

# Examiner's report

## F8 Audit and Assurance

June 2013



### General Comments

The examination consisted of five compulsory questions. Question 1 for 30 marks, question 2 for 10 marks and three further questions of 20 marks each.

The performance of candidates across the paper as a whole was reasonable. Candidates performed particularly well on questions 1b, 2a, 3a, 3bi, 4a and 5a. The questions candidates found most challenging were questions 1ai, 1c, 1d, 3bii and 5c. 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 poor exam technique, as opposed to time pressure.

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. Candidates must remember to answer the question asked and not the question they wish had been asked.
- 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 answer the remaining questions.
- Failure to fully understand the requirement verbs such as "describe", or "explain" and hence not providing sufficient depth to their answers.
- Providing more than the required number of points especially in question 1b.
- Poor layout of answers, including not using columns for questions such as 1b and 3bii when this would have helped to maximise marks.

### Specific Comments

#### Question One

This 30-mark question was based on a manufacturing company, Fox Industries Co (Fox), and tested candidates' knowledge of communicating to those charged with governance (TCWG), internal controls, application controls and substantive procedures for bank and cash.

Part (ai) for 2 marks required candidates to explain why it's important for auditors to communicate with TCWG and part (aii) for 3 marks required three matters that may be communicated by auditors to TCWG.

Most candidates performed unsatisfactorily on part (ai). They needed to focus on WHY it was important to communicate rather than WHAT needed to be reported as this was the requirement of part (aai). Answers that focused on what was to be communicated would not have gained credit as this was not the question requirement for (ai). In addition some candidates simply restated the requirement, explaining that it was important to communicate, but without answering why. Part (aai) was answered better, with most candidates focusing on the areas of fraud, material misstatement and internal control deficiencies. Some candidates focused on providing details of specific audit issues that would be discussed during the audit as opposed to areas which would be formally reported to TCWG.

Part (b) for 14 marks required a report to management which identifies and explains four deficiencies, the implications 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 four deficiencies from the scenario. However, candidates did not always adequately explain the implication of the



deficiency to the business. For example, for the deficiency of purchase orders not being sequentially numbered, many candidates focused on the difficulties of agreeing invoices to orders, as opposed to the key issue of unfulfilled orders and hence stock outs. In addition many implications were vague such as “there will be errors if application controls are not applied by the purchase ledger clerk” this answer does not give any examples of what type of errors and where they may occur. Candidates need to think in a practical manner and apply their knowledge when answering these types of questions.

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, for example simply stating “apply application controls” to address the deficiency of the purchase ledger clerk. The main recommendation where candidates failed to maximise their marks was for sequentially numbered purchase orders. Simply recommending “that purchase 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.

A covering letter to the report was required and there were 2 marks available. Despite this specific requirement a significant number of candidates provided their answers as a memo rather than as a letter. Adopting a memo format resulted in a failure to maximise marks. The two marks were allocated as  $\frac{1}{2}$  for a letterhead,  $\frac{1}{2}$  for an introductory paragraph,  $\frac{1}{2}$  for disclaimers and  $\frac{1}{2}$  for a courteous sign off of the letter, which requires more than just a signature.

Many candidates set their answer out in two (three) columns being deficiency, implication and recommendation. However, those who explained all of the deficiencies, the implications and then separately provided all of the recommendations tended to repeat themselves and possibly wasted some time.

The requirement was for FOUR deficiencies; this session a significant proportion of candidates provided many more than four points, it was not uncommon to see answers with eight deficiencies. Also in many answers deficiencies were combined such as; “purchase orders are not sequentially numbered and only orders over \$5,000 require authorisation”, the implications and recommendations would then also be combined. Providing many more points than required and combining answers leads to unstructured answers that are difficult to mark. Spending too much time on this part of the exam also puts candidates under time pressure for the rest of the paper.

Part (c) for 4 marks required four application controls to ensure the completeness and accuracy of the input of purchase invoices. Performance on this question was quite unsatisfactory. Many candidates failed to pick up marks for this question; also this question was left unanswered by some candidates.

The requirement was for application controls, these could be computerised or manual, but they needed to address the specific area of INPUT of invoices. Many candidates gave general computer controls such as passwords or provided auditor’s substantive tests. In addition candidates listed recommendations from part 1(b) such as “sequentially numbered orders or regular bank reconciliations”; these have nothing to do with input of invoices. Some answers focused on auditing the purchase cycle, agreeing orders to goods received notes and to invoices. Candidates clearly either have a knowledge gap in this area or failed to read the question requirement carefully.

Part (d) for 7 marks required substantive procedures for bank and cash at the year end. Performance on this question was unsatisfactory. Substantive procedures are a key area of the paper and may feature in each session.

Some scripts were with hardly any valid bank and cash procedures. Tests which start with “to ensure that” are unlikely to gain any marks as these are objectives rather than audit tests. Also some candidates failed to read the



question requirement which stated that the audit was of year end cash and bank; these answers focused more on tests of controls over the whole of the year for cash and bank, these did not gain any credit.

Some candidates focused on the bank reconciliation and auditing its detail, such as unpresented cheques and outstanding lodgements. Most candidates were able to suggest obtaining a bank confirmation letter and counting petty cash, however this seemed to be the extent of many answers. It was unsatisfactory to see that many candidates did not understand the purpose of the bank reconciliation as a common answer was “to agree the bank confirmation letter to the financial statements” as opposed to the bank reconciliation. Many provided vague answers such as “cast the ledger” and a minority misunderstood the question and focused on auditing payables and receivables.

### **Question Two**

This 10-mark question covered the topics of ethical threats, going concern responsibilities and emphasis of matter paragraphs.

Part (a) for 5 marks required candidates to list five ethical threats and for each to identify an example of a circumstance that creates this threat. This question was answered very well by almost all candidates with many scoring full marks.

Candidates were able to confidently list the five threats and to provide relevant examples. Some candidates failed to provide a relevant intimidation threat, believing that the existence of overdue fees results in an intimidation threat, whereas it's the threat of not being paid these fees that creates the risk. A small number of candidates provided fundamental principles rather than ethical threats.

Part (b) for 3 marks required an explanation of the auditors and management's responsibilities regarding going concern. This was answered satisfactorily by many candidates.

Many candidates were able to suggest that “directors needed to prepare the financial statements on the correct basis” and that “auditors need to gain evidence over the going concern basis”. However, some candidates wasted time by listing definitions of going concern and providing audit procedures to test going concern. Candidates must focus on only answering the question set, as opposed to listing all they know about the topic area.

Part (c) for 2 marks required a description of the contents of an emphasis of matter (EOM) paragraph. Performance was mixed on this question.

This question divided candidates between those who clearly understood what an EOM paragraph was and hence were able to easily gain the 2 marks available and those who did not understand what EOM was. Some candidates seemed to believe that an EOM paragraph is an “except for qualification” and hence gave these details. Also they did not understand that an EOM paragraph modifies the audit report but that the opinion is unmodified.

### **Question Three**

This 20-mark question was based on Kangaroo Construction Co (Kangaroo) a building company. The question tested the areas of materiality, ratios and audit risks and auditors responses.

Part (a) for 5 marks required an explanation of the concepts of materiality and performance materiality. Candidates' performed well on this question.

The vast majority of candidates were able to score marks on the definition of materiality, provision of some benchmarks for the calculations and a reference to performance materiality being at a lower level. These points would have achieved a pass for this part of the question. An adequate level of detail was provided for this



“explain” requirement by the majority of candidates. Some candidates just gave a definition of materiality and nothing else; this would have gained a maximum of 1 mark.

Part (bi) for 5 marks required candidates to calculate ratios for 2012 and 2013 to assist in planning the audit. This question was answered very well by the vast majority of candidates with many scoring full marks.

Some candidates attempted to calculate ratios despite there being inadequate data available, namely return on capital employed and gearing. Candidates need to think about the information provided in the scenario prior to calculating ratios.

In order to gain the  $\frac{1}{2}$  mark available for each year a relevant ratio had to be calculated. Some candidates did not bring a calculator into the exam and hence were unable to calculate the final ratios; these candidates would not be able to score the 5 available marks. Future candidates are reminded, once again, to bring a calculator into the F8 exam as they are often required.

Part (bii) for 10 marks required a description of five audit risks from the scenario and ratios calculated and the auditor’s response for each. Performance on this question was once again unsatisfactory.

The scenario contained more than five risks and so candidates were able to easily identify enough risks, they then went on to describe how the point identified from the scenario or movement in a ratio was an audit risk by referring to the assertion and the account balances impacted. The improvement in this area noted in December 12 has been reversed and the proportion of candidates who described the audit risk adequately has declined in this session.

Some candidates tended to only identify facts from the scenario such as “Kangaroo has completed houses in inventory where selling price may be below cost” but failed to explain how this could impact audit risk; this would only have scored  $\frac{1}{2}$  marks. To gain a full 1 mark they needed to refer to the risk of the inventory being overvalued. Where candidates did attempt to cover the assertion it was often vague; for example stating that “inventory may be misstated”, this is not sufficient to gain the  $\frac{1}{2}$  mark available.

Additionally, many candidates used the ratios calculated in part (bi) and then gave a detailed analytical review of the ratio movements, commenting on ratio increases and decreases, but with no link at all to the audit risks. It was not uncommon to see very lengthy answers with no audit risks; this just puts the candidate under time pressure.

Many candidates focused on business risks rather than audit risks and hence provided responses related to how management should address these business risks. For example, the scenario stated that “Kangaroo had changed their main supplier to a cheaper alternative and as a result warranty claims had increased”. Some candidates answered “this would lead to the company’s reputation suffering as the quality of their buildings would decline”. The suggested auditor’s response was “to change back to a more expensive supplier”. Neither the risk nor the response has been related to the financial statements and hence would only gain a  $\frac{1}{2}$  mark being the identification of the fact from the scenario.

Additionally, candidates performed inadequately with regards to the auditor’s responses. As detailed above 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 number of houses where selling price was below cost, 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. 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 auditor's response next to it.

#### **Question Four**

This 20-mark question was based on Bush-Baby Hotels Co (Bush-Baby) and tested candidates' knowledge of procedures for obtaining evidence, internal audit and fraud.

Part (a) for 10 marks required a description of five procedures for obtaining audit evidence and an example for each procedure relevant to the audit of property, plant and equipment (PPE). This question was unrelated to the scenario, was knowledge based and candidates' performed well.

Candidates were able to comfortably identify a procedure, such as inspection, describe what this meant, and then provide a well described PPE test for inspection. Those candidates who structured their answers with procedure followed by example PPE test tended to provide tailored relevant answers.

The types of procedures which tended to cause most difficulty were "observation" as candidates seemed to struggle with producing valid observation tests. Recalculation and reperformance were used interchangeably, but these are different types of procedures, a common incorrect answer for re-performance was "to reperform the depreciation calculation" this is a recalculation and not a reperformance test.

Some candidates only identified the types of procedures rather than describing them, or the description was inadequate such as "inspection means to inspect an invoice" this is not an adequate description. In addition some candidates did not link the PPE test to the relevant type of procedure. Some candidates misunderstood what was required and gave financial statement assertions rather than types of procedures.

It was satisfactory that on the whole candidates provided tests relevant to PPE rather than for other statement of financial position areas.

Part (b) for 3 marks required an explanation of how the new internal audit (IA) department of Bush-Baby could assist the directors in preventing and detecting fraud and error. Performance was mixed on this question.

Most candidates were able to gain a mark by suggesting controls that IA could help to develop and monitor to prevent fraud and error. However answers needed to be broader and rather than focusing in excessive detail on internal controls, candidates needed to give more of a general outline in how IA could help, such as fraud investigations.

Part (c) for 2 marks required a description of the limitations of an IA department. Performance was satisfactory on this question.

Many candidates were able to identify the cost outweighing the benefit as being the main limitation or independence issues as they were employees of Bush-Baby. Unfortunately a significant minority of candidates could only provide one of these points. Some candidates referred to the size of the hotel chain as being a limitation, where it was not.

Part (d) for 5 marks required a description of additional functions, other than fraud investigations, the IA department could be asked by the directors to undertake. Performance was mixed on this question.



Candidates were able to easily describe different functions such as internal controls reviews, value for money (VFM) audits, review for compliance with laws and regulations and risk assessment/management.

Some candidates just identified these types of functions with no description of what these functions were; answers such as “the IA department could undertake a VFM audit” were common. Candidates must consider the question requirement verb, a describe requirement requires some detailed descriptions.

There was also some confusion as to the types of functions IA would perform, for example they should not prepare financial statements. In addition some candidates focused exclusively on the IA department liaising with the external auditor.

### **Question Five**

This 20-mark question was based on Panda Co (Panda) and tested candidates’ knowledge of assurance engagements, subsequent events and audit reports.

Part (a) for 5 marks required an explanation of the five elements of an assurance engagement. This question was unrelated to the scenario and was knowledge based. Performance was mixed on this question, in that many candidates either scored full marks or no marks.

Those candidates who were able to identify the elements occasionally failed to score full marks due to a failure to fully explain the element, for example stating “suitable criteria” and then giving an example of accounting standards, rather than explaining that the suitable criteria are the benchmark for comparing the subject matter against.

Some candidates did not understand what was required and focused on the different opinions and positive/negative assurance or on the content of an audit report.

Part (b) for 12 marks required for two events; an explanation of whether the financial statements should be amended and audit procedures that should be performed by the auditor to form a conclusion on any required amendment. Performance was mixed on this question.

Many candidates were able to correctly identify whether the events were adjusting or non-adjusting. However the justification for this was not always correct; for example stating that “the explosion was non-adjusting as it occurred after the year end”. Many candidates were able to calculate the materiality of the potential error, using the numbers provided, although some incorrectly calculated the materiality for event 1 using the total cost of inventory of \$0.85m rather than the write down of \$0.75m. The decision as to whether the financial statements required amendment was answered well for event 1, but less so for event 2 as many candidates did not seem to realise that adding a disclosure note is an amendment.

With regards to procedures to undertake to form a conclusion on any required amendment, candidates seemed to struggle with this. Many procedures lacked sufficient detail to score the available 1 mark per test. This commonly occurred with tests such as; “reviewing board minutes” and “obtain written representation”. These procedures need to be phrased with sufficient detail to obtain credit and must be tailored to the scenario. In addition a significant minority of candidates wanted to contact Panda’s insurance company; this is not a realistic procedure.

In addition some candidates wasted time by discussing the impact on the audit report for each event; this was not part of the question requirement for part (b) and so would not have generated any marks. Candidates once again are reminded to only answer the question set.

Part (c) for 3 marks required the impact on the audit report should the issue for event 2, the explosion, remain unresolved. Performance on this question was unsatisfactory.



Candidates still continue to recommend an emphasis of matter paragraph for all audit report questions, this is not the case and it was not relevant for this issue. Candidates need to understand what an emphasis of matter paragraph is and why it is used. In addition some candidates are confused with regards to audit report terms and used phrases such as “qualify the report” rather than modify the report and “modified opinion” rather than qualified opinion.

A significant minority misread the question and rather than just providing the audit report implications for event 2, gave event 1 as well; this would not have gained any marks. Candidates must read the question requirements carefully.

A significant number of candidates were unable to identify the correct audit report modification, giving multiple options and some candidates seemed to believe that the opinion did not require qualification as it was only the disclosure, as opposed to any numbers that were incorrect. Also some answers contradicted themselves such as “the issue is material therefore an unqualified opinion can be given”. Additionally many candidates ignored the question requirement to only consider the audit report impact if the issue was unresolved. Lots of answers started with “if resolved the audit report .....” this was not required.

Once again future candidates are 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.