

# Examiner's report

## F8 Audit & Assurance December 2009



### General Comments

The examination consisted of five compulsory questions. Section A contained question 1 for 30 marks and question 2 for 10 marks. Section B comprised three further questions of 20 marks each.

It was pleasing to see that the vast majority of candidates attempted all parts of all five questions. Most candidates answered the questions in the order in which they were set (1,2,3,4,5), however some chose to start with a section B question first such as question 3 or 5 and then go on to answer the section A questions. Of those who answered the questions in reverse order (5,4,3,2,1), a number encountered timing difficulties and their question 1 answers were often incomplete. Candidates are reminded that questions can be answered in any order, but remember the importance of allowing sufficient time to answer question 1 as it is a case study and carries 30 marks.

Candidates performed well in particular on questions 1a, 2 and 3b. The questions candidates found most challenging were question 1b, 1c, 1e and question 4. This is partly due to a failure to read the question requirements properly and also possibly due to the subject matter being less well understood.

A number of common issues arose in some candidates' answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks
- Ignoring specific requirements in relation to the number of points required, i.e. if three procedures were required many candidates wasted time by providing six or seven procedures
- Wasting time by rewriting the question requirements out or providing lengthy introductions or definitions which were unnecessary
- Presenting answers inadequately, questions 1d, 3b and 4a in particular lent themselves well to a columnar format as opposed to lengthy paragraphs of text
- Failing to answer each question on a new page of the answer booklet
- Illegible handwriting.

### Specific Comments

#### Question One

This 30-mark question was based on a publisher and producer of poetry books and tested candidates' ability to cope with a number of areas including inventory, royalty charges and sales statistics. There was also a stand-alone sub requirement in relation to audit planning.

Part (a) for 6 marks required candidates to explain the importance of audit planning and to state two matters to be included in an audit plan.

Most candidates performed well on this part of question 1. There were 4 of the 6 marks available for the importance of audit planning and most were able to provide answers of identification of audit risk, ensuring an efficient and effective audit and helping to select appropriate team members. The second part of the question required matters to be included in an audit plan and again many answered this well with points such as materiality and audit procedures to address the risks identified.

A number of candidates did provide a combined answer with their points to be included in an audit plan given when they were covering the importance of audit planning. Candidates are reminded that using headings and subheadings can help to provide a more focused answer. Where the two headings were used importance of planning and matters to be included in an audit plan, the answers tended to score well as it helped to focus the answers and reduce repetition of points.

A significant number of candidates provided substantially more than the two matters which were required. Whilst it is understandable that candidates wish to ensure that they maximise their marks, providing an excessive number of points when only two are required leads to time pressure and a loss of marks elsewhere in the exam.

Part (b) for 4 marks required two procedures to ensure that sales statistics used by the company may be relied upon. This question presented difficulties for almost all of the candidates and was inadequately answered. It would appear that many did not understand what was required of them and they failed to understand what the sales statistics were. The company was keeping records of sales made by month and by type of customer and colleges. The auditor could place reliance on these and perhaps use them for analytical review purposes, but would have needed to test their reliability first.

Many candidates confused the sales statistics with the royalties that the company gave to its poets and so provided a long list of procedures to test royalties, even though this was required in part (c) of the question. Many also provided general sales procedures such as 'vouching a sample of sales from goods despatch note to invoice to the sales ledger' with no reference to the sales statistics at all.

In addition, the question required a description of two procedures for 4 marks. Hence a reasonable level of detail was required in relation to the explanation of the procedure in order to score 2 marks per point. The level of detail provided in the audit procedures was generally fairly brief. Very few candidates managed to score full marks in this area.

Part (c) for 6 marks required three substantive tests in relation to the completeness and accuracy of royalty charges. There was also within this question a requirement to state the objective of each test. This question proved to be challenging for a large number of candidates and there were some disappointing answers. Many provided procedures which tested sales income as opposed to royalty charges. Procedures such as 'agreeing sales invoices to the customer master files' were common, but these do not consider how to gain comfort over royalties.

In addition the question asked for substantive procedures, but many candidates gave tests of control. Candidates need to understand the difference between a substantive procedure and a test of control.

Many candidates failed to provide the objective of their tests and hence missed out on marks. A proportion of candidates presented their answer in a columnar format with a column for the procedure and one for the objective. This seemed to maximise their marks as it reminded them of the second sub-requirement in part (c). Many candidates did attempt to link their procedures into the financial statement assertions of completeness and accuracy.

Part (d) for 4 marks required two inherent risks in relation to inventory and one control to mitigate each risk. Answers to this question were mixed. A significant proportion of candidates were able to provide inherent risks such as damaged goods, theft and slow moving books. However it was unsatisfactory to see the level of general risks given such as 'inventory may be overstated' with no explanation as to how it might be overstated such as it is 'overvalued due to the goods being damaged'.

Candidates were then required to suggest controls to mitigate each risk. There was a significant minority who misread the question and thought that substantive procedures were required as opposed to controls that management might adopt. Their answers took the stance of the auditor testing inventory rather than management looking to reduce risk. This misunderstanding can only have arisen due to a failure to read the question properly.

In addition a reasonable number of candidates started their answer with a definition of inherent risk, this was not required and hence did not generate any marks at all. Candidates must read the question carefully to make sure

that they give an answer to the question actually asked and not the question they would have liked to have seen asked.

Part (e) for 10 marks had two sub requirements, part (i) required a definition of net realisable value (NRV) and part (ii) four procedures to ensure NRV of inventory is above cost.

It was pleasing to see that a significant proportion of candidates could clearly provide the definition of NRV from IAS 2 *Inventories*. However there were a large number of candidates who did not understand what NRV was. Common errors included:

- Confusing NRV with net book value and stating that NRV was cost less depreciation
- Giving the IAS 2 definition of how inventory should be valued i.e. lower of cost and NRV but not actually answering the question asked of what NRV was
- Stating that NRV was market value of goods less the costs of sale, this is the definition of gross profit and not NRV.

It is unsatisfactory that candidates cannot use their accounting knowledge gained in F3 Financial Accounting and apply it to an audit question. This is assumed knowledge for F8 and candidates must be prepared to apply this in an audit question where required.

The second part of this question was not answered well. Perhaps due to the misunderstandings over what NRV involved, many candidates could not provide any relevant procedures let alone the four required by the question. In addition although the question clearly stated that cost has already been determined satisfactorily a significant proportion of answers contained procedures to verify the cost of inventory. Again, candidates must read the question clearly, as it was obvious that standard lists of inventory tests had been learnt and so were written in their answers even though many were irrelevant.

Some of those candidates who did attempt to provide relevant NRV procedures unfortunately did not give sufficient detail in their answers to receive the 2 marks available per procedure, and many tests were too vague such as 'check the sales prices'. Candidates must be able to provide detailed audit procedures in order to be successful in this paper.

## **Question Two**

This 10-mark question covered the areas of audit evidence and communication with those charged with governance.

Part (a) for 4 marks was answered very well by the vast majority of the candidates. They were easily able to identify four factors that influenced the reliability of audit evidence.

A small minority of candidates misunderstood the requirement and provided answers around sufficiency of evidence, methods to obtain evidence or auditor independence.

Part (b) for 6 marks required candidates to describe responsibilities of those charged with governance and to provide examples of matters that the auditor might communicate to them on.

Generally candidates performed well on part (b). There was a minority of candidates who focused on who those charged with governance were rather than on their responsibilities and hence provided answers such as 'those charged with governance are non executive directors'. This would not generate marks as it failed to answer the question asked.

In the second part of question (b) many candidates did not fully explain the matters to be communicated. The requirement was to 'explain' but many answered this question as if the requirement was 'list' or 'state' and hence failed to provide sufficient detail. In a number of cases candidates misunderstood and thought the question required matters that those charged with governance would communicate to the auditors.

### **Question Three**

This 20-mark question was based on a large engineering company with a capital intensive manufacturing process. Candidates were required to identify strengths from the company's control environment in relation to non-current assets, critically evaluate a given audit procedure for completeness and also to explain the importance of obtaining an understanding of the entity and its environment.

Overall this question was well answered in particular part (b), however part (c) provided many inadequate answers.

Part (a) for 4 marks was not related to the scenario and required an explanation of the importance to the auditor of understanding the entity and its environment. Many candidates performed satisfactorily on this question, they were able to identify one or two points such as assessing risks or to assess whether to rely on the internal controls and hence reduce substantive procedures. However after this they could not provide any other relevant answers.

A large proportion of candidates seemed to confuse the requirements of this question with question 1(a) and reproduced their answers from there.

Part (b) for 12 marks was very well answered by almost all candidates. The question required six strengths from the scenario and an explanation of how these may reduce control risk. Many candidates were able to clearly identify the required number of strengths. However it was very common to see answers where candidates had provided nine or ten strengths, when only six were required. This can lead to time pressure in other questions and is to be avoided.

Many candidates presented their answers in a columnar format and this seemed to provide clear and concise answers which covered both parts of the requirement.

Some candidates tended to lack sufficient detail in their explanations of how the strength reduced control risk, with many giving general answers such as 'this reduces control risk' rather than explaining how this reduces risk.

A small number of candidates did not read the requirement clearly and provided weaknesses in the control environment rather than strengths.

Part (c) for 4 marks presented difficulties for most candidates. The question provided a completeness test over non-current assets and candidates were asked to explain why this was not a good test for completeness and to state an alternative.

Many candidates choose to criticise the test because the auditor had used a representative sample, and so they suggested that all non-current assets should be tested. This demonstrates a lack of understanding of the principles of sampling and of the aim of audit procedures. In addition a significant proportion criticised the test as they stated that it was not a good test for existence. The requirement of the question was for completeness and not existence, yet many candidates wrote at length about the need for existence tests. As already stated candidates must take the time to read the question requirements carefully. The confusion over existence versus completeness also demonstrates a lack of understanding of the financial statement assertions and this is unsatisfactory.

Where candidates had read the question carefully and understood assertions, they were able to provide some good alternative completeness procedures such as ‘selecting a sample of non-current assets on the shop floor and tracing back to inclusion in the non-current assets register’.

#### Question Four

This 20-mark question was based on a bread manufacturer who was suffering due to the economic down-turn and required a loan from the bank.

Part (a) for 4 marks considered the differences between an interim and a final audit. The quality of answers was variable. The stronger candidates presented their answers in a columnar format and understood enough about what an interim audit entailed in order to provide a sufficient number of points to pass. They were also able to identify differences as this was what was required and the layout of their answers helped them to consider both issues of interim and final audit. They generally scored marks in relation to the timing of each audit, the opinions (if any) given and the scope of the work at each stage; with most of these candidates recognising that internal controls were tested during an interim audit.

Unfortunately, there seems to be a misunderstanding amongst a significant proportion of the candidates as to what an interim audit is, who performs it and what its aim is. An interim audit is not performed by the internal audit department, it is not a review engagement to assess half year figures and it is not where the audit planning is performed.

Part (b) for 6 marks required an explanation of whether the external auditors would be able to rely on the work of the internal auditors. This question was answered reasonably well by candidates. Some were able to take their knowledge of reliance on internal audit and provide an answer which covered areas such as; independence, competence, professional care as well as scenario specific points such as the possibility of management pressure on internal audit in order to obtain the crucial loan finance.

Some candidates tended to only focus on independence and so failed to generate a sufficient number of points. In addition a significant minority felt that as the bank had asked for the external auditors to review the cash flow forecast that this somehow meant that the internal auditors could not be relied upon and that the internal auditors had allowed the company to encounter financial difficulties and so were unreliable. This shows a lack of commercial awareness as in the current economic environment a number of companies will be facing financing difficulties and this does not reflect on the quality of their internal audit departments.

Part (c) for 6 marks required three procedures in examining the cash flow forecast of the company. This question was unsatisfactorily answered by most candidates.

Common errors included:

- Confusing a cash flow forecast and a cash flow statement
- Not appreciating that the forecast covered a future period as opposed to historic information, therefore it would not be possible to perform such procedures as ‘agreeing revenue to sales invoices’.
- Providing procedures which were unrealistic, such as ‘compare the forecast to competitors cash flow forecast’ it would not be possible to obtain the forecast of a competitor
- Providing procedures which are relevant for an audit as opposed to future information such as ‘perform a receivables circularisation to confirm receivable balances’
- Not understanding that a cash flow forecast does not contain non-cash items such as depreciation
- Few candidates understood that a forecast would be made up of assumptions and hence these needed to be reviewed in detail for reasonableness.

Part (d) for 4 marks required an explanation of the kind of assurance that could be provided to the bank in relation to the cash flow forecast. It was pleasing to see that a significant proportion of candidates were able to correctly identify that negative assurance would be provided to the bank, and to state what this meant. However not many were able to explain why negative assurance was to be provided and incorrectly thought that this was because the company was experiencing cash flow difficulties or that it was because there was not much time available to undertake the work and hence a negative assurance would be provided. Only some candidates were able to explain that it was due to the nature of forecasts being future information and hence reasonable assurance not being a practical option.

### Question Five

This 20-mark question was based on a chain of fast food restaurants. Candidates on the whole performed satisfactorily.

Part (a) for 6 marks required four assertions relevant to accounts payable at the year-end date. It was unsatisfactory to see the number of candidates who could not list the assertions relevant to year-end balances. A significant proportion listed every assertion possible in a scatter gun approach. Financial statement assertions is a key element of the syllabus and is a crucial part of the audit process, future candidates must ensure that they understand the assertions relevant to classes of transactions, year-end balances and presentation and disclosure.

This question required an identification and explanation of the assertion, however a significant proportion provided procedures to test the assertion rather than an explanation of the assertion. Again, candidates are reminded to read the question carefully.

Part (b) for 10 marks required two controls to reduce risk associated with food purchases and preparation and two tests of controls. Overall this part of the question was answered well. Many candidates provided relevant, practical controls for a restaurant chain.

The requirement to generate any two tests of controls to assess whether control risk was low was not answered as well. However a significant minority provided impractical procedures which assumed that the auditor was a food hygiene expert, or suggested that the auditor should 'try the food to assess its quality'.

Part (c) for 6 marks required three items of evidence and an explanation of how they might enable the auditor to assess the likelihood of the claim succeeding. Many candidates had a reasonable attempt at the question and were able to identify three items of evidence, such as a letter from the lawyer, board minutes, discussions with management or management representation. However some candidates failed to explain how these items of evidence would help in the assessment of the claim.

In addition a minority suggested items of evidence that would not help the auditor in making an assessment of the claim, such as what the claimant ate, or his/her till receipt, or discussions with the kitchen staff that worked on the day in question. Candidates need to remember that the auditor is not the lawyer and is only interested in whether the claim requires a provision or disclosure in the financial statements.

Part (d) for 4 marks considered how the claim should be reported in the financial statements and the effect on the audit report. The majority of candidates correctly identified that as the matter was material a contingent liability disclosure was required. However a significant minority incorrectly assumed that a provision was necessary despite the question stating that management felt they had good defences against the claim. This demonstrates a failure to apply knowledge of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the scenario.

The requirement to explain the effect on the audit report produced some mixed answers, a significant proportion correctly identified that if the disclosures were not made than an 'except for' opinion would be required. However



many candidates gave every audit report option including disclaimer of opinion and adverse opinion. This lack of focus demonstrates a lack of understanding of audit reports, as the audit report is the only output to shareholders after the audit then this is disappointing. Future candidates are reminded of the need to understand audit reports and possible modifications.