

Examiner's report

F8 Audit and Assurance

June 2011



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.

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.

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.

Candidates performed particularly well on questions 1b, 1c, 2b, 3a, 4b, 4c and 5b. The questions candidates found most challenging were questions 1a, 1d, 2a, 3b, 5a 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. Question 5a on misstatements tested knowledge of ISA 450 *Evaluation of Misstatements Identified During the Audit*. This was one of the new ISAs issued as part of the clarity project and has been in the F8 study guide since 2010; and hence as a new topic area should have been prioritised by candidates.

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.
- Not learning lessons from earlier examiner's reports and hence making the same mistakes, especially in relation to audit risk.
- Providing more than the required number of points.
- Illegible handwriting and poor layout of answers.

Specific Comments

Question One

This 30-mark question was based on a toy manufacturer, Tinkerbell Toys Co (Tinkerbell), and tested candidates' knowledge of tests of controls, substantive procedures for receivables and revenue and fraud.

Part (a) for 12 marks required candidates to recommend six tests of controls for the sales cycle of Tinkerbell as well as the objective for each test.

Most candidates performed inadequately on this part of the question. The main problems encountered were that candidates struggled to differentiate between tests of control and substantive tests and hence often provided long lists of substantive procedures, which scored no marks. In addition a significant minority of candidates did not read the question carefully, and instead of providing tests of controls, gave control procedures management should adopt. This scored no marks.

The approach candidates should have taken was to firstly identify from the scenario the controls present for Tinkerbell, they then should have considered how these controls could be confirmed by the auditor. In addition candidates' explanations of tests were vague such as; "check that credit limits are set for all new customers." This procedure does not explain how the auditor would actually confirm that the control for new customer credit limits operates effectively. Tests that start with "check" are unlikely to score many marks as they do not explain



how the auditor would actually check the control. Future candidates should practice generating tests; both substantive and tests of controls, which do not start with the word “check”.

The second part of this requirement was to explain the objective of the test of control provided. Again, this was not answered well. A common answer was to state that the objective was “to ensure that the control is operating effectively.” This was far too vague. All tests of controls are looking to verify that controls are operating effectively. Instead, candidates should have considered the aim of the specific control being tested. Therefore the objective of a test over credit limits is “to ensure that orders are not accepted for poor credit risks”.

As noted in previous examiner’s reports candidates are often confused with the differences between tests of controls and substantive tests. Both are methods for obtaining evidence and are key elements of the F8 syllabus. Future candidates must ensure that they understand when tests of controls are required and when substantive procedures are needed. They need to learn the difference between them and should practice questions requiring the generation of both types of procedures.

In addition, the question asked for six tests of controls and objectives, however many candidates provided much more than the required six points. It was not uncommon to see answers which had eight to ten points. Whilst it is understandable that candidates wish to ensure that they gain credit for six relevant points, this approach can lead to time pressure and subsequent questions can suffer. A significant number of candidates presented their answers in a columnar format and this seemed to help them to produce concise and relevant answers.

Part (b) for 8 marks required substantive procedures the auditor should perform on year-end receivables. This was answered well by many candidates. Candidates were able to provide variety in their procedures including both tests of detail and analytical review tests. The most common mistakes made by some candidates were:

- Providing tests of control rather than substantive procedures.
- Providing substantive procedures for revenue rather than receivables.
- Not generating enough tests for 8 marks; it is 1 mark per valid procedure.
- Describing the process for a receivables circularisation at length. This was not part of the question requirement.

The requirement verb was to “describe” therefore sufficient detail was required to score the 1 mark available per test. Candidates are reminded that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures. Answers such as “confirm credit notes are recorded in the correct period” are far too vague as it does not explain how to gain comfort that credit notes are recorded correctly. In addition answers such as “ensure cut- off of receivables is correct” are objectives rather than substantive procedures.

Part (c) for 6 marks required identification and explanation of controls that Tinkerbelle should adopt to reduce the risk of fraud occurring again, as well as an explanation of how this control would mitigate the fraud risk. This question was answered well by most candidates, with some scoring full marks. The scenario provided details of a “teeming and lading fraud” which had occurred during the year and candidates needed to think practically about how Tinkerbelle could reduce the risk of this occurring again. Candidates were able to use the scenario to generate practical controls such as “review of bank reconciliations” and “segregation of duties between the roles of processing cash receipts and preparation of bank reconciliations”.

However, candidates’ performance on the second requirement to describe how the control would mitigate the risk of fraud occurring again was mixed. The main problem was that answers were not specific enough, frequently vague answers such as “this will reduce the risk of fraud and error occurring” were given. This did not score any marks as it does not explain how the control will actually reduce the risk. For example, the review of bank reconciliations will reduce the risk as any unreconciled balances, even if small, will be identified and investigated.



A small minority of candidates failed to read the question properly and so provided weaknesses and then controls to address these, rather than controls and explanations of how these reduce risk.

Many candidates presented their answers in a columnar format and again this seemed to help them to produce clear and concise answers which covered both parts of the requirement.

Part (d) for 4 marks required substantive procedures the auditor should perform on Tinkerbell's revenue. This requirement was not answered well. Some candidates confused this requirement with that of 1b, which required receivables tests, and so provided the same tests from 1b again. In addition a significant number of candidates provided procedures to confirm bank and cash rather than revenue. Perhaps they confused cash receipts with revenue and so thought that if they confirmed cash receipts this would confirm revenue.

Those candidates who performed well were able to provide a good mixture of analytical procedures such as, "compare revenue to prior year or to budget" and "review monthly sales against prior year" and also detailed tests such as confirming cut -off of sales.

Question Two

This 10-mark question covered the topics of narrative notes, internal control questionnaires and engagement letters.

Part (a) for 6 marks required candidates to describe the advantages and disadvantages of narrative notes and internal control questionnaires (ICQs) as methods for documenting the system. Candidates' performance was unsatisfactory on this question, with a number of candidates not even attempting it. A significant minority of candidates did not understand the question requirement fully, and so instead of providing advantages and disadvantages for notes and then for ICQs, they provided answers which were of a general nature and just covered advantages and disadvantages of documenting the internal control system. It is possible that these candidates did not carefully read the scenario paragraph preceding the requirement. This paragraph laid out that there were various methods available for documenting internal controls and it identified notes and ICQs, the requirement then followed on with the advantages and disadvantages of these two methods. Candidates must take the time to read and understand any scenario paragraphs; these are intended to help candidates understand the question requirements.

Those candidates who understood the requirement often made the following mistakes:

- Lack of detail, the requirement was to "describe" and often candidates provided bullet point notes, this is not a sufficient level of detail to be awarded the 1 mark available per point.
- Some candidates were confused as to who prepared the systems documentation, thinking that ICQs were produced by management, and so identified irrelevant advantages and disadvantages.
- Providing definitions and explanations of what notes and ICQs are, rather than answering the question requirement. Definitions will not score marks unless they are a specific part of the question requirement.
- Listing points in relation to internal control evaluation questionnaires (ICEQ)s rather than ICQs. This is another method for documenting systems but was not part of the question requirement and hence scored no marks.

Part (bi) for 1 mark required the purpose of an engagement letter and part (bii) for 3 marks required six matters that should be included in an audit engagement letter. This question was answered well by most candidates with many scoring full marks. In addition the verbs of "state" for part (bi) and "list" in part (bii) were addressed by most candidates and answers were generally succinct.

Where candidates did not score full marks this tended to be because in (bi) they repeated points from (bii) or simply stated that “the engagement letter is a contract” and in (bii) they gave irrelevant points such as date, signature of auditor and company’s year end.

Question Three

This 20-mark question was based on Donald Co, which operated an airline business. The question tested the areas of risk identification and procedures for obtaining evidence.

Part (ai) for 5 marks required five procedures, other than external confirmation, for obtaining evidence and then part (aii) for 5 marks required an example of each procedure relevant to the audit of purchases and expenses. This question was unrelated to the scenario and was knowledge based, and candidates performed satisfactorily.

Where candidates did not score full marks this was because they failed to read the question properly. The scenario clearly excluded the procedure of external confirmation, however, a significant minority of candidates gave confirmations as a procedure. This scored no marks. Some saw the word “confirmation” and then proceeded to provide a lengthy answer only relating to this procedure. Candidates must read the question carefully..

In addition some candidates confused procedures for obtaining evidence with financial statement assertions and so gave answers which focused on completeness, valuation and existence. A number of candidates provided example procedures which were not related to purchases and expenses, but instead focused on inventory, payables or non-current assets. Again this was due to a failure to read the question requirement.

Part (b) for 10 marks required a description of the audit risks and responses for Donald Co. Many candidates performed inadequately on this part of the question. As stated in previous examiner’s reports, audit risk is a key element of the Audit & Assurance syllabus and candidates must understand audit risk. This is the third session in a row where audit risk has been tested and where most candidates’ performance has been unsatisfactory.

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 continue to lose 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 and should include the financial statement assertion impacted. If candidates did not do this then they would have struggled to pass this part of the question as there were no marks available for business risks.

For those candidates who were able to identify audit risks, they mainly focused on going concern and the risk of bad debts arising from irrecoverable receivables. However the scenario did contain a number of other audit risks, such as existence of the planes at the year end and the capital v revenue treatment of the \$15m spent on refurbishment. Not many candidates identified other risks, which was unsatisfactory. The issue of the call centre closing and hence the workforce being made redundant was misunderstood by many. These candidates felt that this must mean that the company was having going concern issues, but there was no indication of this in the scenario. The risk related to the completeness of the redundancy provision.

Even if the audit risks were explained many candidates failed to provide a relevant response to the audit risk, most chose to give a response that management would adopt rather than the auditor. For example, in relation to the risk of valuation of receivables, as Donald Co had a number of receivables who were struggling to pay, many



candidates suggested that management needed to chase these outstanding customers. This is not a response that the auditor would adopt, as they would be focused on testing valuation through after date cash receipts or reviewing the aged receivables ledger. In addition some responses were impractical, such as asking the bank to confirm to the auditors whether they would grant Donald the \$25m loan. The bank is not going to provide this type of information to the auditor especially if they have not yet told Donald. Also some responses were too vague such as “increase substantive testing” without making it clear how, or in what area, this would be addressed.

Future candidates must take note audit risk is and will continue to be an important element of the syllabus and must be understood, and they would do well to practice audit risk questions.

Question Four

This 20-mark question was based on the audit firm NAB & Co (NAB) and its clients Goofy Co and Mickey Co and tested candidates' knowledge of managing conflicts of interest, outsourcing internal audit and ethical threats.

Part (a) for 4 marks required an explanation of the safeguards NAB should implement to manage the potential conflict of interest between their two competing clients. Candidates performed satisfactorily on this part of the question. Most candidates were able to identify safeguards such as separate audit teams and informing both parties and therefore scored half of the available marks. However, many candidates then provided procedures which were a repeat of separate teams, such as separate engagement partners. In addition some candidates' listed general ethical safeguards rather than focusing on the specific requirement of conflicts of interest.

Part (b) for 10 marks required the advantages and disadvantages to both NAB and Goofy Co of outsourcing their internal audit department. Candidates performed well on this question. Most candidates structured their answers to consider advantages and disadvantages for each of the two entities separately and this helped to generate a sufficient number of points. It was pleasing to see that many candidates used the small scenario provided to make their answers relevant, as this was not a general requirement, but one applied to Goofy Co and NAB.

Where candidates did not score as well, this was mainly due to a failure to provide sufficient depth to their answers. A common advantage given was “outsourcing saves costs.” This does not discuss with enough detail how Goofy Co would save costs and hence would not score the 1 mark available. Often candidates then went on to have as a disadvantage “outsourcing costs more money” again with little explanation of how this can occur. A “discuss” requirement is relatively detailed and therefore an answer of just a few words will not be sufficient.

Part (c) for 6 marks required an explanation of the ethical threats with respect to the audit of Goofy Co and how these threats may be reduced. This question was answered well by most candidates, and many scored full marks. Candidates were able to clearly identify from the scenario the ethical issues impacting the audit of Goofy Co. 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 the issue of the engagement partner having been in place for six years, however if they did not then go on to explain that this was a familiarity threat, or they gave an incorrect threat such as self interest, they would have only gained ½ rather than 1 mark.

The second part of this question required methods for reducing the threats. Candidates' performance was generally satisfactory although some answers tended to be quite brief. In addition some candidates confused the issue of contingent fees with undue fee dependence and so focused on ways to reduce the proportion of fees from Goofy Co.

In addition many candidates provided more points than were necessary. The requirement was for six marks and had two elements to it: the marking guide awarded 1 mark per threat and 1 per method for reducing risk, hence 3 threats and methods were required for full marks. Yet some candidates listed up to five threats and methods, this then put them under time pressure and led to later questions being impacted.

Question Five

This 20-mark question was based on Minnie Co and tested candidates' knowledge of misstatements, placing reliance on the work of an expert and audit reports.

Part (a) for 4 marks required an explanation of the term "misstatement" and a description of the auditor's responsibility in relation to misstatements. This question was unrelated to the scenario, and was not answered well by many candidates. Most candidates were able to gain 1 mark by explaining that a misstatement was an error, however they could not then explain the auditor's responsibility.

ISA 450 *Evaluation of Misstatements Identified During the Audit* provides guidance on this area. This is a relatively new ISA and was issued as part of the clarity project. As this ISA had not yet been tested then this is an area which should have been prioritised by candidates. However, many candidates clearly had not studied this area at all. They therefore provided answers which focused on the auditor's responsibilities to provide an opinion on the truth and fairness of the financial statements or to detect material misstatements. In addition a minority of candidates produced answers which focused on materiality.

Part (b) for 4 marks required a description of the factors that should be considered when placing reliance on the work of the independent valuer. Candidates performed well on this question. Many were able to score over half marks by identifying points such as professional qualifications, experience and independence.

The requirement verb was to "describe" therefore sufficient detail was required to score the 1 mark available per test and some answers were a little brief. 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.

Part (c) for 12 marks required a discussion of three issues in the scenario as well as a description of the impact on the audit report if these issues remain unresolved. Candidates' performance was unsatisfactory on this question.

Each of the three issues had a maximum of 4 marks available and in order to score well candidates needed to consider the following in their answer:

- A description of the audit issue; such as incorrectly depreciating land, or lack of evidence to support wages or contingent liability disclosure.
- A calculation of whether the issue was material or not, using the financial information provided in the scenario.
- An explanation of the type of audit report required.
- A description of the impact on the audit report.

A significant minority of candidates stated that it was acceptable to depreciate land, and the issue was that it should have been charged for the prior year as well. This demonstrates a fundamental lack of accounting knowledge.

In relation to the materiality calculation, some candidates stated the issue was material but without using the financial information provided. What was required was a calculation, for example, the land depreciation was \$0.7m and so represented 7% of profit before tax, and then an explanation of whether this was material or not. The benchmark from ISA 320 *Materiality in Planning and Performing an Audit* of 5% of profit before tax was taken as being material.



With regards to the type of audit report required, many candidates provided a scatter gun approach of suggesting every possible audit report option. Candidates often hedge their bets by saying “if management will make an amendment then we will give an unmodified opinion, however if they do not make the adjustment then we will give a qualified except for opinion.” Giving every possible audit report option will not allow candidates to score well.

Many candidates used terms such as “except for”, “modified” or “qualified” but the accompanying sentences demonstrated that candidates did not actually understand what these terms meant. In addition a significant proportion of candidates do not understand when an “emphasis of matter” paragraph is relevant, and seemed to think that it was an alternative to an “except for” qualification. Also candidates are reminded that since the clarified ISAs have been issued the old terminology of “disagreement” is no longer relevant and instead should refer to “material misstatement”.

In relation to the impact on the audit report, many candidates were unable to describe how the opinion paragraph would change and that a basis for qualified opinion paragraph was necessary for issues (i) and (ii).

In addition a significant proportion of candidates provided procedures the auditor would undertake in order to understand or resolve the issues. For example, alternative procedures for verifying wages were given, or the steps to take in contacting lawyers in relation to the lawsuit. Whilst valid procedures, they did not score any marks as they were not part of the question requirement. Candidates must answer the question asked and not the one they wish had been asked.

Future candidates are once again 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.