

# Examiner's report

## F8 Audit and Assurance

December 2011

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

### 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.

The vast majority of candidates attempted all five questions. The level of unanswered questions was marginally higher than in previous sessions. Where questions were left unanswered by candidates, this appeared mainly be due to a lack of knowledge or inadequate exam technique, as opposed to time pressure. There was a small minority of candidates who spent too long on question 1, usually at the expense of question 5; candidates are reminded of the importance of allocating their time appropriately between questions.

As in previous sessions, a small minority of candidates answered question 1 last and their answers were often incomplete. As question 1 is the case study and represents 30 of the available marks, leaving this question until last can be a risky strategy, as many answers presented were incomplete or appeared rushed.

Candidates performed particularly well on questions 1a, 1e, 2b, 3a, 4a, 4b and 4c. The questions candidates found most challenging were questions 1c, 1d, 2a, 3b, 3c, 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.

A number of common issues arose in candidate's answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks.
- Poor time management between questions, some candidates wrote far too much for some questions and this put them under time pressure to finish remaining questions.
- Not learning lessons from earlier examiner's reports and hence making the same mistakes, especially in relation to audit risk.
- Failure to fully understand the requirement verbs such as "explain" or "describe" and hence not providing sufficient depth to their answers.
- Providing more than the required number of points.
- Illegible handwriting and poor layout of answers.

### Specific Comments

#### Question One

This 30-mark question was based on a light manufacturer, Chuck Industries Co, and tested candidates' knowledge of the payroll cycle, substantive procedures for payroll and a redundancy provision, law and regulations and reliance on internal audit.

Part (a) for 12 marks required candidates to explain the implications and suggest recommendations for deficiencies identified in the scenario for the payroll cycle of Chuck Industries.

Most candidates performed well on this part of the question. They were able to confidently provide answers for five to six deficiencies identified from the scenario. The question did not specify the number of implications and recommendations required and hence some candidates provided more than six. This meant that if some points were not specific enough to attain the 1 mark available for each of implications and recommendations, candidates were still able to achieve a strong overall score.

The scenario contained an abundance of deficiencies and so on the whole candidates were able to easily identify enough points. A small minority of candidates provided implications and recommendations for general

deficiencies which were not specified within the scenario; these points would not have gained credit as the question requirement clearly stated that points needed to be raised for the deficiencies identified in the scenario.

A significant proportion of candidates wasted time by writing out the deficiencies from the scenario; there were no marks available for deficiencies, only for the implications and recommendations. It would have been better to use headings to identify to the marker which deficiency was being addressed, or to give brief details within the explanation of the implication. Also many candidates felt that Chuck Industries paying wages in cash was in itself a deficiency; this is not the case as many businesses pay their employees in cash, and as long as the process is well controlled no issues should arise.

Common mistakes made by candidates were failing to explain the implications fully. Many just paraphrased the deficiency without considering how this would impact the company. For example, candidates' easily identified the deficiency of joiners and leavers not being notified to the payroll department on time, leading to incorrect salaries being paid out. However some candidates did not then consider what the implication, other than incorrect salaries being paid, would be to Chuck Industries. They could have explained that the payroll expense would be incorrect and also possible loss of employee goodwill. Also for the deficiency of "no monitoring/supervision of the clocking in/out process" most candidates stated that the implication was that employees could clock in and out for each other, but this was not sufficient for 1 mark; they needed to link this to the implication, that this could result in wages being paid even though the employees had not worked.

In addition some candidates failed to provide sufficient detail in their recommendations and some answers were vague. Such as recommending that "the HR department should promptly inform payroll of joiners and leavers" but without detailing how and also how this would resolve the issue of HR staff members being on holiday and therefore failing to notify payroll on time.

A majority of candidates adopted a columnar approach with deficiency, implication and recommendation, or just implication and recommendation. If this was not done then most other candidates laid their answer out in paragraphs giving the implication and then the related recommendation. This ensured that for each implication sufficient detail was provided for the recommendation. A minority of candidates listed out all the implications and then the recommendations. Where this approach was taken it was often difficult to link up which recommendation related to which implication, in addition the recommendations tended to become combined. Future candidates should take note that where the requirements are linked it is advisable to use columns or to address an implication along with the related recommendation.

Part (b) for 6 marks required substantive procedures the auditor should perform to confirm the accuracy and completeness of Chuck Industries payroll charge. Performance was mixed on this part of the question.

The main area where candidates made mistakes was to provide tests of control rather than substantive procedures. As noted in previous examiner's reports candidates are often confused with the differences between tests of controls and substantive tests. Both are methods for obtaining evidence and are key elements of the F8 syllabus. Future candidates must ensure that they understand when tests of controls are required and when substantive procedures are needed. They need to learn the difference between them and should practice questions requiring the generation of both types of procedures.

Other common mistakes made by some candidates were:

- Not considering analytical procedures, only tests of detail.
- Providing vague tests which were not related to the payroll charge in the financial statements.
- Not generating enough tests for 6 marks; it is 1 mark per valid procedure.

The requirement verb was to “describe” therefore sufficient detail was required to score the 1 mark available per test. Candidates are reminded that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures. An answer such as “perform analytical review of payroll” is far too vague as it does not explain how to undertake the analytical review, what is being compared and for what period. In addition answers such as “ensure tax deductions are correct” are objectives, if a test starts with “ensure that...” it is likely to be an objective rather than a substantive procedure.

Part (c) for 4 marks required an explanation of the responsibilities of management and auditors in relation to compliance with law and regulations under ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. This question, where it was attempted, was answered unsatisfactorily by most candidates. The scenario provided details of a situation where the company had been visited by the tax authorities and they had discovered problems with the tax being deducted.

Many candidates did not attempt this question at all, and for those who did it seemed clear that most had little knowledge of responsibilities under law and regulations. If candidates had applied their knowledge of responsibilities under fraud and error to law and regulations, then they would have scored at least 2 marks. Management are responsible for ensuring compliance with law and regulations, whilst auditors are not responsible for preventing or detecting non-compliance with law and regulations. These points would have scored a pass for this part of the question.

Unfortunately, most candidates focused on management’s responsibility for preparing financial statements and implementing controls and auditors’ responsibility to provide a true and fair opinion. These points are not related to law and regulations. Many candidates’ answers did not even mention law and regulations. A significant minority only focused on the tax issues arising from the visit by the authorities rather than on law and regulation responsibilities.

Part (d) for 4 marks required substantive procedures the auditor should perform on Chuck Industries’ redundancy provision. This requirement was answered unsatisfactorily by many candidates.

Candidates who did not score well tended to focus on whether the redundancy was legal or not; therefore wanted the auditor to focus on reviewing redundancy law and contacting the company lawyer. Others wanted to focus on the outsourcing of the sales ledger, which was irrelevant in confirming the provision. Some candidates wanted to undertake a proof in total of the redundancy provision; however with only 14 employees this procedure would not have been practical. In addition some candidates wanted to compare this provision to an industry average, which was impractical and demonstrated that candidates seem to learn generic lists of procedures. Candidates must tailor their knowledge to the scenario in order to pick up application marks.

Those candidates who performed well were able to produce detailed procedures which related to the scenario. In addition sufficient breadth was given including recalculation of the provision, discussion with management with regards to the basis of the provision, reviewing disclosures, reviewing post year-end period for payment of the provision and obtaining written representations.

In relation to the popular answer of obtaining written representations this procedure needs 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 which assertion we wanted confirmation over.



- “Obtain a written representation from management confirming the completeness 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 assertion

Part (e) for 4 marks required an explanation of the factors an external auditor should consider prior to placing reliance on a company’s internal audit department. Candidates performed well on this question, with many attaining full marks.

Most candidates easily identified the areas of independence and competence. Many then identified professional care and skill or scope of the work performed, least popular was communication between internal and external audit.

Where some candidates did not score fully this was due to a failure to adequately explain the factors, some just stated “independence of the auditors”; this was not sufficient for 1 mark. Also some gave answers such as “Independence of internal auditors – we would consider the independence of the auditors”, whilst longer than the first point it still does not actually explain what is meant by independence of the internal auditors. In addition some candidates repeated their points on competence and independence, this simply wasted time.

### **Question Two**

This 10-mark question covered the topics of internal control components and elements of an unmodified auditor’s report.

Part (a) for 5 marks required candidates to state and briefly explain the components of an entity’s internal control as per ISA 315 *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and Its Environment*. Candidates’ performance was unsatisfactory on this question, with a number of candidates not even attempting it.

A significant minority of candidates did not understand the question requirement, or did not have sufficient technical knowledge of this area and so instead of providing components, such as, control environment and control activities relevant to audit, they focused on providing a list of internal controls such as authorisation or segregation of duties controls. Candidates are reminded to read the question requirements carefully and to answer the question asked and not the one they wish had been asked.

ISA 315 is an important element of the F8 syllabus and candidates need to ensure that they have a better knowledge of this area.

Part (b) for 5 marks required a description of the elements of an unmodified auditor’s report. This question was answered well by most candidates with many scoring well.

However the verb of “describe” was not as well addressed as it should have been. A description requires a certain level of detail and therefore to just give an answer such as “auditor’s responsibilities” is not a description and so would not have scored 1 mark. A brief paragraph explaining what the auditors’ responsibilities are, to form an opinion on the truth and fairness of the financial statements, was needed to score the full mark available.

In addition a minority of candidates were confused as to what was required for “elements of an audit report”, and so gave an explanation of what an unmodified audit opinion means, rather than what the elements are. Therefore they wrote at length about what true and fair means, this was not the question requirement. In addition a significant minority misunderstood the requirement and gave lists of the different types of audit opinions that can be given.

### **Question Three**



This 20-mark question was based on a manufacturer of pharmaceuticals, Abrahams Co. The question tested knowledge of audit risk, the areas of risk identification and substantive procedures for inventory.

Part (a) for 6 marks required an explanation of the components of audit risk and for each component an example of a factor which increased audit risk. This question was unrelated to the scenario, was knowledge based and candidates performed well.

Where candidates did not score full marks this was because they failed to read the question properly. The question clearly required an example for each component of audit risk, being inherent, control and detection risk. A minority of candidates did not provide three examples, and just gave one example, or in many cases did not give any examples at all. Also some gave valid examples but for the wrong component.

A significant proportion of candidates wasted time by providing a definition of audit risk along with how the components fit together into the audit risk model, as well as which components the auditor had control over. This generated no marks as it was not part of the requirement. Candidates are reminded yet again that they must answer the question asked as opposed to the one they wish had been asked.

Part (b) for 10 marks required a description of five audit risks and responses for Abrahams Co. Many candidates performed inadequately on this part of the question. As stated in previous examiner's reports, audit risk is a key element of the Audit & Assurance syllabus and candidates must understand audit risk. This is now the fourth session in a row where audit risk has been tested and where most candidates' performance has been unsatisfactory. This is unsatisfactory, especially as guidance was recently provided in an article on how to tackle audit risk questions.

The main area where candidates continue to go wrong is that they did not actually understand what audit risk relates to. Hence they provided answers which considered the risks the business would face or 'business risks,' which are outside the scope of the syllabus.

In addition many candidates correctly identified an issue from the scenario such as "the standard costs are set when a product is first manufactured and are not usually updated", but this is all that they would state in their answer. There was no attempt to link this issue to the audit risk which arises in the financial statements i.e. the risk that the inventory could be under or overvalued as the standard cost might be out of line with actual cost. Audit risks must be related to the risk arising in the audit of the financial statements and should include the financial statement assertion impacted. Just stating that "this increases inherent risk" is not sufficient to gain the mark available. If candidates did not link the risk to the financial statement assertion then they would have struggled to pass this part of the question.

Even if the audit risks were explained many candidates failed to provide a relevant response to the audit risk, most chose to give a response that management would adopt rather than the auditor. For example, in relation to the issue of the new IT manager not starting until January, many candidates suggested that the auditor needed to discuss with management why the new manager was not starting for two months. This is not a response that the auditor would adopt, as they would be focused on testing the risk of errors arising in the new system due to the lack of IT support. Also some responses were too vague such as "increase substantive testing" without making it clear how, or in what area, this would be addressed.

Future candidates must take note audit risk is and will continue to be an important element of the syllabus and must be understood, and they would do well to practice audit risk questions.

Part (c) for 4 marks required substantive procedures to obtain evidence in relation to (i) inventory held at third party warehouses and (ii) standard costs used for inventory valuation. This question was answered unsatisfactorily by most candidates, especially (cii).



Many candidates had a reasonable attempt at part (ci) on third party warehouses, suggesting obtaining a confirmation from these warehouses or attending an inventory count.

However part (cii) on standard costs was inadequately attempted. Candidates seemed to see “inventory valuation” in the requirement and so produced generic tests for verifying that inventory should be at the lower of cost and NRV. This was not what the question required. Candidates did not seem to understand that standard costing was an acceptable option for calculating the cost of inventory and hence they needed to test how close an approximation to actual cost standard cost was.

#### **Question Four**

This 20-mark question was based on a listed company Serena VDW Co and tested candidates’ knowledge of corporate governance and auditor’s responsibilities with regard to client confidentiality.

Part (a) for 3 marks required an explanation of corporate governance and why it is important. This question was unrelated to the scenario, was knowledge based and candidates performed well.

Many candidates were able to provide a definition of corporate governance and suggest a reason as to why it is important. This was sufficient to score a pass on this requirement. A small minority of candidates wrote far too much on this part of the question even though it only had a maximum of 3 marks available. Candidates need to consider the mark allocation when allocating time and effort in answering questions.

Part (b) for 12 marks required a description of six weaknesses and recommendations faced by Serena VDW to ensure compliance with corporate governance. Candidates performed well on this question. Most candidates structured their answers in two columns to consider weaknesses and recommendations and this helped to generate a sufficient number of points.

The majority of candidates scored an overall pass on this requirement and they were able to easily identify the weaknesses within the scenario. However the requirement was to “describe” the weaknesses as opposed to “identify” and this was where some candidates failed to score as well as they could have. A common weakness given was “chairman and chief executive are the same person”. This does not describe how this could be a weakness to the company; the answer needed to expand into the potential abuse of power by allowing one person to perform both roles. Also some felt that by adding “this is not allowed under corporate governance rules” this would be sufficient as a description. Again this was not.

Candidates must pay close attention to the verb of the question requirement; if it is “describe” or “explain” then candidates must identify an issue and then provide detail as to how this is an issue for the entity in question.

With regards to the recommendations, many candidates had adequate corporate governance knowledge; however for some candidates it was the application of this knowledge that they struggled with. A common mistake was to suggest that “the auditors remuneration should be proposed by the remuneration committee” In addition some recommendations were phrased as statements rather than as recommendations, such as, “corporate governance says that chairman and chief executive should be separate”. However, this does not explain what Serena VDW Co should now do to resolve this issue.

Part (c) for 5 marks required an explanation of the auditor’s ethical responsibilities in relation to client confidentiality and when there is an obligatory or voluntary responsibility to disclose information. Candidates performed well on this question.

A majority of candidates were able to provide sufficient examples of when an auditor can disclose client information. However, some candidates confused these examples and gave obligatory examples for voluntary and



vica versa. In addition a significant number did not answer the first part of the question which was to "explain the auditor's ethical responsibilities"; many just went straight into the examples when information can be disclosed. This was due to a failure to read the question carefully.

### Question Five

This 20-mark question was based on a chain of food wholesalers, Humphries Co and tested candidates' knowledge of subsequent events and audit reports.

Part (a) for 5 marks required a description of the auditor's responsibility in relation to subsequent events occurring between the year-end and the date the audit report is signed, and then from this point to the date the financial statements are issued. This question was unrelated to the scenario, and performance was on the whole unsatisfactory.

The question focused on responsibilities as opposed to audit procedures; however a significant proportion of candidates provided a list of audit procedures to be performed during a subsequent events review. This suggests that these candidates did not read the question carefully, saw the words subsequent events and proceeded to just list any procedures they had knowledge of.

The other common mistake made was for candidates to focus on what adjusting and non-adjusting events are. Whilst candidates need to bring their F3 *Financial Accounting* knowledge to this paper, they should only give this knowledge if it is asked for. Answers which focused on the impact on financial statements if events were adjusting or non-adjusting would not have scored any marks; as this was not what was required from the question.

It was also clear to see that many candidates had learnt standard phrases such as "active duty" and "passive duty"; however they did not understand what these meant and hence were unable to elaborate on these points.

A minority of candidates failed to appreciate that in the second situation, from the date the auditors' report was signed to the financial statements being issued, the auditors are unable to modify their report as it has already been issued.

Subsequent events are an important element of the completion stage of an audit, and future candidates should ensure that they have sufficient technical knowledge of this area.

Part (b) for 15 marks required a discussion of whether three subsequent events in the scenario required the financial statements to be amended, as well as audit procedures to form a conclusion on the amendment and an explanation of the impact on the audit report if these issues remain unresolved. Candidates' performance was unsatisfactory on this question. There were a significant number of candidates who did not devote sufficient time and effort to this question bearing in mind it was worth 15 marks.

Each of the three issues had a maximum of 5 marks available and in order to score well candidates needed to consider the following in their answer:

- A discussion of whether the event was adjusting or non-adjusting and why
- A calculation of whether the event was material or not, using the financial information provided in the scenario
- Subsequent events audit procedures
- A description of the type of audit report required
- An explanation of the impact on the audit report.



A significant proportion of candidates were able to correctly state whether an event was adjusting or not, however they could not explain why. In order to maximise marks candidates needed to link into their F3 *Financial Accounting* knowledge, and focus on whether there were any pre-existing conditions at the year end date, as this was required for the event to be adjusting.

A significant minority of candidates ignored the materiality calculation completely. Some candidates stated the event was material but without using the financial information provided. What was required was a calculation, for example, the receivable balance was \$0.3m and so represented 4% of profit before tax and 0.4% of revenue, and then an explanation of whether this was material or not.

Having assessed the materiality, many candidates then struggled to link the implications of this to whether the financial statements should be amended and possible implications for the audit report if not correctly treated. If an error is immaterial then the financial statements do not require amendment and an unmodified audit report would be given. Many candidates stated that an error was material, but that the audit report would be unmodified and vice versa.

In relation to the audit procedures, many candidates were able to suggest a few appropriate tests. However there still tended to be vague and unrealistic procedures given, such as “write to the receivable and ask them if they will pay the outstanding balance”; the receivable is not going to give this information to the auditor.

Of the three events, candidates performed best on the receivable and worst on the warehouse. Very few understood the implication of the insurance cover meaning that it was only if uninsured losses were material then they would potentially need disclosure.

With regards to the type of audit report required, many candidates provided a scatter gun approach of suggesting every possible audit report option. Giving every possible audit report option will not allow candidates to score well. Candidates seemed unable to decide whether for each of the three events the opinion should be modified or not.

A significant proportion of candidates do not understand when an “emphasis of matter” paragraph is relevant, and seemed to think that it was an alternative to an unmodified opinion or an “except for” qualification. Alternatively rather than amending the financial statements, candidates felt an emphasis of matter paragraph would be sufficient.

In relation to the impact on the audit report, many candidates were unable to describe how the opinion paragraph would change and that a basis for qualified opinion paragraph was necessary for the lawsuit and the warehouse if the disclosure of uninsured losses was inadequate.

Future candidates are once again 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.