consider reasonableness
• Vouch capitalisation of employee costs to employee timesheets, if available
• Confirm with management that ten years is a reasonable basis for estimated useful life
• Compare useful life to that used by other companies in the industry sector
• Recalculate amortisation charge and check that it has been correctly pro-rated
• Ensure the amortisation policy is correctly stated in the notes to the financial statements
• Discuss functionality of system with staff
• Review correspondence with Sweepweb and confirm whether issues were resolved
• Consider results of testing undertaken by IT auditors
• Inspect evidence of impairment reviews undertaken by management
Check that any costs relating to the old website have been written off.

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General Justification
The firm did not audit the prior year financial statements and opening balances may be misstated. Additionally, the figures in the financial statements may be deliberately misstated because of stock market pressure to maintain earnings.

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Procedures
• Review outgoing auditor's working papers, if available
• Check opening balances have been brought forward correctly
• Consider if substantive procedures are required.

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Answers to this part of the question were generally good. 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 as a deficiency in answers in previous examiners' reports. 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.

Many candidates overlooked that the firm had recently been appointed as external auditor and that obtaining assurance over opening balances may be an issue.

Volume-based supplier rebates

Answers to this part of the question were particularly pleasing as candidates had to consider the risk associated with supplier rebates using "first principles" rather than listing justifications and procedures that had been rote learned from the learning materials. Most candidates were able to provide a number of reasons to justify why supplier rebates was a key area of audit risk, including making use of analytical procedures to identify that the increase in rebates was inconsistent with the decrease in revenue and cost of sales. Most candidates also correctly identified that it was a complex area (due to the volume of suppliers, range of rebate percentages and contracts straddling the year-end), that it relied on estimations in forecasts and that the reliance on spreadsheets to calculate the rebates increased the risk of manual error.

Most candidates identified a number of plausible procedures such as testing the reasonableness of assumptions in the revenue forecasts, agreeing rebate percentages to contracts with suppliers, testing arithmetical accuracy of calculations and evaluating controls over spreadsheets. The most commonly overlooked procedures were:

- enquiring of management why the movement in rebates was inconsistent with the decrease in revenue and cost of sales
- obtaining a written representation from management regarding the appropriateness of the assumptions used in the calculations
- confirming purchase volumes with suppliers
- comparing rebates actually received after the year end to the estimates included in the year-end figure.

Inventory
Again, most candidates identified a number of reasons to justify why inventory was a key area of audit risk, including making use of analytical procedures such as calculating inventory days. Most candidates also correctly identified that inventory may not be stated at the lower of cost and net realisable value due to factors increasing the risk of obsolescence, such as the nature of inventory (being technological and fashionable items), competitors undercutting sales prices and the planned store closures. The majority of candidates also correctly identified that the issues encountered with the integration between the systems may give rise to errors as would inappropriate translation of supplier invoices denominated in a foreign currency. A significant number of candidates also cited that the absence of a year-end inventory count increased the risk of misstatement, failing to appreciate that a perpetual inventory system may provide added assurance. These candidates frequently went on to suggest that the auditor demand that the client perform a year-end count, or that the audit firm perform one itself, which would not be appropriate.

The majority of candidates presented a range of relevant procedures. Commonly cited appropriate procedures included:

- attending 19 June 2015 inventory count and carrying out relevant procedures (such as testing the controls over the count procedures, performing test counts and inspection of inventory for potentially obsolete items)
- obtaining the aged inventory analysis to identify slow-moving items
- agreeing costs recorded in the inventory records to supplier invoices and
- performing cut-off procedures.

The most commonly overlooked procedures included:

- considering reliance on the work of the internal auditors who had attended a number of inventory counts during the year
- reviewing post year-end selling prices to ascertain whether items included in inventory were subsequently sold below cost
- following up items identified as potentially obsolete at the inventory count and
- vouching key movements in inventory between 19 June count and the year end.

Intangible assets – website development costs
Answers relating to the justification of audit risk for website development costs were generally good with the majority of candidates identifying a number of appropriate reasons. The most commonly overlooked justifications were those relating to potential impairment resulting from the issues identified with the system during the year, and the prior year balance of £11 million.

Candidates were also able to cite a number of appropriate audit procedures to address the risks, such as vouching external costs to the Sweepweb contract, ascertaining the basis for the IT director's estimate of internal employee costs and obtaining a breakdown of the costs to ascertain whether they met the recognition criteria. The most commonly overlooked procedures were those relating to impairment, such as inspecting evidence relating to management's impairment review, considering the results of any testing undertaken by the internal auditors, discussing the functionality with employees and reviewing correspondence with Sweepweb.

The majority of candidates also appreciated that the determination of the useful life of the asset was subjective and that it would be appropriate to ascertain the basis for the estimate and compare this with that used by other companies in the sector.

Total possible marks	76½
Maximum full marks	30

Question 8
Total Marks: 20

General comments

This was the second highest scoring long-form question but was mainly due to a number of excellent answers on part (a) (ii).

Question 8a

(i) Describe how the Financial Reporting Council (FRC) promotes improvements in the quality of auditing.

The FRC promotes improvements in the quality of auditing through issuing International Standards on Auditing (UK and Ireland) (ISAs), Ethical Standards (ES) and occasional briefing papers on key audit issues such as professional scepticism. The FRC monitors compliance with ISAs and ESs through reviews of audit firms' policies and procedures. The findings from these reviews are presented in reports, which are available to the public. The FRC also oversees the regulatory activities of the professional accountancy bodies and investigates matters of misconduct with the power to take disciplinary action against audit firms. Additional work includes influencing the development of ISAs and commissioning research on audit and assurance issues.

Answers to this part of the question were disappointing with many candidates failing to score any marks by either not attempting the question or by discussing quality control procedures implemented by individual audit firms. Candidates who did score marks on this part of the question were able to identify that the FRC issued standards and briefing papers with a smaller number identifying that they also monitor compliance with standards through reviews of individual audit firms. The points most commonly overlooked were those relating to the oversight of the regulatory activities of the professional accountancy bodies, disciplinary powers and research on audit and assurance issues.

Total possible marks	8
Maximum full marks	3

(ii) Explain why matters (1) to (4) above have been reported to your firm and describe the actions that your firm should take in respect of each matter.

Target setting
The scenario represents a self-interest threat. External audit partners and staff may promote services not required by the client or make exaggerated claims about the benefit of such services to receive credit in their annual pay review. There is a loss of objectivity and independence and audit quality may suffer if external audit partners and staff overlook errors or are reluctant to raise contentious issues. It is also a breach of ES4 which requires firms to establish policies and procedures to ensure that:

- the objectives of the members of the engagement team do not include selling non-audit services to the audited entity
- the criteria for evaluating performance or promotion of members of the engagement team do not include success in selling non-audit services to the audited entity; and
- no specific element of remuneration of members of the engagement team is based on their success in selling non-audit services to the audited entity.

Actions
The firm must remove the targets and break the link between sales of non-audit services and pay of audit partners and staff. Objectives should be set that include a link between audit quality and pay.

Long association
Shane Smith has worked continuously as the audit partner for Garfield plc for over 6 years. The long association of Shane represents a familiarity threat as he may be too trusting and insufficiently sceptical of Garfield's financial statements. A reasonable and informed third party may consider or perceive the firm's independence and objectivity to be impaired. There is also a self-interest threat as Shane may fear losing the fees generated by this client. A self-review threat may arise as Shane will be reluctant to identify any errors or misstatements made in prior years' financial statements.

Actions
ES3 requires that, for listed companies, the firm establishes procedures to ensure that no one shall act as audit engagement partner for more than five years and shall not subsequently participate in the audit engagement for a further five years. When it is necessary to safeguard the audit quality (because of, for example, a substantial change in the business or an unexpected change in senior management), the engagement partner can continue for a further two years. The firm must therefore review the effectiveness of its procedures to monitor the length of time engagement partners are associated with audited entities. If Shane has acted for 6 years, he can continue for up to one more year but the reasons must be disclosed to the shareholders and safeguards applied. These safeguards should include an expanded review of the audit work by the engagement quality control reviewer. If Shane has acted for 7 years he must cease to act as engagement partner.

Review of work
The firm cannot demonstrate that it has complied with ISA requirements. ISA 220 requires that a review is undertaken of the work performed by junior members of the audit team and without a record of the review there is no evidence that it has taken place. Paragraph A13 of ISA 230 requires that reviews of audit files are documented to show what audit work was reviewed, who reviewed it and when it was reviewed. A review reduces the risk of material misstatements and the issue of an inappropriate opinion.

Actions
The firm's audit and quality control manuals should be checked and, if necessary, updated to ensure that the review procedure is adequately covered. Staff should be reminded of the procedure with training given, if appropriate. Partners should monitor that the procedure is undertaken and disciplinary action taken in the event of non-compliance.

Use of an external expert
The firm cannot demonstrate that it has complied with ES2, which requires that the audit engagement partner shall be satisfied that any external consultant involved in the audit will be objective and shall document the reason for that conclusion. Paragraph 11 of ISA 620 requires that a number of matters are agreed between the auditor and auditor's expert. Without a formalised arrangement, there is no evidence that these matters have been considered.

Actions
The firm must obtain confirmation, in writing, of Kapil's objectivity and independence. They should also assess the competence and capabilities of Kapil. The arrangement should then be agreed with Kapil, in writing if appropriate. The agreement should cover:

- the nature, scope and objectives of Kapil's work
- the respective roles of Kapil and the audit firm
- the nature, extent and timing of communication and the form of Kapil's report
- the need to observe confidentiality requirements
- access to Kapil's working papers.

It was pleasing to note that the standard of answers to part (ii) of the question was particularly high. Most candidates were able to explain why each of the four matters had been reported and suggest some actions for the firm to take. There were some excellent answers in respect of the first two matters although the final two matters caused some issues for weaker candidates.

Target setting
Most candidates were able to identify that this matter presented a self-interest threat and consequently audit quality may suffer. These candidates then correctly identified the actions required to be taken by the firm. Stronger candidates covered the requirements of ES4 in their answers. Disappointingly, a small minority of candidates thought that setting targets for selling non-audit services was either perfectly acceptable or acceptable provided that there were safeguards in place. A number of candidates incorrectly discussed low-balling when there was no evidence in the scenario that this had occurred and provided the fee income thresholds for listed and unlisted companies. A minority of candidates stated, incorrectly, that it is inappropriate for the audit firm to sell any non-audit service to its clients.

Long association
This matter was the best answered part of the question. The areas less frequently mentioned were the self-interest and self-review threats and the circumstances in which the length of time for which the engagement partner may act could be extended. Only stronger candidates correctly mentioned that the

firm needs to review the effectiveness of its procedures to monitor the length of time engagement partners are associated with audit entities. **Review of work** Answers to this matter were of a mixed standard. Most candidates identified that the work of the junior staff should be reviewed by more senior members and suggested some actions for the firm to take. Only the stronger candidates identified that the firm was unable to demonstrate that it had complied with the requirements set out in ISA 220 and ISA 230. Many candidates assumed the review had not been done rather than the review may have been done but not documented hence restricting the number of marks available to them. **Use of an external expert** Answers to this matter were of a mixed standard. Most candidates identified the need for the agreement with Kapil to be formalised, preferably in writing. Stronger candidates who were familiar with ISA 620 were able to identify the contents of the agreement. Very few candidates considered non-compliance with ES2 and that the firm must obtain written confirmation from Kapil of its independence from, or connections with, the audited entity. A number of candidates wasted time listing the audit procedures that should be performed when auditing a property valuation included in the financial statements of an audited entity. This was not within the scope of the question and no marks were awarded for these points.	
Total possible marks	29½
Maximum full marks	10

Question 8b

(i) In respect of quality control procedures undertaken by audit firms, outline the differences between:

- **an engagement quality control review (hot review); and**
- **a review as part of the firm's monitoring procedures (cold review).**

A hot review is designed to provide an objective evaluation of the significant judgments made and conclusions reached in formulating an audit report. A cold review seeks to provide the firm with reasonable assurance that its system of quality control is operating effectively.

A hot review involves:

- 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.

A cold review considers compliance with:

- firm's procedures
- ISAs
- Ethical Standards
- legislative requirements
- UK Audit Regulations.

A hot review is mandatory for audits of listed entities and for other audits where the firm has determined a review is required, for example, those engagements where risk is assessed as high. A cold review is performed on a sample of audit files.

A hot review takes place on or before the date of the audit report whereas a cold review is performed after the date of the audit report.

Answers to this part of the question were of a mixed standard. Most candidates identified that engagement quality control reviews are mandatory for listed companies and that cold reviews are undertaken on a sample of files. Most candidates also correctly identified when the reviews should take place although some candidates thought that cold reviews are undertaken before the hot reviews. Only the stronger candidates were then able to identify some of the procedures undertaken on each review. Weaker candidates confused the engagement quality control review with that of the supervisory review that is required on all audit engagements.

Total possible marks	9
Maximum full marks	5

(ii) Set out the attributes required of an individual who is appointed by an audit firm to undertake engagement quality control reviews.

The reviewer should be a technically competent person with experience of the audited entity's industry and listed companies. The reviewer must be independent of both the engagement team and the audited entity and have the authority to evaluate objectively the judgments made and conclusions reached during the audit.

This part of the question was very well answered. The majority of candidates identified four or more attributes of a reviewer and consequently scored maximum marks. The point most commonly overlooked was that the reviewer should have experience of listed companies.

Total possible marks	4
Maximum full marks	2

Question 9
Total Marks: 25

General comments
This was the least well answered long-form question particularly in respect of part b(i). Disappointingly, a number of candidates presented incomplete answers to this question. A number of answers were very short, possibly indicating mismanagement of time allocation across the paper.

Question 9a

Draft points for inclusion in your firm's report to those charged with governance and management at Yorker. For each of the two internal control deficiencies identified above, you should outline the possible consequence(s) of the deficiency and provide recommendation(s) to address the deficiency.

Consequences	Recommendation
Completed projects not invoiced **Consequences** Invoicing may never take place or may be delayed resulting in a higher risk of non-payment by clients. Customer goodwill could be damaged leading to a loss of reputation and future trade. The above points will lead to an adverse impact on profits and cash flow and, ultimately, the going concern status may be at risk. Profits and losses will not be recognised on a timely basis resulting in unreliable management information for decision making.	**Recommendation** • Implement a company policy of invoicing immediately on project completion • Project managers must notify the accounts department when a project is completed • Introduce a system of stage payments throughout projects • Regularly (for example weekly or monthly) assess the level of unbilled work in progress
No comparison of actual against budget costs **Consequences** Cost overruns will not be identified 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 Yorker to price future contracts on a profitable basis. There will be an adverse impact on cash flow and reduced profitability.	**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 at Edinburgh office to identify additional provisions for losses

General marks applicable to both scenarios
The following recommendations apply:

- communication of procedures and staff training
- staff 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.

This part of the question was reasonably well answered. Generally, candidates were better at identifying the consequences of the internal control deficiencies than providing recommendations. Most candidates were able to outline a broad range of possible consequences and provide some suitable recommendations in both scenarios. The most common omissions in scenario (1) were that customer goodwill could be damaged leading to a loss of reputation and that a system of stage payments throughout projects should be introduced. The most common omissions in scenario (2) were that penalty clauses for late completion could be triggered and that significant variances should be investigated. A number of candidates incorrectly provided consequences and recommendations for a company that manufactured and sold finished goods.

Total possible marks	21
Maximum full marks	9

Question 9b

(i) Briefly state the additional disclosure requirements that should be included in the auditor's report on the financial statements of listed companies that are required to apply the UK Corporate Governance Code. Identify and explain the attributes that are required to make these disclosures effective.

The additional disclosure requirements that should be included in the auditor's report on the financial statements of listed companies required to apply the UK Corporate Governance Code are:

- a description of the assessed risks of material misstatement
- an explanation of how the auditor applied the concept of materiality in planning and performing the audit
- an overview of the audit scope
- a statement on the result of the auditor's review of the part of the Corporate Governance Statement relating to the audited entity's compliance with the nine provisions of the UK Corporate Governance Code.

The explanations need to be clear and specific to the audited entity (non-generic) so that users can understand the implications of the disclosures in the audit report.

Answers to this part of the 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. 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 also set out in paragraph 19 of ISA 700. The better-prepared candidates who were familiar with this material provided very succinct answers and scored maximum marks. A number of candidates provided long answers and scored maximum marks but ignored "Briefly state" in the requirement.

Total possible marks	7
Maximum full marks	4

(ii) State, with reasons, the implications for the auditor's report on Spinball's financial statements for the year ended 31 May 2015 if the directors of Spinball:

(1) adequately disclose; or
(2) do not disclose

the information in respect of the licence to operate in Turkey in the notes to the financial statements.

There is uncertainty over the going concern status of Spinball, as 40% of revenue comes from Turkey, where its licence to operate is expected to be withdrawn. This is a material amount and disclosure in the financial statements is therefore fundamental to the users' understanding of the financial statements.

Appropriate disclosures
The audit opinion should not be modified because there is no material misstatement as appropriate disclosures have been made and there is no limitation on scope as sufficient appropriate evidence is available. The audit report should be modified with an emphasis of matter paragraph below the opinion section of the report. The paragraph draws the users' attention to the uncertainty disclosed in the notes to the financial statements. It should include a brief description of the circumstances and include a specific statement that the opinion is not modified/qualified in respect of this matter.

No disclosures
The opinion should be modified because there is a material misstatement due to the failure to disclose the uncertainty in the notes to the financial statements. If the issue is considered material, but not pervasive, a qualified ('except for') opinion should be given. If the issue is considered material and pervasive, an adverse opinion ("do not present fairly/give a true and fair view") should be given. A paragraph, headed "Basis for qualified opinion/adverse opinion", describing the matter giving rise to the modification should be included in the report.

This part of the question was generally well answered with a number of candidates scoring maximum marks. The points most commonly overlooked were those relating to the uncertainty over going concern and the materiality of the revenue generated in Turkey. Some candidates strayed beyond the requirement which was restricted to an uncertainty about the going concern and wrote at length about the implications for the financial statements if the audited entity was not a going concern. These candidates failed to appreciate that the financial statements are still prepared on the going concern basis even if there is an uncertainty about the going concern status.

Total possible marks	10
Maximum full marks	7

(iii)State, with reasons, the implications for the auditor's report if the directors had based their assessment of the company's ability to continue as a going concern on financial forecasts for the six months ending 30 November 2015, instead of the 18 months ending 30 November 2016.

Failure to base assessment on twelve months
Management's assessment of the entity's ability to continue as a going concern should cover twelve months from the date of the financial statements (ISA 570) or date of approval of the financial statements (ISA 570 UK and Ireland). The assessment covering six months will not provide sufficient appropriate evidence (ie is a limitation on scope) and consequently the opinion should be modified. If the issue is considered material, but not pervasive, a qualified ('except for') opinion should be given. If the issue is considered material and pervasive, a disclaimer of opinion ("do not express an opinion") should be given. In addition, the Companies Act 2006 requires a reference to be made to the fact that all information necessary for the audit has not been received.

Failure to disclose the period of assessment in the financial statements
If the directors fail to disclose that the period of assessment is less than twelve months, the auditor should include a reference to that fact in the basis of opinion section of audit report. Where non-disclosure is a departure from the applicable financial reporting framework a qualified opinion should be issued.

Generally, answers to this part of the question were of a high standard. Most candidates appreciated that the six-month period of assessment was insufficient and that it should be extended to at least twelve months and that there was a limitation on scope as the auditor was unable to obtain sufficient, appropriate evidence to support the going concern assumption. Only a minority of candidates appreciated that the issue had to be reported by exception under Companies Act 2006. A significant number of candidates who correctly identified that the opinion should be modified incorrectly stated, in the case of material and pervasive, that it should be an adverse opinion instead of a disclaimer of opinion. A number of candidates incorrectly identified the need for an emphasis of matter paragraph to highlight the issue.

Total possible marks	10
Maximum full marks	5

