

Examiner's report

F8 Audit and Assurance

December 2012



General Comments

The examination consisted of five compulsory questions. Question 1 for 30 marks, question 2 for 10 marks and three further questions of 20 marks each.

The performance of candidates across the paper as a whole was unsatisfactory. Candidates performed well on questions 1, 2 and 4a but struggled with questions 3, 4b and 5.

Candidates performed particularly well on questions 1a, 1cii, 1ciii, 2a and 4a. The questions candidates found most challenging were questions 1b, 1ci, 2c, 3a, 3b, 3c, 4b, 5a and 5b. This is mainly due to candidates not understanding core syllabus areas well enough; a lack of technical knowledge and also due to a failure to read question requirements carefully.

It was evident this session that many candidates had learnt generic tests and standard answers for topic areas. They made little effort to apply these answers to the scenario or the actual question requirement and so provided irrelevant answers. For example, question 1b covered procedures to be undertaken during the inventory count; candidates had learnt inventory tests and so listed these out; failing to recognise that the question only wanted tests DURING the count. They provided tests that would be undertaken before and after the count and so failed to score more marks. Candidates must apply their knowledge rather than just learning and then listing standard points.

The vast majority of candidates attempted all five questions, and there was little evidence of time pressure. Where questions were left unanswered by candidates, this appeared to be due to a lack of knowledge or poor exam technique, as opposed to time pressure.

A number of common issues arose in candidates' answers:

- Failing to read the question requirement carefully and therefore providing irrelevant answers which scored few if any marks. Candidates must remember to answer the question asked and not the question they wish had been asked.
- Poor time management between questions, some candidates wrote far too much for some questions such as 1a, 2a and 2b and this put them under time pressure to finish remaining questions.
- Failure to fully understand the requirement verbs such as "describe", "recommend" or "explain" and hence not providing sufficient depth to their answers.
- Providing more than the required number of points especially in question 1a and 2a.
- Poor layout of answers, including not using columns for questions such as 1a and 3b when this would have helped to maximise marks.

Specific Comments

Question One

This 30-mark question was based on a glass manufacturer, Lily Window Glass Co (Lily), and tested candidates' knowledge of internal controls, procedures undertaken by the auditor during an inventory count and computer assisted audit techniques (CAATs).

Part (a) for 12 marks required candidates to identify and explain, for the inventory count arrangements of Lily, six deficiencies and suggest a recommendation for each deficiency.



Most candidates performed very well on this part of the question. They were able to confidently identify six deficiencies from the scenario. However, some candidates did not address the question requirement fully as they did not “identify and explain”. Candidates identified, but did not go on to explain why this was a deficiency. For example “additional inventory sheets are not numbered” would receive $\frac{1}{2}$ mark, however to obtain the other $\frac{1}{2}$ mark they needed to explain how this could cause problems during the inventory count; such as “the additional sheets could be lost resulting in understated inventory quantities”.

The requirement to provide controls was also well answered. Most candidates were able to provide practical recommendations to address the deficiencies. The main exception to this was with regards to the issue of continued movements of goods during the count. The scenario stated that Lily undertakes continuous production; therefore to suggest “that production is halted for the inventory count” demonstrated a failure to read and understand the scenario. The scenario is designed to help candidates and so they should not ignore elements of it.

Some candidates incorrectly identified deficiencies from the scenario, demonstrating a fundamental lack of understanding of the purpose of an inventory count. For example, a significant minority believed that inventory sheets should contain inventory quantities when in fact this is incorrect, as this would encourage markers to just agree the stated quantities rather than counting properly. In addition candidates felt that counters should not use ink on the count sheets as pencil would be easier for adjustments, again this is incorrect, as if the counts are in pencil then the quantities could be erroneously amended after the count. Also candidates felt that there should be more warehouse staff involved in the count, despite the self- review risk.

Many candidates set their answer out in two columns being deficiency and recommendation. However, those who explained all of the deficiencies and then separately provided all of the recommendations tended to repeat themselves and possibly wasted some time. In addition, the requirement was for six deficiencies; it was not uncommon to see candidates provide many more than six.

Part (b) for 6 marks required procedures the auditor should undertake during the inventory count of Lily. Performance was unsatisfactory on this part of the question.

The requirement stated in capitals that procedures DURING the count were required; however a significant proportion of candidates ignored this word completely and provided procedures both before and after the count. Many answers actually stated “before the count...”, candidates must read the question requirements properly.

Those candidates who had read the question properly often struggled to provide an adequate number of well described points. The common answers given were “to observe the inventory counters” although candidates did not make it clear what they were observing for; or “undertake test counts” but with no explanation of the direction of the test and whether it was for completeness or existence. Some candidates provided all possible inventory tests, in particular focusing on NRV testing. This demonstrated that candidates had learnt a standard list of inventory tests and rather than applying these to the question set just proceeded to list them all. This approach wastes time and does not tend to score well as of the six answers provided very few tended to be relevant.

Part (c) for 4 marks required a description of four audit procedures that could be carried out for inventory using CAATs. Performance on this question was unsatisfactory.

Candidates needed to apply their knowledge of CAATs to inventory procedures, many failed to do this. Again lots of candidates did not read the question properly and so despite the requirement to apply their answer to inventory, they proceeded to refer to tests on receivables and payables. Also many candidates appear not to actually understand what CAATs are, who uses them and how they work. Therefore many answers focused on



the company using CAATs rather than the auditor, many procedures given were not related to CAATs for example “discuss inventory valuation with the directors” or “agree goods received notes to purchase invoices”.

Those candidates who scored well tended to mainly focus on analytical review procedures for inventory that could be undertaken as part of audit software tests.

Part (cii) for 4 marks required an explanation of the advantages of using CAATs. This question was on the whole answered well.

Candidates were able to identify an adequate number of advantages to score well on this part of the question. The main advantages given related to saving time; reducing costs; improving the accuracy of testing and the ability to test larger samples. A minority of candidates failed to explain their advantages; answers such as “saves time” were commonly provided, this is not an explanation and so would not have scored well.

Part (ciii) for 4 marks required an explanation of the disadvantages of using CAATs. Again, this part of the question was answered well.

Like in (cii) candidates were able to identify an adequate number of points to score well. The main disadvantages given related to increased costs; training requirements and the corruption of client data. It was apparent here and for (cii) that candidates had learnt a standard list of points for CAATs, however some candidates did try to apply their knowledge of standard advantages and disadvantages to inventory.

Question Two

This 10-mark question covered the topics of auditor rights, internal control activities and limitations of external audits.

Part (a) for 3 marks required candidates to state three rights of an auditor excluding those related to resignation and removal. This question was answered well by almost all candidates with many scoring full marks.

Candidates were able to confidently state three rights and most scored full marks. Some gave far more than three rights, however as the requirement was only to state this was unlikely to have caused too much additional time pressure. Many candidates provided irrelevant answers such as “the auditor has a right to be paid a fee” or “the auditor has a right to request information from third parties”. A common misunderstanding was with regards to meetings the auditors can attend; they have the right to attend shareholder or general meetings but not board meetings.

Part (b) for 4 marks required an explanation of four control activities to prevent and detect fraud and error. This was answered satisfactorily by many candidates.

Most candidates were able to provide an adequate number of controls which would prevent and detect fraud and error, with many identifying activities such as segregation of duty, authorisation and physical controls. However, some candidates misunderstood the question and gave internal control components rather than activities, such as risk assessment process and information processing. In addition some candidates failed to explain the controls, instead just stating “segregation of duties” rather than explaining what this means or providing an example segregation of duties control.

Part (c) for 3 marks required a description of three limitations of external audits. Performance was inadequate on this question.

This question was left unanswered by a significant minority of candidates. Those who attempted it were often unable to provide more than one relevant answer; the most common correct answer given was with regards to auditors needing to sample rather than testing all transactions.



Some candidates seemed to think the question wanted disadvantages of having an audit, rather than the limitations of an audit, these are two different requirements. The most common incorrect answers given were related to the cost of an audit, ethical threats such as confidentiality and the auditor not understanding the entity.

Question Three

This 20-mark question was based on Sunflower Stores Co (Sunflower) which operated 25 food stores. The question tested the areas of understanding an entity, audit risks and responses and internal audit.

Part (a) for 5 marks required a list of five sources of information for gaining an understanding of Sunflower and what each source would be used for. Candidates' performance on this question was unsatisfactory.

A significant proportion of candidates did not seem to understand what was required from them for this question. They did not seem to understand what a "source of information" was and so failed to list where they would obtain information from such as prior year financial statements or last year's audit file. Some were able to explain what they would want to gain knowledge on e.g. audit risks or accounting policies but did not tie this into the source of information.

In addition the question requirement related to gaining an understanding of Sunflower, this is part of the planning process, however a significant proportion of candidates gave sources of information relevant to carrying out the audit fieldwork, such as bank letters, written representations or receivables circularisation.

Most candidates' confused requirements 3a and 3b and so gave sources of information relevant to auditing the risks from requirement 3b. These points were not relevant to gaining an understanding of Sunflower and hence scored no marks.

Part (b) for 10 marks required a description of five audit risks from the scenario and the auditor's response for each. Performance on this question was mixed, although slightly better than December 2011 when audit risk was last tested.

The scenario contained many more than five risks and so many candidates were able to easily identify enough risks, they then went on to describe how the point identified from the scenario was an audit risk by referring to the assertion and the account balance impacted. There seemed to be a higher proportion of candidates this session who described the audit risk adequately.

Some candidates tended to only identify facts from the scenario such as "Sunflower has spent \$1.6 million in refurbishing all of its supermarkets" but failed to explain how this could impact audit risk; this would only have scored ½ marks. To gain 1 mark they needed to refer to the risk of the expenditure not being correctly classified between capital and repairs resulting in misstated expenses or non-current assets. Additionally, candidates were able to identify the fact from the question but then focused on categorising this into an element of the audit risk model such as inherent or control risk. The problem with this approach is that just because they have stated an issue could increase control risk does not mean that they have described the audit risk and so this does not tend to score well.

The area where most candidates performed inadequately is with regards to the auditor's responses. Some candidates gave business advice such as, for the risk of the finance director (FD) leaving early, that "the auditor should ask management to replace the FD quicker" this is not a valid audit response. Other responses focused more on repeating what the appropriate accounting treatment should be, therefore for the risk of inventory valuation due to the policy of valuing at selling price less margin, the response given was "inventory should be valued at the lower of cost and NRV", again this is not a valid audit response.



Responses which start with “ensure that.....” are unlikely to score marks as they usually fail to explain exactly how the auditor will address the audit risk. Also some responses were too vague such as “increase substantive testing” without making it clear how, or in what area, this would be addressed. Audit responses need to be practical and should relate to the approach the auditor will adopt to assess whether the balance is materially misstated or not.

A significant minority of candidates misread the scenario and where it stated that it was the first year on this audit for the senior, candidates seemed to think that it was the first year for the firm as a whole and so identified an audit risk of Sunflower being a new client with higher detection risk. This scored no marks as it was not the first year of the audit, candidates must read the scenario more carefully.

Most candidates presented their answers well as they adopted a two column approach with audit risk in one column and the related response next to it.

Part (c) for 5 marks required candidates to describe factors the finance director should consider before establishing an internal audit (IA) department. Performance was unsatisfactory on this part of the question.

Many candidates were able to gain a few marks with points on considering cost and benefits of the IA department and whether it should be outsourced or run in house. However, this seemed to be the limit of most candidates’ knowledge in this area. Unfortunately many candidates strayed into the area of who IA should report to and the qualifications and independence of the department; these are factors to consider when running IA as opposed to whether or not to establish an IA department. Once again, candidates must answer the question set and not the one they wish had been asked.

Question Four

This 20-mark question was based on Rose Leisure Club (Rose) and tested candidates’ knowledge of ethical principles and substantive procedures.

Part (a) was for 5 marks and required the identification and explanation of five fundamental ethical principles. This question was unrelated to the scenario and was knowledge based, candidates’ performed very well, with many scoring full marks.

Ethics questions are usually popular and well answered by candidates. The vast majority of candidates confidently identified the five principles, where they did not score full marks was normally due to a failure to adequately explain the principles or because they gave incorrect explanations. Often the principle of integrity was explained with the objectivity explanation and vica versa; this would have not scored well. In addition a small minority of candidates gave ethical threats such as self-review and self-interest rather than the principles, this may have been due to a failure to read the question properly.

Part (bi) for 6 marks required substantive procedures for an issue on trade payables and accruals with regards to an early cut off of the purchase ledger resulting in completeness risk. Performance on this question was unsatisfactory.

Candidates were unable to tailor their knowledge of general substantive procedures to the specific issue in the scenario. Most saw that the scenario title was trade payables and accruals and proceeded to list all possible payables tests. This is not what was required and hence did not score well. The scenario was provided so that candidates could apply their knowledge; however it seems that many did not take any notice of the scenario at all. What was required was tests to specifically address the risk of cut off and completeness due to the purchase ledger being closed one week early.

Common mistakes made by candidates were:

- Providing procedures to address assertions such as rights and obligation for example “review year end purchase invoices to ensure in the company name”.
- Giving objectives rather than procedures “ensure that cut off is correct”, this is not a substantive procedure and so would not score any marks.
- Lack of detail in tests such as “perform analytical procedures over payables”, this would score no marks as the actual analytical review procedure has not been given.
- Believing that “obtaining a management representation” is a valid answer for all substantive procedure questions.
- Not providing enough tests, candidates should assume 1 mark per valid procedure.

Part (bii) for 5 marks required substantive procedures for an issue on trade receivables circularisations with regards to non-responses and responses with differences. Performance on this question was also unsatisfactory.

As above, candidates failed to identify the specific issue from the scenario and instead provided a general list of receivables tests. Some candidates failed to recognise that analytical review procedures were unlikely to be of any benefit as Rose’s receivables had changed significantly on the prior year due to a change in the business model. Also Rose was a leisure club and so provided services rather than goods; however candidates still recommended “reviewing goods despatch notes for cut off”. This again demonstrates that candidates are learning generic lists of procedures and just writing them into their answers with little thought or application to the scenario. This approach will score very few if any marks at all.

Part (biii) for 4 marks required substantive procedures for an issue on a reorganisation announced just before the year end. Performance on this question was also unsatisfactory; a significant minority did not even attempt this part of the question.

Those candidates who scored well focused on gaining evidence of the provision, therefore they provided valid procedures like “recalculating the provision”, “discussing the basis of the provision with management”, “obtaining a written representation confirming the assumptions and basis of the provision” and “reviewing the board minutes to confirm management have committed to the reorganisation”.

Some candidates failed to read the question properly and assumed that the reorganisation had already occurred as opposed to being announced just before the year end. Therefore many provided answers aimed at confirming that assets had been disposed of and staff had been retrained. In addition some candidates focused on whether the company was making the correct business decisions by reorganising.

Many procedures also lacked sufficient detail to score the available 1 mark per test. This commonly occurred with tests such as; “reviewing board minutes” and “obtain written representation”. These procedures need to be phrased with sufficient detail to obtain credit, therefore if we consider the following candidates answers:

- “Obtain a written representation from management” - this would not have scored any marks as it does not specify what the representation is for.
- “Obtain a written representation from management in relation to the provision” - this would have scored ½ marks as it did not specify what element of the provision we wanted confirmation over.
- “Obtain a written representation from management confirming the assumptions and basis of the provision”- this would have scored 1 mark as it clearly states what is required from management, and in relation to which balance and for which element.

As stated in previous examiner reports, substantive procedures are a core topic area and future candidates must focus on being able to generate specific and detailed tests which are applied to any scenario provided.

Question Five

This 20-mark question was based on an audit firm Violet & Co (Violet) and its two clients Daisy Designs Co (Daisy) and Fuchsia Enterprises Co (Fuchsia) and tested candidates' knowledge of written representations, evidence and audit reports.

Part (a) for 5 marks required an explanation of the purpose and procedures for obtaining written representations. This question was unrelated to the scenario and was knowledge based. Performance was unsatisfactory on this question.

A majority of candidates were able to provide answers on the purpose of a written representation. However a significant minority strayed from the question requirement and focused on what the audit report implications were if management refused to provide a representation; this was not required and scored no marks.

Candidates seemed to confuse written representations with third party confirmations such as bank letters and receivables circularisations. Therefore when discussing the procedures for obtaining a representation these candidates were unable to provide valid answers.

Part (b) for 3 marks required a description of the relevance and reliability of an oral representation given by management for the completeness of the bank overdraft balance. Performance was unsatisfactory on this question.

Many candidates were able to apply their knowledge of relevance and reliability of evidence to the specific example given. Many of these easily scored two marks by discussing oral versus written evidence and client generated Vs third party or auditor generated evidence. However, very few adequately considered whether a representation on completeness would be relevant for a liability balance. Some candidates ignored the requirement to focus on relevance and reliability and so provided general points on representations, despite having already done this in part (a).

Part (c) for 12 marks required a discussion of two issues; an assessment of the materiality of each; procedures to resolve each issue and the impact on the audit report if each issue remained unresolved. Performance was mixed on this question. There were a significant minority of candidates who did not devote sufficient time and effort to this question bearing in mind it was worth 12 marks.

The requirement to discuss the two issues of Daisy's corrupted sales ledger and Fuchsia's going concern problem was on whole, answered well by most candidates. In addition many candidates correctly identified that each issue was clearly material. A significant minority seemed to believe the corruption of the sales ledger was an adjusting event and so incorrectly proceeded to focus on subsequent events.

With regards to procedures to undertake at the completion stage, candidates seemed to struggle with Daisy. Given that the sales ledger had been corrupted procedures such as "agree goods despatch notes to sales invoices to the sales ledger" or "reconcile the sales ledger to the general ledger" were unlikely to be possible. Most candidates correctly identified relevant analytical review procedures and a receivables circularisation. Candidates performed better on auditing the going concern of Fuchsia, however some candidates wasted time by providing a long list of going concern tests when only two or three were needed.

Performance on the impact on the audit report if each issue remained unresolved was unsatisfactory. Candidates still continue to recommend an emphasis of matter paragraph for all audit report questions, this is not the case and it was not relevant for either issue. Candidates need to understand what an emphasis of matter paragraph is and why it is used.



A significant number of candidates were unable to identify the correct audit report modification, suggesting that Daisy's should be qualified or adverse, as opposed to disclaimer of opinion. Also some answers contradicted themselves with answers of "the issue is not material therefore qualify the opinion". Additionally many candidates ignored the question requirement to only consider the audit report impact if the issue was unresolved. Lots of answers started with "if resolved the audit report" this was not required. In relation to the impact on the audit report, many candidates were unable to describe how the opinion paragraph would change and so failed to maximise their marks.

Once again future candidates are reminded that audit reports are the only output of a statutory audit and hence an understanding of how an audit report can be modified and in which circumstances, is considered very important for this exam.