

Examiner's report

F8 Audit and Assurance

June 2012



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.

Overall the performance of candidates across the paper as a whole was significantly improved on previous sessions. Candidates performed well on questions 1, 2 and 3 but struggled with questions 4 and 5.

Candidates performed particularly well on questions 1a, 1c, 1d, 2a, 2b, 3b, 3c and 5b. The questions candidates found most challenging were questions 1e, 3a, 4a, 4b, 4c and 5d. 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.

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

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.

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.
- 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 especially in question 1a and 3b.
- Illegible handwriting and poor layout of answers, including not using columns for questions such as 1d when this would have helped to maximise marks.

Specific Comments

Question One

This 30-mark question was based on an electrical equipment manufacturer, Pear International Co (Pear), and tested candidates' knowledge of internal controls, tests of controls, substantive procedures for property, plant and equipment, levels of assurance and internal audit.

Part (a) for 15 marks required candidates to identify and explain five deficiencies, suggest a control for each deficiency and recommend tests of controls to assess if the internal controls of Pear were operating effectively.

Most candidates performed well on this part of the question. They were able to confidently identify five deficiencies from the scenario. However, many candidates did not address the question requirement fully as they did not "identify and explain". Candidates identified, but did not go on to explain why this was a deficiency. For example "couriers do not always record customer signatures as proof of delivery" would receive ½ mark, however to obtain the other ½ mark they needed to explain how this could cause problems for the company; such as customers could dispute receipt of goods and Pear would need to resend them.

The requirement to provide controls was generally well answered. Some candidates gave objectives rather than controls for example "Pear should ensure that all sales are forwarded to the despatch department" without



explaining what the control should be to ensure that this happened. In addition some candidates provided controls which were just too vague to attain the 1 mark available per control.

The requirement to provide tests of control was not answered well. Many candidates simply repeated their controls and added “to check that” or “to make sure”. These are not tests of control. Also many candidates suggested that the control be tested through observation. For example “observe the process for authorisation of sales discounts”. This is a weak test as it is likely that if the auditor is present that the control will operate effectively; instead a better test would be “to review sales invoices for evidence of authorisation of discounts by sales manager.”

Many candidates set their answer out in three columns being deficiency, control and test of control. However those who set it out as identification of deficiency, explanation of deficiency and control and then separately addressed the requirement of test of controls tended to miss out some relevant tests of controls.

In addition the requirement was for five deficiencies; it was not uncommon to see candidates provide many more than five. Often in one paragraph they would combine two or three points such as authorisation of credit limits and of sales discounts. When points were combined, some candidates did not fully provide controls and tests of controls for each of the given points, therefore failing to maximise their marks.

Part (b) for 4 marks required substantive procedures the auditor should perform on year-end property, plant and equipment (PPE) additions and disposals. Performance was mixed on this part of the question.

There were two available marks for addition tests and two marks for disposal tests. Candidates who scored well often did so by providing a number of tests for each area, each test was average and so scored $\frac{1}{2}$ mark each and so they managed to attain full marks in this way. However, some candidates provided detailed procedures and so achieved the 1 mark available per test. This is better utilisation of time.

The requirement verb was to “describe” therefore sufficient detail was required to score 1 mark per test. Candidates are reminded that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures. Many tests given were just too brief. Answers such as “check accounting records to ensure correct treatment of disposals” are far too vague as it does not explain how we gain comfort that disposals have been recorded correctly. In addition answers such as “ensure that additions are correctly included” are objectives rather than substantive procedures.

Other common mistakes made by candidates were:

- Providing general PPE tests such as for depreciation, rather than just focusing on additions and disposals.
- Giving unrealistic tests such as “to physically verify on the factory floor that an asset has been disposed of” if it's been disposed of then how can it be physically verified!
- Focusing too much on whether the asset has been disposed of for the best possible price; this is a concern of management and not of the auditor.

Part (c) for 3 marks required an identification and explanation of the levels of assurance provided by external audit and other review engagements. This question was on the whole answered well.

Many candidates produced clear and concise answers which addressed the levels of assurance for each of the types of engagements. A minority of candidates just referred to positive and negative assurance without linking them back to the two types of engagements.



Part (d) for 4 marks required candidates to distinguish between internal and external audit. This question was answered well by most candidates with many scoring full marks.

Many candidates laid their answers out in two columns and this tended to increase their marks, as it meant they considered both internal and external audit for each point raised. Those who wrote a paragraph each for internal and external audit sometimes missed out points. For example they might answer that “external auditors report to shareholders” but then fail to say that “internal audit report to management or those charged with governance”.

Weaker answers were those which were far too brief. For example “private/public” with the heading of reports is not sufficient to score the 1 mark available. Candidates who provide answers such as these possess the knowledge, they just failed to write with sufficient detail.

Part (e) for 4 marks required candidates to explain the impact on the external auditor’s work at the interim and final audits if Pear was to establish an internal audit department. Performance on this question was unsatisfactory.

Where the question was attempted, many candidates failed to score more than 1 mark. What was required was an explanation of tasks that internal audit might perform that the external auditor might then look to rely on in either the interim or final audit. For example, they could utilise systems documentation produced by internal audit during the interim audit. Or they could rely on year-end inventory counts undertaken by internal audit as part of their inventory testing at the final audit.

Where candidates achieved 1 mark this was usually for a general comment about relying on the work of internal audit and so reducing substantive procedures.

Mistakes made by candidates were:

- Focusing on the role of internal audit in general.
- Giving lengthy answers on factors to consider when placing reliance on internal audit.
- Providing details of what an external auditor does at the interim and final audit stages.

Question Two

This 10-mark question covered the topics of planning, sampling and audit reports.

Part (a) for 4 marks required candidates to explain the benefits of audit planning. This question was answered well by almost all candidates with many scoring full marks.

Most candidates were able to identify the benefits of identifying risks early, achieving an efficient and effective audit, selecting appropriate teams and resolving problems quickly. Weaker answers were those who focused on the benefits of gaining an understanding of an entity rather than of audit planning. Also some answers were again too short and resembled brief notes rather than explanations.

Part (b) for 3 marks required an identification and explanation of three methods for selecting a sample. This was answered well by most candidates.

Nearly all candidates could identify three sampling methods and so attained at least half of the available marks. However, weaker answers failed to explain the methods adequately. Answers such as “random selection method – pick sample randomly” would only have scored ½ mark for the identification of the method. It would have scored nothing for the explanation as this is not how this method works.

In addition a small minority focused on statistical and non-statistical sampling rather than the methods for picking samples. Also some candidates started their answers with a general definition of what sampling is; this was not required and so scored no marks.

Part (c) for 3 marks required a description of three types of modified audit opinions. Performance was mixed on this question.

Better answers correctly identified qualified, adverse and disclaimer opinions and were able to concisely describe what these opinions meant. However, there were a considerable amount of candidates who gave emphasis of matter as a type of modified opinion, this is incorrect. An emphasis of matter paragraph modifies the audit report but it does not affect the opinion. In addition, some candidates wasted time by referring to unqualified opinions; even though the question was on modified opinions only; this may be due to a failure to read the question properly.

Also candidates are reminded that since the clarified ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* has been issued the old terminology of "disagreement" and "limitation of scope" is no longer relevant and instead should refer to "material misstatement" or "inability to obtain sufficient evidence".

Candidates' inability to correctly identify modified audit opinions and to clearly explain them is unsatisfactory. Audit reports are a key part of the F8 syllabus and candidates need to understand this area better. This point has been made many times in previous examiners reports.

Question Three

This 20-mark question was based on audit firm Currant & Co and their client Orange Financial Co, who provided loans and financial advice. The question tested the areas of fraud and error, ethics and benefits of an audit committee.

Part (a) for 4 marks required an explanation of auditors' responsibilities in relation to prevention and detection of fraud and error. This question was answered unsatisfactorily.

The focus of the question was what the auditors' responsibilities were; it did not require an explanation of directors' responsibilities, however many candidates did provide this and there were no marks available for this. Candidates also wanted to focus on what was not the auditors responsibility, namely to prevent fraud and error. In addition some answers strayed onto providing procedures for detecting fraud and error rather than just addressing responsibilities.

A majority of candidates were able to gain marks for reporting any frauds to management or those charged with governance, for the auditors' general responsibility to detect material misstatements caused by fraud or error and that the auditors are not responsible for preventing fraud or error.

Part (b) for 12 marks required an explanation of six ethical threats from the scenario and a method for reducing each of these threats. This was very well answered with many candidates scoring full marks. Ethics questions are often answered well by candidates and the scenario provided contained many possible threats.

Where candidates did not score well this was usually because they only identified rather than explained the ethical threat. In addition some candidates identified the threat but when explaining them they came up with incorrect examples of the type of threat; such as attending the weekend away at a luxury hotel gave rise to a familiarity threat rather than a self-interest threat.



The threat which candidates struggled with the most was the intimidation threat caused by management requesting the audit team ask minimal questions. The response given by many candidates was to decline the assurance engagement; this does not address the intimidation threat. Instead candidates needed to stress that this issue needed to be discussed with the finance director and that appropriate audit procedures would be undertaken to ensure the quality of the audit was not compromised.

In addition when explaining issues some candidates listed many examples of ethical threats; such as “the assistant finance director being the review partner gives rise to a familiarity, self-review and self-interest threat.” This scatter gun approach to questions is not recommended as it wastes time.

Part (c) for 4 marks required candidates to explain the benefits of an audit committee. This question was answered well.

Most candidates were able to identify and explain a sufficient number of benefits of an audit committee to pass this question. Where candidates did not score well this was due to them giving answers on the role or composition of an audit committee rather than the benefits.

Question Four

This 20-mark question was based on Pineapple Beach Hotels Co and tested candidates' knowledge of financial statement assertions, substantive procedures and working papers.

Part (a) was for 8 marks in total and in (ai) required four financial statement assertions relevant to year end account balances and part (a(ii)) required an example substantive procedure for each assertion relevant to the audit of inventory. This question was unrelated to the scenario and was knowledge based, and candidates' performance was on the whole unsatisfactory.

Financial statement assertions are a key element of the F8 syllabus and so it was unsatisfactory to see that a significant minority of candidates do not know the assertions relevant to account balances; with many giving incorrect assertions of accuracy and cut-off which are relevant to classes of transactions rather than account balances. Where candidates did correctly identify the assertions they often failed to explain them adequately or did so with reference to transactions rather than assets and liabilities.

A number of candidates provided example procedures which were not related to inventory, but instead focused on non-current assets or receivables. This can only be due to a failure to read the question requirement properly. In addition many example procedures were not relevant to the linked assertion, for example giving an existence test for confirming valuation. Also many of the procedures were vague such as “check inventory is valued at the lower of cost and net realisable value” without explaining how we would confirm this.

Part (b) for 8 marks required substantive procedures for depreciation and a contingent liability for a food poisoning case. Performance on this question was unsatisfactory. A significant minority did not even attempt this part of the question.

Candidates' answers for depreciation tended to be weaker than for the food poisoning. On the depreciation many candidates did not focus their answer on the issue identified, which related to the depreciation method adopted for the capital expenditure incurred in the year. In the scenario the issue was headed up as depreciation and so this should have given candidates a clue that they needed to focus just on depreciation. However, a significant proportion of answers were on general PPE tests often without any reference at all to depreciation. In addition many felt that generic tests such as “get an expert's advice” or “obtain management representation” were appropriate tests; they are not.



The food poisoning issue tended to be answered slightly better; however again tests tended to be too brief, “read board minutes”, “discuss with management” or “discuss with the lawyer” did not score any marks as they do not explain what is to be discussed or what we are looking for in the board minutes. In addition a minority of candidates focused on auditing the kitchen and food hygiene procedures with tests such as “observing the kitchen process” or “writing to customers to see if they have had food poisoning.” This is not the focus of the auditor and does not provide evidence with regards to the potential contingent liability.

As already stated in this report, question 1b, substantive procedures are a core topic area and future candidates must focus on being able to generate specific and detailed tests.

Part (c) for 4 marks required an explanation of four items that would be included on every working paper prepared by the audit team. This was answered unsatisfactorily.

Many candidates seemed completely confused by what was required and instead of focusing on contents of a working paper provided answers in relation to contents of an audit report, or contents of a permanent and current audit file. Answers giving examples such as engagement letter, management letter, risk assessments, representation letter, etc were common. It is not clear why candidates failed to understand this question as the requirement was clear.

Where candidates did provide examples of items to be included in working papers, they often failed to explain their purpose and so this reduced their available marks.

Question Five

This 20-mark question was based on audit firm Kiwi & Co (Kiwi) and tested candidates' knowledge of analytical procedures, going concern and audit reports.

Part (a) for 3 marks required an explanation of the three stages of an audit when analytical procedures can be used. Performance was satisfactory on this question.

Many candidates were able to correctly identify three stages when analytical procedures could be used as planning or risk assessment stage, substantive testing stage and final review or completion stage. They were then often able to explain how analytical procedures could be used at one of these stages, usually the planning stage; some candidates struggled with how they could be used at the substantive testing and final review stages.

Some candidates ignored the stages of the audit and instead just explained what analytical procedures were. In addition some candidates discussed the three stages of an audit and what an auditor does at each stage with no reference to analytical procedures; this may have been due to a failure to read the question properly.

Part (b) for 6 marks required an explanation of potential going concern indicators from the scenario. This was answered well by many candidates.

The scenario contained many going concern indicators and candidates were able to easily identify an adequate number of indicators. However, the explanation of why these indicators might imply that Strawberry Kitchen Designs Co (Strawberry) was not a going concern was not as well answered. Many candidates' explanations of indicators were limited to “this could indicate the company is not a going concern” this is not an adequate explanation and so would not score marks. The answer needed to explain how the indicator could stop Strawberry from being a going concern. For example “a major customer ceasing to trade” is a going concern indicator because it means that future sales and cash flows could be reduced if this customer is not replaced.

In addition a small minority spent significant time calculating ratios using the limited financial data available. Ratios were not specifically required, and whilst there were some available marks for explanations of current or



quick ratios falling, this time would have been better served explaining any of the numerous indicators from the non-financial information given in the scenario.

Part (c) for 6 marks required going concern audit procedures. Performance was mixed on this question.

Candidates failed to maximise their marks here by providing too brief tests such as “check cash flow forecasts” and “obtain management rep” or unrealistic tests such as “write to the bank and ask if they will require the loan to be repaid”, the bank will not answer such a request. In addition some answers focused on audit procedures which would have already been undertaken during the substantive testing stage such as “perform a receivables circularisation”.

Part (di) for 2 marks required Kiwi’s responsibility for reporting going concern to the directors. This question was answered unsatisfactorily.

Many candidates were unable to correctly identify any of the auditors’ responsibilities on reporting going concern to the directors. Where candidates did score a mark it was usually with regards to the requirement to inform the directors if the going concern assumption was appropriate. Many candidates focused instead on the directors’ responsibilities under going concern; this was not what was required.

Part (dii) for 3 marks required the impact on the audit report if the directors refused to amend the financial statements. This was answered unsatisfactorily.

Many candidates were unable to provide the correct audit opinion and so adopted a scatter gun approach of listing every audit report modification available.

Also many candidates correctly identified that the opinion needed to be modified; however they then suggested an emphasis of matter paragraph. This demonstrates that candidates do not understand when an “emphasis of matter” paragraph is relevant, and seem to think that it is an acceptable alternative to modifying the opinion. This demonstrates candidates’ fundamental lack of understanding of audit reports.

Where candidates were able to correctly identify that an adverse opinion was required they failed to describe the impact on the audit report, many were unable to describe how the opinion paragraph would change and that a basis for adverse opinion paragraph was necessary.

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