

Examiner's report

F8 Audit and Assurance

December 2013



General Comments

The examination consisted of five compulsory questions. Question 1 carried 30 marks and question 2 10 marks. Questions 3, 4 and 5 carried 20 marks each.

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

Candidates performed particularly well on questions 1a, 2b, 3c, 4b, 4c, and 5b. The questions candidates found most challenging were questions 1c, 1d, 2c, 3a, 3b, 4aii and 5a. This is mainly due to a lack of technical knowledge, failure to apply general knowledge to the specific scenario 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 or generic answers which scored few if any marks.
- Poor time management between questions, some candidates wrote far too much for some questions, such as 1b and this put them under time pressure to finish remaining questions.
- Failure to fully identify all the question requirements, "identify and explain or describe" are two separate requirements and both required an answer.
- Not learning lessons from earlier examiner's reports and hence making the same mistakes, especially in relation to audit risk and substantive procedures.
- Poor layout of answers, including not using columns for questions such as 1b, 3c, 4c and 5c when this would have helped to maximise marks.

Specific Comments

Question One

This 30-mark question was based on a fizzy drinks manufacturer, Minty Cola Co (Minty), and tested candidates' knowledge of audit risks and responses, audit strategy documents and substantive procedures for three specific areas.

Part (a) for 5 marks required candidates to explain audit risk model and its components. This question was answered well by the majority of candidates.

Most were able to define audit risk as being the risk of the auditor giving an incorrect opinion and to list the components of inherent, control and detection risk. The definitions of control and detection risk tended to be better than for inherent risk, where many candidates did not include that inherent risk is before consideration of any controls. In addition few candidates mentioned that audit risk is a function of the risk of material misstatement and detection risk.

Where candidates did not tend to score well this was due to a failure to understand exactly what audit risk is with answers such as "audit risk is the risk of the financial statements containing material misstatements". Also some candidates simply gave a formula for audit risk of $IR \times CR \times DR$.

Part (b) for 12 marks required an identification and description of six audit risks from the scenario and the auditor's response for each. Performance on this question was mixed.



The scenario contained significantly more than six 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.

As in previous diets, some candidates tended to only **identify** facts from the scenario such as “Minty’s finance director does not see the need for an allowance for receivables and so has released the opening balance” but failed to **describe** how this could impact audit risk; this would only have scored $\frac{1}{2}$ marks. To gain 1 mark they needed to refer to the risk of receivables being overvalued. Where candidates did attempt to cover the assertion it was often vague and non-committal; for example stating that “receivables may be misstated”, this is not sufficient to gain the $\frac{1}{2}$ mark available.

Also it was disappointing to see that rather than consider audit risks, some candidates continued to focus on business risks and hence provided responses related to how management should address these business risks. For example, the scenario stated that “the company has expanded the number of warehouses it uses to store inventory”. Some candidates focused on how management should look to control all of these warehouses, rather than focus on the auditor’s increased detection risk as inventory counts were taking place at all the sites simultaneously.

Some candidates also identified irrelevant risks such as going concern and litigation risks surrounding the batch of damaged cola. It is highly unlikely that \$1 million of damaged inventory will cause the company with revenue of \$85 million to experience going concern problems. Candidates are clearly learning a list of generic risks and providing them for every audit risk question; this is not the correct approach to take.

Additionally, some candidates performed poorly with regards to the auditor’s responses. Some candidates gave business advice, other responses focused more on repeating what the appropriate accounting treatment should be, therefore for the risk of inventory valuation due to the damaged cola, the response given was “inventory should be valued at the lower of cost and NRV”, 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 weak such as “discuss with the directors” without making it clear what would be discussed and how this would gather evidence re the risk. 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.

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 4 marks required an identification of the main areas to be included within Minty’s audit strategy document and an example for each area.

This question, where attempted, was poorly answered by most candidates. Most candidates did not answer both parts of the requirement; failing to identify the areas of an audit strategy. This is a knowledge area and demonstrated a gap in candidates’ technical knowledge. Where candidates did score marks this was for providing examples, the most common answers given were around materiality, timetable and staff resources.

Those candidates who did not score well tended to repeat points made in part 1b on audit risks, despite the question requirement clearly stating “other than audit risks” or they listed out lots of audit tests.



Part (d) for 9 marks required substantive procedures the auditor should perform on three areas; the treatment of \$5 million spent on improving the production process, the release of the opening allowance for receivables and the damaged inventory. Performance on this question was disappointing.

Candidates were unable to tailor their knowledge of general substantive procedures to the specific issues in the scenario. Many identified the account balances being audited of PPE and repairs expense, receivables and inventory and proceeded to list all possible tests for these areas. 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.

As addressed in other examiners reports candidates must strive to **understand** substantive procedures. Learning a generic list of tests will not translate to exam success as they must be applied to the scenario. For example in 1dii on the release of the allowance for receivables, the scenario clearly stated that there was no longer an allowance, yet many candidates provided tests on “recalculating the allowance”, or “comparing it to last year” these scored no marks. In addition the damaged inventory in 1diii had a different taste due to an error in the mixing process; many candidates suggested “inspecting the damaged inventory to assess the level of damage” this is impossible as the problem was the taste of the cola not the physical condition.

Common mistakes made by candidates were:

- Giving objectives rather than procedures “ensure that inventory is valued at the lower of cost and NRV”, this is not a substantive procedure and so would not score any marks.
- Lack of detail in tests such as “agree the expenditure on the production to invoices”, this would score few marks as it does not address what we should be looking to agree on the invoice.
- Believing that “obtaining a management representation” is a valid answer for all substantive procedure questions.
- Providing controls tests rather than substantive procedures.
- Not providing enough tests, candidates should assume 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 yet again that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures.

Question Two

This 10-mark question covered the topics of tests of control and substantive procedures, audit evidence and overall review of financial statements.

Part (a) for 4 marks required candidates to define “tests of control” and “substantive procedures” as well as provide an example for each relevant to the audit of wages and salaries.

Candidates’ performance was mixed on this question. Many candidates were able to adequately define tests of controls but did not define substantive procedures as well, the definitions were often incomplete. This is a core area of the syllabus and it is disappointing that candidates are unable to provide clear definitions of procedures that are frequently examined.

The requirement to provide examples of each type of procedure was answered unsatisfactorily by a significant proportion of candidates. Rather than giving tests of control many candidates provided example controls, these would not have scored any marks. The substantive procedures examples given were often vague and some candidates were confused in that they gave tests of controls here rather than substantive tests.



As has been 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.

Part (b) for 3 marks required candidates to identify and explain three factors which influence the reliability of audit evidence. This question was answered well by most candidates, with many scoring full marks.

Where candidates did not score full marks this tended to be because they misunderstood the question and discussed sufficiency of evidence with points on materiality of the area and the level of judgements required.

Part (c) for 3 marks required candidates to explain three procedures an auditor should perform when conducting an overall review of the financial statements. Performance on this question was disappointing.

This question tested knowledge of completion procedures specific to reviewing the draft financial statements, however the vast majority of candidates did not provide valid answers and this was clearly a gap in their technical knowledge. Candidates are reminded that they must study all areas of the syllabus as it is all tested over a number of diets.

Some candidates were able to correctly identify that analytical review to form an overall conclusion was required. However, those candidates who did not score well focused on general completion procedures such as going concern and subsequent event reviews, or they focused on the different stages in the audit being planning fieldwork and completion.

Question Three

This 20-mark question was based on a tinned fruit and vegetables manufacturer Oregano Co (Oregano). The question tested the areas of documenting systems, control objectives and deficiencies and recommendations for Oregano's sales and despatch system.

Part (a) for 6 marks required a description of two methods for documenting the sales and despatch system along with an advantage and disadvantage for each method.

Candidates' performance was unsatisfactory on this question, with a number of candidates not even attempting it. A significant proportion of candidates did not understand the question requirement fully, and so instead of suggesting methods such as flowcharts, narrative notes or questionnaires they considered manual and automated/electronic methods for a system. In addition some candidates considered online versus telephone methods for recording sales transactions and others interpreted the question as requiring the documents of a sales system and so considered sales invoices and despatch notes. The question requirement was clear, candidates either did not read it carefully or they lacked the technical knowledge on documentation methods.

Those candidates who did correctly interpret the requirement often failed to maximise their marks as they identified the methods but did not describe them. In addition, candidates advantages and disadvantages were far too brief, a describe requirement needs more than a few words and "easy to understand" is not detailed enough to score the 1 mark available.

Part (b) for 2 marks required two controls objectives for the sales and despatch system. Candidates could have used the scenario to help or answered this question using their technical knowledge, however overall performance was unsatisfactory. A significant proportion of candidates provided controls rather than control objectives, this was not what was required and so would not have scored any marks. This indicates a lack of



knowledge as to what a control is rather than a control objective. Objectives have been tested in previous diets, and candidates should endeavour to practice past exam questions when preparing for this exam.

Part (c) for 12 marks required an identification and explanation of six deficiencies and a recommendation for each of these deficiencies.

This part of the question was answered very well and candidates were able to confidently identify six deficiencies from the scenario. However, candidates did not always adequately explain what the deficiency meant to Oregano. For example, candidates easily identified the deficiency that credit limits were being exceeded by 10% for online orders; however some failed to explain that this could lead to an increase in bad debts.

The requirement to provide controls was, on the whole, well answered. Most candidates were able to provide good recommendations to address the deficiencies; however some of these recommendations were too brief. In addition some recommendations failed to address the deficiency, for example for the credit limits being exceeded some candidates suggested “a review of credit limits by a responsible official”, this would not prevent orders from exceeding the limits. The main recommendation where candidates failed to maximise their marks was for sequentially numbered orders. Simply recommending “that sales orders should be sequentially numbered” only scored $\frac{1}{2}$ marks, as the control is to undertake sequence checks, for which the orders need to be sequential. This demonstrated a lack of understanding of this type of control.

Question Four

This 20-mark question was based on the audit firm Salt & Pepper & Co and tested candidates' knowledge of audit acceptance procedures, preconditions, engagement letters and ethical threats.

Part (ai) for 5 marks required a description of the steps the firm should take prior to accepting a new audit client Cinnamon Brothers Co (Cinnamon). Candidates performed satisfactorily on this part of the question. Many candidates were able to identify a good range of points including ensuring the firm had adequate resources to complete this audit, identifying if any ethical threats arise, understanding the entity and contacting the previous auditors.

However some candidates focused solely on obtaining professional clearance from the previous auditors and it was not uncommon to see a whole page on the detailed steps to be taken. The question requirement was steps prior to accepting an audit; it was not the process for obtaining professional clearance. Those that focused solely on this area would not have scored enough marks to pass this part of the question. Candidates are reminded to answer the question actually asked as opposed to the one they wish had been asked.

In addition, some candidates provided answers which focused on the engagement letter; this was incorrect as an engagement letter is only produced once an engagement has been accepted as opposed to prior to acceptance.

Part (a ii) for 3 marks required the steps the firm should take to confirm whether the preconditions for the audit were in place. Where it was answered, candidates performed unsatisfactorily on this question. Answers tended to be in two camps, those who had studied preconditions and were able to score all three marks and those who had not studied it and so failed to score any marks. This is a knowledge area and has been tested in a previous diet. Candidates must practice past exam questions and ensure they study the breadth of the syllabus.

Those candidates who did not score well, tended to repeat points that had been made in part (ai) of the question or they included points that should have been in their answer for (ai). Some chose to combine their answers for (ai) and (a ii) together, this tended to produce unfocused answers.

Part (b) for 2 marks required four matters to be included within an engagement letter. This was knowledge based and unrelated to the scenario. Candidates performed well on this question with many scoring full marks.



Where candidates did not score full marks this tended to be because they focused on generic items which would appear in any letter such as, the date, signature and addressee, none of these points scored marks.

Part (c) for 10 marks required an identification and explanation of five ethical risks which arise from the audit firm's actions and how these risks may be reduced. This question was answered well by most candidates.

Candidates were able to identify from the scenario the ethical risks arising from the firm's actions. Some candidates did not explain the risks correctly or in sufficient detail, sometimes just identifying the risk and not explaining correctly how this was an ethical issue. For example, many identified the risk of the audit fee being based on a percentage of the client's pre-tax profit; however this was incorrectly explained as being an issue of fee dependence rather than it being a contingent fee. As the risk was incorrectly explained this resulted in an irrelevant action for reducing the ethical risk. Therefore only the identification $\frac{1}{2}$ marks would have been awarded.

In addition some candidates incorrectly thought that there was an ethical risk because Cinnamon wanted their audit complete by February. The ethical risk was that in order to meet the client's deadline the firm would be using more junior staff and hence increased the risk of giving an incorrect opinion.

The second part of this question required steps for reducing the ethical risks. Candidates' performance was generally satisfactory although some answers tended to be quite brief. For example for the risk of the engagement letters not being updated, the response given by some candidates was "Update the engagement letters," this is not a sufficiently detailed explanation.

Some candidates thought that a risk had to be identified for each of the ethical threats of self-review, self-interest etc. This resulted in them trying to identify a situation from the scenario to fit each of the types of threats. This is not the correct approach to take as it is unlikely that the scenario will be based around one of each of the five ethical threats.

Question Five

This 20-mark question was based on Brown Co and tested candidates' knowledge of opening balances, placing reliance on the work of an expert and audit reports.

Part (a) for 4 marks required a description of the procedures an auditor should undertake in confirming opening balances for a new audit client and the audit report implications if opening balances could not be confirmed or if they contained misstatements. This question was unrelated to the scenario, and was not answered well by many candidates.

Most candidates were able to recommend agreeing the opening balances to the prior year closing balances. However, often the source of the closing balances was missing, i.e. the prior year financial statements, and so only $\frac{1}{2}$ marks were gained. A significant number thought that the opening balances needed to be audited again in detail and recommended procedures such as bank confirmations and receivables circularisation. Others did not read the requirement carefully and so did not appreciate that this was a new engagement for the firm, hence there were no prior year audit files for the firm to look at. In addition some candidates suggested obtaining a written representation from management. Candidates seem to believe that a written representation is appropriate evidence for each and every audit situation, it is not.

The second part of the requirement focused on the audit report implications. This was also answered unsatisfactorily. Candidates did not seem to understand that the question wanted two situations, unable to confirm the balances and if they contained misstatements. Many confused the two or thought they were the



same situation and so just gave a combined answer. Very few candidates understood that if the opening balances contained misstatements then they may materially impact the current year financial statements.

It was apparent that there were significant gaps in candidates' technical knowledge on the area of opening balances and the audit report implications of them.

Part (b) for 4 marks required a description of the factors that should be considered when placing reliance on the work of the independent expert in confirming raw material quantities. Candidates performed well on this question. Many were able to identify points such as professional qualifications, experience and independence.

The requirement verb was to "describe" therefore sufficient detail was required to score the 1 mark available per step and some answers were a little brief. Candidates are reminded to look carefully at the verb at the beginning of the question requirement, as this should help them to understand the level of detail required for their answers.

Part (c) for 12 marks required an identification and explanation of six elements of the draft audit report provided which required amendment. Candidates' performance was mixed on this question.

Reviewing a draft audit report and identifying areas that require amendment was a different style of audit report question than in previous diets. However, many candidates answered this question satisfactorily. These recognised that there were two parts to the requirement, a need to identify the element from the scenario and then a need to explain why this sentence needed amending. Those candidates who scored well also tended to use a two column approach of identify and explain. This resulted in them maximising their marks as they easily identified six elements from the scenario and then for each explained why there was a problem.

Those candidates who did not score as well tended to ignore the "identify" requirement and jumped straight into the explanation. This is not what the question wanted as there were clearly two requirements "identify" and "explain" and both needed to be addressed to score well. In addition many candidates focused on redrafting the audit report extracts even though this was specifically excluded from the question requirement.

In this question it was also common to see many more than six points being provided. All points made are reviewed but marks are only allocated to the six best points. Candidates would do better if they focused on the quality of points made rather than the quantity.