

Examiner's report

F8 Audit and Assurance

June 2014



General Comments

The examination consisted of five compulsory questions. Question 1 for 30 marks, question 2 for 10 marks as well as three further questions of 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 1b, 1c, 2a, 2b, 3d, 4a, 4b and 5b. The questions candidates found most challenging were questions 1d, 3b, 3c, 5a and 5d. This is mainly due to a lack of technical knowledge and due to a failure to read question requirements carefully.

A number of common issues arose in candidates' answers:

- Failing to read the question requirement carefully 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 1a and this put them under time pressure to finish remaining questions.
- Failure to fully identify all the question requirements, "identify and explain" are two separate requirements and both required an answer.
- Not learning lessons from previous examiner's reports and hence making the same mistakes, especially in relation to audit risk and audit reports.
- Poor layout of answers, including not using columns for questions such as 1a, 3a, 4a and 5b when this would have helped to maximise marks.

Specific Comments

Question One

This 30-mark question was based on a hotel chain, Trombone Co (Trombone), and tested candidates' knowledge of the payroll system including tests of controls, interim and final audits and substantive procedures for the payroll expense and accrual for tax payable on employment income.

Part (a) for 15 marks required candidates to identify and explain five deficiencies in the payroll system, recommend controls to address these deficiencies, and a test of control for each of these recommendations that could be used to assess if it was operating effectively if implemented. The first two parts of this questions were answered satisfactorily by candidates, however the tests of controls proved challenging for many.

Candidates were able to comfortably identify five deficiencies from the scenario, although a minority of candidates identified deficiencies which were generic to payroll systems rather than specific to the question, such as references to "clock cards", which were not a component of the system under review. Also some candidates identified points which were not valid deficiencies, such as employees being able to complete their own overtime sheets, being allowed a choice between days off or payment of overtime and overtime sheets being entered by payroll clerks.

Although sufficient deficiencies were identified by many candidates, they did not always adequately explain what the deficiency meant to Trombone. For example, candidates identified the deficiency that "the overtime worked reports are not always checked," however some failed to explain the implication of this in that it could lead to employees taking days off when they had not worked the overtime hours required.



The requirement to provide controls was answered satisfactorily. Most candidates were able to provide good recommendations to address the deficiencies; however in some instances these recommendations were too brief. Candidates have a tendency to state control objectives rather than valid procedures which can be implemented by the client. In addition some recommendations failed to address the deficiency identified, for example where department heads failed to assign a deputy to authorise overtime whilst on annual leave, many candidates simply recommended that this control already existing control be put in place, rather than addressing how the control should be amended to ensure it was followed at all times.

The requirement for tests of controls was answered unsatisfactorily. Many candidates are still confusing substantive procedures and test of controls. A significant number of candidates suggested substantive procedures such as “recalculating gross and net pay calculations”, rather than a test of control which might be to “review evidence of the recalculation of payroll”. Candidates need to review their understanding of these different types of audit procedures and ensure that they appreciate that substantive tests focus on the number within the financial statements whereas test of controls are verifying if client procedures are operating.

In many instances candidates focused on re-performing the control rather than testing it had operated. Observation of a control was commonly suggested by candidates, however in many cases this is not an effective way of testing that a control has operated **throughout** the year.

Most candidates presented their answers well, adopting a three column approach with deficiency, the control recommendation and the test of control in separate columns. This approach ensured that all elements of the question were addressed and it was easier to see which recommendations and tests related to which deficiencies.

Part (b) for 5 marks required candidates to explain the difference between an interim and final audit. This question was answered well by candidates.

Many demonstrated an understanding of when each audit visit would be carried out in relation to the client’s year end and the different areas that would be focused on during each visit such as testing of controls at interim and substantive procedures at final. A minority of candidates incorrectly suggested that planning procedures would be undertaken at the interim audit and that they were undertaken by internal auditors. Also a significant minority confused this requirement with a comparison of internal and external audit roles. Candidates must remember to read the question carefully and think and plan before writing to ensure that they answer the question asked.

Part (c) for 6 marks required substantive procedures to confirm the completeness and accuracy of the payroll expense. On the whole candidates performed well in this area.

A good proportion of candidates were able to suggest practical payroll procedures such as analytical review of prior year and current year charges or undertaking a proof in total calculation. Other common answers included recalculation of a sample of payroll calculations or statutory deductions.

Common mistakes made by candidates were:

- Giving objectives rather than procedures “ensure that the gross and net pay calculations are correct”, this is not a detailed substantive procedure and so would not score any marks.
- Lack of detail in tests such as “check that the payroll calculations are correct”, this would not score any marks as it does not explain **what** should be checked or **how** this testing would be carried out.
- Providing tests of controls rather than substantive procedures, such as focusing on authorisation of payroll.



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 and to apply their knowledge to different areas of the financial statements.

Part (d) for 4 marks required substantive procedures in respect of the year end accrual for tax payable on employment income. Where answered, performance on this requirement was disappointing.

Candidates were provided with a short scenario to explain how the employment taxes were remitted to the taxation authorities and that at the year end there would be an accrual for any outstanding amount. The scenario was provided so that candidates could apply their knowledge of accruals to the specific circumstances; however from the answers provided it seems that some did not take notice of detail provided.

Many answers demonstrated that candidates did not know what a tax accrual was and hence suggested procedures focused on “discussions with management” or “obtaining written representations”. This accrual was not judgemental and so the above procedures would not have scored many marks. Those candidates that scored well suggested answers such as “recalculation of the accrual,” “comparison with prior year or months” and “verifying the subsequent payment after the year end”.

Question Two

This 10-mark question covered the topics of value for money audits, benefits of documenting work and sampling.

Part (a) for 3 marks required candidates to define the “three E’s” of a value for money audit. Candidates’ performed well on this question.

Almost all candidates were able to identify the three E’s of economy, efficiency and effectiveness and the explanation of economy, however, the explanations of efficiency and effectiveness were often vague or mixed up.

Part (b) for 4 marks required candidates to describe benefits of documenting audit work. This question was answered well by most candidates.

Most candidates were able to score well in this requirement, with the most common answers being “it provides evidence of the work done” and “helpful for future planning and audits”. However, a number of candidates provided repetitive points, which only scored marks once; this was usually in the area of providing evidence of work done.

Part (c) for 3 marks required candidates to define audit sampling and to explain the need for this. Performance on this question was mixed.

Many candidates struggled to provide a definition of sampling with many providing answers such as “sampling is when an auditor tests a sample”, this would not score any marks. In addition a minority of candidates wrote at length about the different methods for obtaining a sample, when this was not required. In terms of why auditors need to sample, many candidates were able to suggest that testing 100% of items was not feasible; however they did not explain why this was the case i.e. due to time or cost constraints.

Question Three

This 20-mark question was based on a mobile phone company Recorder Communications Co (Recorder). The question tested the areas of audit risks and responses, procedures for placing reliance on continuous counts for inventory, substantive procedures for directors’ bonus payments and managing conflicts of interest.



Part (a) for 10 marks required identification and description of five audit risks from the scenario and the auditor's response for each. Performance on this question was mixed, and unfortunately not as good as in December 2013 when audit risk was last tested.

The scenario contained significantly more than five risks and so candidates were able to easily identify enough risks, and strong answers 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 "Recorder purchases goods from a supplier in South Asia and the goods are in transit for two weeks" but failed to **describe** how this could impact audit risk; this would only have scored ½ marks. To gain 1 mark the point needed to be developed to also explain that this could result in issues over the completeness of inventory.

More so than in previous diets, candidates disappointingly provided business risks rather than audit risks with answers such as stock outs due to the two week transit period and possible damage to inventory during transit. As a result these candidates then provided responses related to how management should address these business risks rather than how the auditor should respond. This meant that out of a potential 2 marks per point, candidates would only score ½ marks for the identification of the issue from the scenario.

Some candidates also identified irrelevant risks such as Recorder undertaking continuous inventory counts. While an audit risk was present around inventory in relation to the effectiveness of the perpetual inventory system, very few candidates explained the risk in this manner instead focussing on the lack of a full year-end count. This demonstrated a lack of understanding of continuous inventory counts.

Additionally, many candidates performed poorly with regards to the auditor's responses. Many candidates gave business advice, such as changing the salesmen's bonus structure or provided vague responses such as perform detailed substantive testing or maintain professional scepticism. 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. 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.

Most candidates presented their answers well, adopting 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.

Part (b) for 3 marks required procedures the auditor should perform in order to place reliance on the continuous counts for inventory. Candidates' performance was disappointing.

Many candidates provided lengthy answers on procedures to be carried out when attending a year-end inventory count or procedures to verify valuation or completeness/existence of inventory, suggesting that a significant proportion of candidates do not understand continuous inventory counts, the risks associated with this and therefore the areas the auditor needs to focus on. A small proportion of candidates correctly identified that it was important to confirm if all inventory items were counted at least once a year and also to assess the level of adjustments made during these counts.

Inventory is a key element of the financial statements and candidates need to be able to provide relevant procedures for both full year-end counts as well as continuous counting.

Part (c) for 3 marks required substantive procedures for confirming the directors' bonus payment made during the year. Candidates' performance was disappointing.



Unfortunately, many candidates focussed on the authorisation of the bonus; this is not a substantive procedure and would not have scored any marks. A significant minority thought that the directors' bonus was based on sales which was not the case. The scenario stated that salesmen's bonuses were based on sales, hence candidates either confused these two items or failed to read the scenario properly. They then looked to recalculate the bonus based on sales levels which was not appropriate in the circumstances.

A number of vague procedures were suggested such as obtaining written representations or reading board minutes without explaining what for. Analytical procedures were suggested; however they were unlikely to be valid procedures as bonuses by their very nature tend to vary each year.

Part (d) for 4 marks required candidates to detail safeguards the audit firm should implement to ensure conflicts of interests between two clients were properly managed. Candidates performed well on this question.

Most candidates were able to score at least two marks, with the most common answers focusing on having two separate teams, security of files and informing both clients. However, a significant number of candidates provided the same point multiple times; such as separate teams, different partners and Chinese walls; these would only have scored a maximum of 1 mark due to the repetitive nature of these points.

In addition some candidates wrote about the principles of conflict of interest, rather than safeguards and others focused on other areas such as confidentiality. It was also disappointing that a number of candidates, rather than assess the issues, simply felt that the auditors should resign; this is an extreme step for the firm to take in the circumstances.

Question Four

This 20-mark question was based on a listed company which sold insurance services, Saxophone Enterprises Co (Saxophone). This question tested candidates' knowledge of outsourcing internal audit and corporate governance.

Part (a) for 10 marks required advantages and disadvantages for Saxophone and its audit firm, Cello, of outsourcing the internal audit department. Candidates performed well on this question.

Many candidates were able to identify a good range of points for both Saxophone and Cello, and the mark allocation of 8 and 2 marks respectively was adhered to. Many answers were well structured with a section for each company with sub headings for advantages and disadvantages; this facilitated the marking of this question.

Those candidates who did not score well tended to provide very little detail in their answers, such as for advantages simply stated "lower costs" or "more flexibility" these are far too brief to score the 1 mark available per point. The requirement asked candidates to "explain" their points and this does not provide adequate explanation. Candidates must pay attention to the requirement verb and provide the required level of detail.

In addition some candidates included incorrect points such as for advantages the fact that the internal audit work would be quicker as the external auditors knew the company, or that the audit fee would reduce implying that the same team would be used for both tasks or that the work would automatically be relied on which was not appropriate.

Part (b) for 10 marks required an identification and explanation of five corporate governance weaknesses as well as a recommendation for each. Candidates performed well on this question.

Most candidates were able to confidently identify weaknesses from the scenario. However many could not explain the weakness, relying on explanations such as "this is not good corporate governance". This was not sufficient to



score the extra $\frac{1}{2}$ marks available for each point. Candidates needed to be able to explain how these weaknesses impacted the company.

In addition a significant proportion of candidates misread the scenario and thought the chairman and chief executive was the same person. This was not correct; Bill Basson had been the chief executive and was now the chairman. Hence answers focused on these key roles being held by the same person rather than the chairman not being independent and failed to score marks as a result. Candidates must read the scenario carefully before they start to write.

The recommendations provided were not adequate in many cases and often answers gave corporate governance objectives rather than recommendations, such as, “the board should be balanced between executive and non-executives”. This is an objective; the recommendation should have been to “appoint additional non-executive directors to ensure a balanced board”.

Question Five

This 20-mark question was based on a computer hardware specialist, Clarinet Co (Clarinet) and tested candidates’ knowledge of misstatements, going concern and audit reports.

Part (a) for 4 marks required a description of the procedures the auditor of Clarinet should undertake in relation to the uncorrected inventory misstatement. This question, where answered, was disappointing.

Many candidates entered into lengthy discussions as to whether the write down to inventory was an adjusting or non-adjusting event (and frequently came up with the wrong conclusion). Relatively few considered how critical it was to determine the materiality of the misstatement or to perform further substantive procedures to determine the size of the misstatement. Many also wrote at length about every possible impact on the audit report as well as providing detailed inventory count procedures. It was apparent that there were significant gaps in candidates’ technical knowledge in this area.

Part (b) for 6 marks required an explanation of six indicators the company was not a going concern. Candidates performed well on this question.

Most candidates were able to identify six indicators from the scenario; this resulted in them achieving 3 marks. However in order to gain the final 3 marks, candidates were required to explain why this indicator could impact the going concern of Clarinet. Many did not do this, or the explanations provided did not give sufficient depth often simply stating “this could impact the going concern status”. This would not have scored marks as it does not make clear how the going concern status could be impacted.

The requirement verb was to “explain” therefore sufficient detail was required to score the 1 mark available per point. Once again 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.

A small minority of candidates misread the requirement and provided indicators from the scenario that Clarinet **was** a going concern, rather than **was not**. This can only be due to a failure to read the question requirement properly.

Part (c) for 6 marks required a description of going concern procedures. Candidates’ performance was mixed in this area.

Those candidates who failed to score well produced vague procedures such as “obtain the cash flow forecast,” “review board minutes” and “discuss with management”. These examples lack the detail of what the actual procedure involves and therefore limit the amount of credit that can be awarded. In addition some procedures



were unrealistic such as asking the bank to confirm whether it will renew the overdraft facility when the scenario made it clear that the bank would only make such a decision after seeing the audit report. Candidates must use the scenario and be practical when generating audit procedures.

Part (d) for 4 marks required a description of the impact on the audit report if the auditor believes the company is a going concern but is subject to a material uncertainty. Candidates performed disappointingly on this question.

Unfortunately many candidates approached this requirement by suggesting every possible impact on the audit report. Very few candidates seemed to realise that the key issue was whether the disclosures given by the directors were adequate or not and so did not approach the answer in a methodical way. It appears that there is a lack of knowledge in relation to the differences between a modified report and a modified opinion and that if the inclusion of an emphasis of matter paragraph is considered appropriate **the report but not the opinion** is modified.

Once 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.