

Examiner's report

F8 Audit & Assurance
December 2014



General Comments

The examination consisted of twelve objective test questions in Section A, worth 20 marks and six questions in Section B worth 80 marks. The marks in section B were allocated to four 10 mark questions, and two 20 mark questions. All questions were compulsory. Section A covered a broad range of syllabus topics and Section B aimed to test the candidates' understanding and application of audit and assurance in more depth. This is the first examiner's report since the introduction of the new exam format and question types. The following paragraphs report on each section and focus on some of the key learning points.

Specific Comments

Section A

It was very pleasing to see that the majority of candidates attempted all of the questions and there was little evidence of time pressure. Candidates preparing for the next examination of F8 are advised to work through the pilot paper and sample questions discussed here and to carefully review how each of the correct answers were derived. Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F8 syllabus, rather than attempting to question spot.

The following two questions were answered incorrectly by a significant proportion of candidates and are reviewed with the aim of giving future candidates an indication of the types of questions asked, guidance on dealing with exam questions and to provide a technical debrief on the topics covered by the specific questions selected.

Sample Questions for Discussion

Example 1

Which of the following procedures are TESTS OF CONTROL an auditor should perform in testing the inventory cycle of their client whilst attending the inventory count?

- (1) Observe whether the client's staff are following the inventory count instructions
- (2) Review inventory present in the warehouse for evidence of damage or obsolescence
- (3) Obtain a sample of the last goods received notes and goods despatched notes and follow through to ensure inclusion in the correct accounting period
- (4) Inspect and review management's inventory count instructions

- A 2 and 3
B 1 and 4
C 1 and 2
D 3 and 4

This question tested the distinction between tests of control and substantive procedures over the key area of inventory. When an auditor undertakes testing during an inventory count, they use a combination of tests of controls and substantive procedures. Tests of control focus on evaluating the effectiveness of controls implemented by the company at preventing and/or detecting material misstatements, whereas substantive procedures are designed to detect material misstatements at the assertion level. The procedures listed in this question were a combination of substantive and tests of control. In order to correctly answer this question, candidates needed to assess each procedure in turn and identify what category of procedure each option referred to.

Procedures 1 and 4 focused on the inventory count instructions provided by management. Procedure 4 involved reviewing the instructions to allow the auditor to assess whether the inventory count was being conducted in an appropriate manner and was well controlled. Hence this procedure was a test of control. Procedure 1 focused on ensuring the counting team were following the instructions and hence that management's directives were being implemented and therefore was also a test of control.

Procedure 2 focused on reviewing inventory for evidence of damage, this was not testing a management control rather it was aimed at gaining evidence over the valuation of inventory. This procedure was testing financial statement assertions and so was a substantive procedure. Procedure 3 also focused on assertions as it tested the cut-off of inventory rather than a control, and hence was substantive in nature. Candidates must be able to identify correctly the type of procedure given, and for substantive tests they need to be able to identify the assertion being tested.

The correct answer was therefore B, options 1 and 4.

Example 2

Which of the following statements, relating to the auditor's reporting responsibilities for going concern, if any, is/are correct?

(1) Where management is unwilling to make their assessment of the company's ability to continue as a going concern, the auditor should include an emphasis of matter paragraph in the audit report

(2) Where the use of the going concern assumption is inappropriate, the auditor should include a qualified opinion in the audit report

- A 1 only
- B 2 only
- C Both 1 and 2
- D Neither 1 nor 2

This question tested the areas of going concern and audit reports and was not well answered by the majority of candidates. Audit reports and going concern are important parts of the syllabus and require candidates to have the necessary technical knowledge.

Statement 1 involved a situation where management were unwilling to make a going concern assessment, which would result in the auditors being unable to obtain sufficient and appropriate evidence. This inability to collect evidence would give rise to a modified opinion. Candidates needed to be able to identify that an emphasis of matter paragraph is a modification of the audit report only as it does not result in a modified opinion. Therefore statement 1 was incorrect in the circumstances.

Statement 2 was also incorrect because if the going concern basis of preparation is inappropriate the effects are widespread throughout the financial statements and as such a material and pervasive misstatement has occurred. Consequently only an adverse opinion would be appropriate and again candidates were expected to identify that the modification suggested was inappropriate in the circumstances.

As both statements were incorrect the correct answer was D. It is possible that some candidates were unsure about answer option D, as they guessed that one of the statements was likely to be correct. This is not always the case and candidates are encouraged to spend time reading the question and evaluating the answer options properly rather than guessing.



Section B

Question One

This 10-mark question covered the topics of planning and the audit of wages where there was an increased risk of fraud.

Part (a) for 5 marks required candidates to explain the importance of audit planning. Candidates' performance was satisfactory on this question. Many candidates were able to confidently identify that planning resulted in sufficient attention being devoted to important areas/audit risks, selection of an appropriate audit team, an efficient and effective audit and resolution of issues in a timely manner.

Where candidates did not score enough marks to pass, this tended to be because they focused on the contents of an audit strategy and plan, which was not the specific focus of the question. Often candidates identified the procedures which would be considered prior to planning, such as confirming the independence of auditors or used to obtain an understanding of the entity resulting in some candidates focusing on what was done at the planning stage rather than explaining the importance of planning.

Part (b) for 5 marks required candidates to describe procedures to be undertaken during the audit of wages where an increased risk of fraud had been identified. Candidates' performance was unsatisfactory on this question. The accompanying scenario described a situation where a payroll fraud had occurred during the year; however it is clear that many candidates did not consider the details included scenario at all when providing their answer. Candidates gained credit for points such as "agreeing from payroll records to contracts of employment in the HR department" or for "physically confirming the existence of a sample of employees listed on the payroll records" as these procedures are specifically focussed on verifying that employees are genuine.

Many candidates failed to score marks because they made the following mistakes:

- Providing a long list of general payroll substantive procedures, such as "recalculate statutory deductions" rather than tailoring their answer to the scenario.
- Listing internal controls that management should implement to prevent future frauds from occurring, rather than the procedures to be conducted by the auditor in the circumstances.
- Failing to recognise that procedures could be both substantive based or tests of control.
- Missing standard fraud procedures, such as "discussing with management the materiality of the fraud" or "discussing with management how the fraud occurred".

Candidates are reminded to read the question carefully and to make full use of the information that is provided to them within the scenario.

Question Two

This 10-mark question required identification and description of five audit risks from the scenario and the relevant auditor's response for each. Performance on this question was mixed, although better than June 2014 when audit risk was last tested.

The scenario contained significantly more than five risks and so candidates were able to easily identify enough risks for the marks available. Candidates who scored well in this question 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 however, a significant number of candidates tended to only **identify** facts from the scenario such as "Eagle Heating has reduced its selling price due to increased competition" but failed to **describe** how this



results in an audit risk, thus limiting the marks that can be scored to $\frac{1}{2}$ marks. To gain the full 1 mark candidates needed to explain that this drop in selling price could impact inventory valuation as there was a risk that inventory may be overvalued due to NRV now being lower than cost or that this presents a going concern risk as this drop in selling price may not be sustainable. Only by connecting the fact from the scenario to the relevant assertion and area of the financial statement will the candidate have adequately explained the audit risk.

Unfortunately many candidates yet again focused on business risks rather than audit risks with answers such as increased risk of theft and difficulties in counting inventory arising due to the increase in inventory levels. These candidates then provided responses related to how management should address these business risks. This meant that out of a potential 2 marks per point, candidates would only score $\frac{1}{2}$ marks for the identification of the issue from the scenario.

Additionally, many candidates performed poorly with regards to the auditor's responses. Many candidates gave business advice, such as replacing the financial controller who was dismissed or provided inappropriate responses such as attending inventory counts to address the inventory valuation risk. Audit responses need to be practical and should relate to the approach (ie what testing) the auditor will adopt to assess whether the balance is materially misstated or not.

Many 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. This helps candidates to ensure that for every risk identified there is a related response and candidates are encouraged to continue to use this approach where appropriate.

Future candidates must take note of the importance of audit risk which is a key element of the syllabus and must be understood, and they would benefit from practising audit risk questions.

Question Three

This 10-mark question was based on a retail company which was planning on obtaining a listing within the next six months. The question tested candidates' knowledge and understanding of audit committees and non-executive directors.

Part (a) for 4 marks required an explanation of the benefits to the company of establishing an audit committee. This part of the question was answered well by the majority of candidates.

Most were able to identify that establishing an audit committee would improve the internal control environment, help with internal audit and assist in appointing or liaising with external auditors.

Where candidates did not score well, this was generally because they focused too much on the role of an audit committee rather than the benefits, or failed to explain exactly how the company would benefit. For example, many candidates identified that the audit committee could be responsible for overseeing internal audit; however this does not explain the benefit to the company, which is an increase in the independence of internal audit. Also some candidates did not provide adequate breadth of points, some only focused on internal and external audit and raised several points on each, rather than identifying other benefits such as improved public confidence.

Part (b) for 6 marks required a discussion of the advantages and disadvantages of appointing two potential non-executive directors (NEDs). The scenario contained an abundance of points and candidates scored well on this part of the question, with many obtaining full marks.

Where candidates did not well this was often because they misunderstood the question and thought they needed to compare the two NEDs and make a recommendation, which was not part of the requirement. Candidates should use their allotted reading time to read the question requirements carefully prior to writing their answer.



In addition some candidates confused the advantages and disadvantages and clearly did not understand their relevance in the scenario. For example a significant number thought paying a fixed fee to a NED was a disadvantage as if the company did not make adequate profits then this fee would be onerous, failing to recognise that in order to conserve independence a fixed-fee is a recommendation of the guidance on Corporate Governance relevant to the syllabus. Further many candidates stated that a seven year contract was an advantage, rather than a disadvantage, as it meant the NED would have a long term commitment to the company and again failed to understand the effect that a long term contract may have on independence.

Also some candidates listed a disadvantage for one NED, such as lack of independence, and then reversed it to be an advantage for the other NED. This approach did not generate marks as it was not suitably tailored to the scenario.

Question Four

This 10-mark question covered the topics of audit reports and subsequent events.

Part (a) for 4 marks required a description of the elements of an unmodified audit report and an explanation of why they are included. Performance on this part of the question was mixed.

Many candidates were able to correctly identify a good number of the elements included in an unmodified audit report. However, it was common to see answers where a heading such as “auditor’s responsibility” was provided without any description of what would be included in this element. The requirement was to **describe** and not to state or list, hence where an element was identified but not described, this did not score any marks. Candidates are again reminded to take note of the verb used in the requirement to ensure that they appreciate the level of depth that is required to score the marks available.

The second part of the requirement was to **explain** why the element was included; it was disappointing to see that the majority of candidates were not able to do this. Perhaps it was due to a failure to read the question properly, or due to a lack of understanding of audit reports. Where candidates did attempt this part of the question, they often used circular answers, such as “management responsibilities are included in the audit report to explain the responsibilities of management” instead of explaining that the responsibilities paragraphs are included to try and reduce the expectations gap and to clarify for the user the division of responsibility between management and auditor.

In addition a minority of candidates misunderstood the requirement and instead of describing the elements, they explained the different types of audit opinions available, such as adverse or qualified. Some candidates explained the elements of an assurance engagement, rather than answering the question actually set.

Part (b) for 6 marks centred on a website design company where it had come to light that one of the company’s customers was experiencing financial difficulties. The question asked candidates to provide (bi) an explanation of whether the 2014 financial statements required amendment and (bii) audit procedures to perform in order to form a conclusion on any required amendment. Performance on this question was again varied.

Candidates were generally able to identify that the financial statements required amendment, as the error was material and constituted an adjusting event in line with IAS 10 *Events after the Reporting Period*. Fewer candidates were able to fully explain why the amendment was required, with many just stating this was an adjusting event, rather than why it was adjusting.

Unfortunately, the requirement for audit procedures was overlooked by many candidates, as rather than listing tests they instead focused on audit report implications if the amendment was not made. This was not what the question required and hence did not score any marks. Candidates must answer the question that has been set.



Question Five

This 20-mark question was based on a manufacturer of luxury toiletries, Hummingbird Scents Co (Hummingbird). This question tested candidates' ability to identify and explain deficiencies and recommendations for Hummingbird's sales system and to provide appropriate substantive procedures for revenue.

Part (a) for 16 marks required identification and explanation of seven deficiencies within the sales system as described and a recommendation for each of these deficiencies. In addition a covering letter was required.

This part of the question was answered very well and candidates were able to confidently identify seven deficiencies from the scenario. However, some candidates did not always adequately explain what the deficiency meant for Hummingbird. In addition some deficiencies were incorrect, such as "a failure by couriers to obtain customer signatures" or "orders being placed without inventory levels being checked". Deficiencies should be identified directly from the scenario rather than referring to generic points learned for a sales system.

The requirement to provide control recommendations 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 and did not provide sufficient depth to demonstrate how the control could be implemented. In addition some recommendations failed to address the deficiency identified or were unrealistic. In addition as noted in previous examiner's reports the recommendation of sequence checks was not fully answered. Simply recommending "that good despatched notes should be sequentially numbered" only scored $\frac{1}{2}$ marks, as the control is to undertake sequence checks, for which the despatch notes need to be sequential. This demonstrated a lack of understanding of this type of control.

A covering letter to the report was required and there were 2 marks available. It was disappointing that some candidates did not provide any letter at all and despite the specific requirement, a significant number of candidates provided their answers as a memo rather than a letter. Not providing a letter or adopting a memo format would have resulted in a failure to maximise marks. Also some candidates provided the beginning of the letter, being a letterhead and an introductory paragraph, but did not complete the letter after the deficiencies and recommendations had been listed. It might have been better to produce the letter in full and then refer to an appendix for the deficiencies and recommendations.

It was pleasing that many candidates set their answer out in two columns being deficiency and recommendation as this allows candidates to ensure they have a sufficient number of points and a recommendation for every deficiency identified. Where candidates did not adopt this format the deficiencies and recommendations tended to be repetitive and hence resulted in wasted time.

Part (b) for 4 marks required substantive procedures for revenue. Performance on this question was unsatisfactory.

Many candidates provided tests of controls rather than substantive procedures and of those that did provide substantive tests, many provided receivables or cash receipts tests rather than those for revenue. Tests such as reviewing the sales ledger control account or circularising receivables were common but irrelevant.

For those candidates who understood what was required their descriptions were often inadequate, such as simply stating 'cut off testing' which is not detailed enough to constitute a substantive procedure as it does not explain how this testing should be performed. Where candidates did explain cut-off testing many chose to examine invoices and rather than despatch notes which demonstrates a lack of judgment and understanding of what



triggers transactions to be recorded in the sales system. Many candidates who provided procedures regarding completeness of revenue often did not provide a complete audit trail and often traced their tests to sales ledger rather than sales day book suggesting a lack of understanding over the fundamentals of financial records.

Those candidates who scored well provided a range of tests including analytical review against prior year and/or budget, detailed tests on sales invoices and casting of sales day books or invoices.

Question Six

This 20-mark question was based on a motor car manufacturer, Jackdaw Motor Cars Co (Jackdaw). The question tested the areas of reliance on an expert, substantive procedures for property plant and equipment and work in progress (WIP) and audit reports.

Part (a) for 5 marks required an explanation of factors to consider when placing reliance on the work of an independent valuer. Performance on this requirement was satisfactory.

Many candidates were able to identify relevant points such as consideration of the qualifications, independence and experience of the valuer, however only the very best candidates discussed the scope of the work or reasonableness of assumptions used.

Candidates who did not score well often repeated the same point; competence/qualifications/professional body/knowledgeable all relate to the same point and hence would only score a maximum of 1 mark. Candidates are reminded to consider a breadth of points to maximise the marks available to them.

Part (bi) for 6 marks required substantive procedures in relation to a revaluation of land and buildings and a warehouse addition. Part (bii) for 4 marks required substantive procedures in relation to valuation of WIP. Performance on this question was unsatisfactory.

Many candidates were unable to tailor their knowledge of general substantive procedures to the specific issues in the scenario and question requirements. Many candidates spotted the terms property plant and equipment 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 as in previous questions and diets it seems that many did not take any notice of the scenario at all. As addressed in other examiner's 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.

In part (bi) candidates needed to focus on testing that the revaluation had correctly been recorded in the accounting records, that it agreed to a valuation report, and that the depreciation had been calculated based on the revised values. Some candidates focused on testing the basis of the valuation report and whether the valuer could be relied on; unfortunately these were relevant for requirement 6(a) rather than 6(bi). For the warehouse addition the focus should have been on confirming the acquisition cost to an invoice or contract, confirming ownership, physically verifying for existence and calculating depreciation on a pro rata basis.

In part (bii) many candidates provided standard procedures such as those used when attending an inventory count rather than focusing on valuation of WIP such as confirming standard costs and the percentage completion method used.

Common mistakes made by candidates in part (b) were:

- Giving objectives rather than procedures "ensure that land and buildings is valued correctly", this is not detailed enough for a substantive procedure and so would not score any marks.



- Lack of detail in tests such as “check the revaluation”, this would not score any marks as it does not address how the auditor should “check” and what part of the revaluation we are testing.
- 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.

Part (c) for 5 marks informed candidates of an error in the WIP calculation due to outdated assumptions and required an explanation of the steps to take on discovering this error and the impact on the audit report should the WIP error remain unresolved. Performance on this question was unsatisfactory.

Candidates who scored well considered steps such as assessing the materiality of the error and discussing with management why they did not wish to amend the accounts. Unfortunately as noted in previous examiner’s reports the requirement to consider the impact on the audit report produced a “scatter gun” approach of answers. Many candidates confused terminology and referred to modified opinions and qualified reports. Others contradicted themselves by stating that a material misstatement had occurred but that an unmodified report was required. As usual candidates suggested an emphasis of matter paragraph, despite this being irrelevant to this scenario.

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