

Examiner's report

F8 Audit and Assurance

June 2010



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.

It was pleasing to see that the vast majority of candidates attempted all five questions, with the exception of question 2a. Many candidates chose to start with question 4 or 5 first, and then moved onto questions 1, 2 and 3. A significant proportion 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.

Candidates performed particularly well on questions 3bi, 3bii, 4 and 5b, questions 2b and 5a were also answered to a satisfactory level. The questions candidates found most challenging were questions 1a, 1d, 2a, 3biii, 3c and 5d. This is mainly due to candidates not understanding core syllabus areas well enough and also partly due to a failure to read question requirements carefully.

A number of common issues arose in some candidate's answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks
- Wasting time by providing definitions which were unnecessary
- Presenting answers inadequately, questions 3b and 4b in particular lent themselves well to a columnar format as opposed to lengthy paragraphs of text
- Failing to answer each question on a new page of the answer booklet
- Illegible handwriting.

Specific Comments

Question One

This 30-mark question was based on a paint manufacturer, Smoothbrush Paints Co, and tested candidates' ability to cope with a number of areas including audit risks, planning and inventory.

Part (a) for 10 marks required candidates to identify and explain the audit risks identified at the planning stage of the audit.

Many candidates performed inadequately on this part of the question. Audit risk is a key element of the Audit & Assurance syllabus and candidates must understand audit risk.

A number of candidates wasted valuable time by describing the audit risk model along with definitions of audit risk, inherent risk, control and detection risk; this generated no marks as it was not part of the requirement. Candidates are reminded that they must answer the question asked as opposed to the one they wish had been asked.

The main area where candidates lost marks is that they did not actually understand what audit risk relates to. Hence they provided answers which considered the risks the business would face or 'business risks,' which are outside the scope of the syllabus. Audit risks must be related to the risk arising in the audit of the financial statements. If candidates did not do this then they could not have passed this part of the question as there were no marks available for business risk explanations. Candidates were able to pick up a few marks by identifying risk factors from the scenario, but if they then went onto provide a business risk explanation; they would have scored at most $\frac{1}{2}$ marks for this point, as opposed to a possible $1\frac{1}{2}$ marks for each valid point.



An example of this is most candidates identified from the scenario a valid risk factor of goods being in transit for two months. The explanation of the audit risk should have been to ascertain that the cut-off of inventory was appropriate at the year end. However many candidates went onto explain that Smoothbrush Paints Co may encounter problems with stock-outs of goods, this is focused more on operational business risk rather than on the risks to the financial statements. Future candidates must take note; audit risk is an important element of the syllabus and must be understood.

Additionally, some of the candidates who were able to provide valid audit risks tended to focus too much on inventory risks as opposed to any number of the additional audit risks presented in the scenario. Credit was awarded for valid inventory risks in 1a; however where candidates focused overly on inventory they tended to lose marks in question 1c, which asked for inventory controls, as candidates did not then consider the inventory issues in question 1c as they had raised them in 1a.

The majority of answers were presented in detailed paragraphs as opposed to a columnar approach; either approach was suitable for this question. In addition a number of candidates provided far too many points for this question, which resulted in their answers to later questions either being incomplete or rushed.

Part (b) for 4 marks required a discussion of the importance of assessing risk at the planning stage of an audit. This was well answered by the majority of candidates with many identifying that assessing risk would lead to an effective audit with the focus of testing being on high risk areas only.

Part (c) for 10 marks required an identification and explanation of controls over the continuous/perpetual inventory counting system in order to ensure completeness and accuracy of the inventory records. This question proved to be challenging for a number of candidates and there were some unsatisfactory answers. Many identified controls, such as “the inventory team should be independent of the warehouse staff” but failed to then explain these controls, this would have restricted their marks to $\frac{1}{2}$ mark per control as opposed to the $1\frac{1}{2}$ marks available for an identification and explanation.

As noted above for question 1a, many candidates identified inventory risks in 1a, but then did not consider the controls required to address these risks for question 1c, and hence missed out on available marks.

In addition despite the question asking for controls a significant minority of candidates provided substantive procedures the auditor would perform at an inventory count. Candidates must read the question carefully. Also many candidates failed to appreciate that the controls required were in relation to the perpetual inventory system only and not for the whole inventory cycle, hence controls in relation to goods received notes and purchase invoices were not relevant.

Part (d) for 6 marks required three substantive procedures each to confirm the valuation of inventory and the completeness of provisions or contingent liabilities.

Performance was mixed for this question; candidates were generally able to provide adequate substantive procedures for provisions or contingent liabilities. However candidates are reminded that procedures such as;

- obtain management representations,
- discuss with management, or
- read board minutes

are only likely to score $\frac{1}{2}$ mark unless there is an explanation of what the management representation should contain, what the management discussions should cover, or what the minutes are being reviewed for. Substantive procedures must be sufficiently detailed otherwise at best only $\frac{1}{2}$ marks rather than 1 mark can be obtained.



The requirement to consider valuation of inventory, which is a topic which is regularly examined, was on the whole inadequately answered. Candidates seemed to ignore the requirement to consider valuation and often structured their answers with headings such as existence or rights and obligations. Clearly many failed to read the question properly. In addition despite substantive procedures being required, many started with a definition of net realisable value, this scored no marks.

Question Two

This 10-mark question covered the areas of assurance and materiality.

Part (a) for 5 marks required an explanation of the elements of an assurance engagement. A large number of candidates did not attempt this question, and where it was attempted it was inadequately answered. Most candidates who provided an answer clearly did not know what the elements of an assurance engagement were and therefore proceeded to write down anything they knew about assurance. The usual answers focused on positive and negative assurance or on the different types of assurance engagements. Only a small minority of candidates actually understood the requirement and provided valid answers.

It was fairly apparent from the answers provided that many candidates had simply not studied the area of assurance and hence were unable to score any marks at all.

Part (b) for 5 marks required candidates to define materiality and determine how the level is assessed. Generally candidates performed well on defining materiality and were able to provide a couple of points in relation to the assessment of materiality. Most candidates correctly identified benchmarks that can be used to calculate materiality and many also commented on the need for professional judgement.

Unfortunately, some candidates failed to identify a sufficient number of points, as a definition of materiality along with an assessment of benchmarks such as 1% of revenue would only have scored two marks in total. In order to pass this part of the question further points were required. In addition only a small minority of candidates commented on performance materiality which is a new topic from the revised ISA 320 *Materiality in Planning and Performing an Audit*.

Question Three

This 20-mark question was based on a window cleaning company, Shiny Happy Windows Co, along with unrelated requirements on substantive procedures and tests of control as well as substantive procedures over a company's bank balance.

Part (a) for 4 marks had two sub requirements which were not related to the scenario. Candidates were required to define a substantive procedure and a test of control and then provide an example of each procedure relevant to sales invoicing.

A large number of candidates could not provide valid definitions. Most were able to define test of control, but struggled with substantive procedure. The attempts by most candidates at providing examples of tests of control and substantive procedures were unsatisfactory. Many provided controls rather than how to test the controls and the substantive procedures were weak in relation to the level of detail provided. As noted in previous Examiner's reports a substantive procedure which starts with "check" is unlikely to score many marks.

In addition some candidates provided valid examples of tests of controls and substantive procedures, but these were not in relation to sales invoicing. It can only be assumed that this was due to a failure to read the question properly.



Obtaining evidence is a core part of the syllabus and for candidates to not be able to provide examples and definitions for substantive procedures and tests of control is unsatisfactory. Future candidates must ensure that they are mindful of the importance of this topic area.

Part (b) for 9 marks had three sub requirements; an identification and explanation of deficiencies in the cash cycle, controls to address these deficiencies, and tests of controls to assess the effectiveness of the controls.

The first two parts of these three sub requirements were answered well by almost all candidates, many scored full marks. Where candidates did not score full marks this was usually due to the fact that they had not explained the deficiencies and controls in sufficient detail or because they identified deficiencies/controls which were unrealistic, such as suggesting that all customers should be required to pay by BACS rather than by cash/cheques or suggesting that only senior members of the finance team should be allowed to open the post.

The third sub requirement for tests of controls was not well answered. Following on from comments made in relation to question 3a, candidates do not seem to understand what a test of control is and how it operates. Many provided unsatisfactory tests such as “observe the post” or they provided substantive procedures instead.

The question required three deficiencies, controls and tests of control and it was pleasing to see that the vast majority of candidates were able to clearly identify only the required number of points.

Many candidates presented their answers in a columnar format and this seemed to provide clear and concise answers which covered all parts of the requirement. Some answered just the first two sub requirements in columns whilst others answered all three parts in columns; either approach was acceptable.

Part (c) for 7 marks required substantive procedures for verifying a company’s bank balance. It presented difficulties for many candidates.

Common errors included:

- Writing at length about the steps involved in obtaining a bank confirmation, even though this was not the requirement.
- Focusing on testing transactions which would go through the bank account over the year as opposed to focusing on the year-end bank reconciliation.
- Providing tests of controls over bank, this yet again demonstrated the confusion over substantive versus tests of control.

Those candidates who did understand the requirement often failed to focus enough on the auditing of the year-end bank reconciliation and hence lost out on marks in relation to such items as un-presented cheques and outstanding lodgements.

Substantive procedures over the key categories of assets and liabilities is a core part of the syllabus and future candidates must ensure that they devote adequate exam preparation time to this critical area.

Question Four

This 20-mark question was based on a manufacturer of luxury mobile phones, LV Fones Co, and addressed the syllabus area of professional ethics.

Part (a) for 5 marks was unrelated to the scenario and required five threats from the ACCA’s *Code of Ethics and Conduct* along with an example for each threat.



This part of the question was very well answered by the vast majority of candidates with most scoring full marks. A significant minority of candidates confused the requirement for threats with that of the fundamental principles and hence provided answers in relation to objectivity, integrity, confidentiality, professional competence and due care and professional behaviour; unfortunately these answers gained no marks. In addition some candidates did not provide an example of each threat, choosing instead to explain the threat in more detail, however this was not what was required.

Part (b) for 10 marks required an explanation of the ethical threats for LV Fones Co along with an explanation of how the threats might be avoided.

This question was well answered by most candidates; they were able to clearly identify from the scenario the ethical issues impacting the audit of LV Fones. Some candidates did not explain the threats in sufficient detail, sometimes just identifying the issue and not explaining how this was an ethical threat. For example, many identified that the offer of a staff discount of 10% was an issue, however if they did not then go onto explain that this was a self-interest threat they would have only gained $\frac{1}{2}$ rather than 1 mark.

The second part of this question required methods for avoiding the threats, candidates performance here was generally satisfactory. Some answers tended to be quite brief and to include unrealistic steps, such as resigning as auditors to reduce the risk of fee dependence, not allowing the finance director and partner to be friends or suggesting the finance director should resign. In addition many candidates demonstrated that they had not read the scenario properly, as a common suggestion was to not allow the audit senior to undertake the secondment, this was despite the scenario clearly stating that the secondment had already occurred.

Part (c) for 5 marks required the steps an auditor should perform prior to accepting a new audit engagement. This question was well answered by most candidates who were able to identify steps such as contacting the previous auditors as well as various client screening procedures.

Question Five

This 20-mark question was based on a pharmaceutical company, Medimade Co, which was experiencing going concern problems.

Part (a) for 2 marks required a definition of the going concern assumption. Most candidates were able to score at least one mark in relation to a reference to continuing to trade for the foreseeable future. In order to gain further credit there either needed to be an explanation of what the foreseeable future was, or a reference to the IAS 1 *Presentation of Financial Statements* requirement to prepare financial statements on a going concern basis.

Part (b) for 8 marks required an identification of going concern indicators for Medimade Co and a description of why these indicators could impact upon going concern.

Generally candidates scored well in the identification of going concern indicators for Medimade Co, a small minority of candidates did not relate their answers to the scenario and instead produced a standard list of indicators.

The requirement to then describe the impact upon going concern was more problematic for candidates, as many answers just stated “this will lead to going concern problems” as opposed to explaining why there would be an impact on going concern. Therefore although the marking allocation was to give $\frac{1}{2}$ mark for an indicator and up to 1 mark for the explanation of the impact, few candidates scored $1\frac{1}{2}$ marks for their points. However, due to the considerable number of going concern issues in the scenario, many candidates did score well in this question.

Part (c) for 6 marks required audit procedures to assess if Medimade Co was a going concern. This question was satisfactorily answered by most candidates.



Many had a reasonable attempt at this question and generated some satisfactory tests such as obtaining a management representation on going concern and reviewing cash flow forecasts, however there were also a number of unsatisfactory tests provided.

Common errors included:

- Providing procedures which were based upon the year that had passed rather than the coming 12 months
- Requesting a written confirmation or a meeting with the bank to ascertain whether they would renew the overdraft facility, this is unrealistic.
- Lack of detail in the going concern procedure, such as “review board minutes” without an explanation of what to look for.
- Lack of variety of procedures, many tests started with “discuss with management”.

Part (d) for 4 marks required a description of the impact on the audit report if the auditor believed Medimade Co was a going concern but a material uncertainty existed. In addition the scenario stated that the directors had now agreed to make going concern disclosures.

This question was unsatisfactorily answered by many candidates. Previous Examiner’s reports have stressed the need for candidates to understand audit reports.

As the auditors believed that the going concern basis was appropriate, and the directors had made disclosures then the impact on the audit report was dependent on the adequacy of the disclosures made. If adequate then an emphasis of matter paragraph would be needed, if the disclosures were not adequate then a material misstatement modification would be required.

Unfortunately, not many candidates understood the point about the adequacy of disclosures; they did suggest an emphasis of matter paragraph or material misstatement modifications, but this was without any reference to disclosures and so demonstrated a lack of understanding. In addition a number of candidates wasted time on a discussion of whether the company was a going concern and therefore whether the break up basis should instead be used, this was despite the scenario stating that the auditor believed the company was a going concern. Candidates must take the time to read the scenario and requirements carefully.