Answers

Section B

16 **(a)** Key controls and tests of control

Key control	Test of control
Raspberry Co has a separate human resources (HR) department which is responsible for setting up all new employees. Having a segregation of roles between human resources and payroll departments reduces the risk of fictitious employees being set up and also being paid.	Review the job descriptions of payroll and HR to confirm the split of responsibilities with regards to setting up new joiners. Discuss with members of the payroll department the process for setting up new joiners and for confirmation that the process is initiated by HR.
Pre-printed forms are completed by HR for all new employees, and includes assignment of a unique employee number, and once verified, a copy is sent to the payroll department. Payroll is unable to set up new joiners without information from these forms. The use of pre-printed forms ensures that all relevant information, such as tax IDs, is obtained about employees prior to set up. This minimises the risk of incorrect wage and tax payments. In addition, as payroll is unable to set up new joiners without the forms and employee number, it reduces the risk of fictitious employees being set up by payroll.	Select a sample of new employees added to the payroll during the year, review the joiner forms for evidence of completion of all parts and that the information was verified as accurate and was received by payroll prior to being added to the system. Select a sample of edit reports for changes to payroll during the year; agree a sample of new employees added to payroll to the joiners forms.
The quarterly production bonus is input by a clerk into the payroll system, each entry is checked by a senior clerk for input errors prior to processing, and they evidence their review via signature. This reduces the risk of input errors resulting in over/underpayment of the bonus to employees.	If attending Raspberry Co at the time of bonus processing, observe the clerk inputting and senior clerk checking the bonus payments into the payroll system. In addition, obtain listings of quarterly bonus payments and review for evidence of signature by the senior clerk who checks for input errors.
Production employees are issued with clock cards and are required to swipe their cards at the beginning and end of their shift, this process is supervised by security staff 24 hours a day. This ensures that genuine employees are only paid for the work actually done, and reduces the risk of employees being paid but not completing their eight-hour shift. In addition, due to the supervision it is unlikely that one employee could swipe in others.	Observe the use of clock cards by employees when entering the power station. Confirm the security team is supervising the process and following up on discrepancies through discussions with the security staff.
The clock card information identifies the employee number and links into the hours worked report produced by the payroll system. As the hours worked are automatically transferred into the payroll system, this reduces the risk of input errors in entering hours to be paid in calculating payroll, ensuring that employees are paid the correct amount.	Utilise test data procedures to input dummy clock card information, verify this has been updated into the payroll system.
On a quarterly basis, exception reports of changes to payroll standing data are produced and reviewed by the payroll director. This ensures that any unauthorised amendments to standing data are identified and resolved on a timely basis.	Select a sample of quarterly exception reports and review for evidence of review and follow up of any unexpected changes by the payroll director.
For production employees paid in cash, cash is received weekly from the bank by a security company. It is likely the sum of money required to pay over 175 employees would be considerable. It is important that cash is adequately safeguarded to reduce the risk of misappropriation.	Enquire of payroll clerks how cash is delivered to Raspberry Co for weekly pay packets. Review a sample of invoices from the security company to Raspberry Co for delivery of cash.

Key control	Test of control
The pay packets are prepared by two members of staff with one preparing and one checking the pay packets and this is evidenced by each staff member signing the weekly listing. This ensures there is segregation of duties which prevents fraud and errors not being identified.	Observe the preparation of the pay packets ensuring that two members of staff are involved and that pay packets are checked for accuracy. For a sample of weeks throughout the year, inspect the weekly payroll listing for evidence of signature by the two members of staff involved in the preparation of the pay packets.

(b) Deficiencies and recommendations

Control deficiency	Control recommendation
Production supervisors determine the amount of the discretionary bonus to be paid to employees. Production supervisors should not determine this as they could pay extra bonuses to friends or family members, resulting in additional payroll costs.	The bonus should be determined by a responsible official, such as the production director and should be formulated based on a written policy. If significant in value, the bonus should be formally agreed by the board of directors. The bonus should be communicated in writing to the payroll department.
The wages calculations are generated by the payroll system and there are no checks performed. Therefore, if system errors occur during the payroll processing, this would not be identified. This could result in wages being over or under calculated, leading to an additional payroll cost or loss of employee goodwill.	A senior member of the payroll team should recalculate the gross to net pay workings for a sample of employees and compare their results to the output from the payroll system. These calculations should be signed as approved before payments are made.
Student loan deduction forms are completed by relevant employees and payments are made directly to the third party until the employee notifies HR that the loan has been repaid in full. As the payments continue until the employee notifies HR, and employees are unlikely to be closely monitoring payments, there is the risk that overpayments may be made, which then need to be reclaimed, leading to employee dissatisfaction. In the case of underpayments, Raspberry Co has an obligation to remit funds on time and to reconcile to annual loan statements. If the company does not make payments in full and on time, this could result in non-compliance by both the company and employee, which could result in fines or penalties.	The payroll department should maintain a schedule, by employee, of payments made to third parties, such as the central government as well as the cumulative balance owing. On a regular basis, at least annually, this statement should be reconciled to the loan statement received from the government and sent to the employee for agreement. In accordance with the schedule, payments which are due to cease shortly should be confirmed in writing with the third party, prior to stopping.
Holiday request forms are required to be completed and authorised by relevant line managers, however, this does not always occur. This could result in employees taking unauthorised leave, resulting in production difficulties if an insufficient number of employees are present to operate the power plant. In addition, employees taking unauthorised leave could result in an overpayment of wages.	Employees should be informed that they will not be able to take holiday without completion of a holiday request form, with authorisation from the line manager. Payroll clerks should not process holiday payments without agreement to the authorised holiday form.
The senior payroll manager reviews the bank transfer listing prior to authorising the payments and also amends the payroll records for any changes required. There is a lack of segregation of duties as it is the payroll team which processes the amounts and the senior payroll manager who authorises payments. The senior manager could fraudulently increase the amounts to be paid to certain employees, process this payment as well as amend the records.	The senior payroll manager should not be able to process changes to the payroll system as well as authorise payments. The authorisation of the bank transfer listing should be undertaken by an individual outside the payroll department, such as the finance director.

Control deficiency	Control recommendation
The pay packets are delivered to the production supervisors, who distribute them to employees at the end of their shift. The supervisor is not sufficiently independent to pay wages out. They could adjust pay packets to increase those of close friends whilst reducing others. In addition, although the production supervisors know their team members, payment of wages without proof of identity increases the risk that wages could be paid to incorrect employees.	All pay packets should be distributed by the payroll department, directly to employees, upon sight of the employee's clock card and photographic identification as this confirms proof of identity. Payroll should undertake a reconciliation of pay packets issued to production supervisors, wages distributed with employee signatures to confirm receipt and pay packets returned to payroll due to staff absences. Any differences should be investigated immediately. As employees work eight-hour shifts over 24 hours, consideration should be given to operating a shift system for the payroll department on wages pay out day. This will ensure that there are sufficient payroll employees to perform the wages pay out for each shift of employees, with the same level of controls in place.
Monthly management accounts do not analyse the variances between actual and budgeted wages and salaries; this is because there are no overtime costs. However, wages and salaries are a significant expense and management needs to understand why variances may have arisen. These could occur due to extra employees being recruited which were not budgeted for, or an increase in wage pay out rates. The board would need to monitor the wages and salaries costs as if they are too high, then this would impact the profitability of the company.	The monthly management accounts should be amended to include an analysis of wages and salaries compared to the budgeted costs. These should be broken down to each relevant department and could also include an analysis of headcount numbers compared to budget.

(c) Assignments for internal audit department (IAD)

Value for money review – The IAD could be asked to assess whether Raspberry Co is obtaining value for money in areas such as capital expenditure.

Review of financial/operational controls – The IAD could undertake reviews of controls at head office and the power station and make recommendations to management over such areas as the purchasing process as well as the payroll cycle.

Monitoring asset levels – The IAD could undertake physical verification of property, plant and equipment (PPE) at the production site and head office and compare the assets seen to the PPE register. There is likely to be a significant level of PPE and the asset register must be kept up to date to ensure continuous production. If significant negative differences occur, this may be due to theft or fraud.

Regulatory compliance – Raspberry Co produces electricity and operates a power station, hence it will be subject to a large number of laws and regulations such as health and safety and environmental legislation. The IAD could help to monitor compliance with these regulations.

IT system reviews – Raspberry Co is likely to have a relatively complex computer system linking production data to head office. The IAD could be asked to perform a review over the computer environment and controls.

Cash controls – Raspberry Co's internal auditors could undertake controls testing over cash payments. 70% of employees are paid in cash rather than bank transfer, therefore on a weekly basis cash held is likely to be significant, therefore the cash controls in payroll should be tested to reduce the level of errors.

Fraud investigations – The IAD can be asked to investigate any specific cases of suspected fraud as well as review the controls in place to prevent/detect fraud.

(d) Accrual for income tax payable on employment income

Procedures the auditor should adopt in respect of auditing this accrual include:

– Compare the accrual for income tax payable to the prior year, investigate any significant differences.
– Agree the year-end income tax payable accrual to the general ledger and payroll records to confirm accuracy.
– Re-perform the calculation of the accrual to confirm accuracy and discuss any unexpected variances with management.
– Agree the subsequent payment to the post year-end cash book and bank statements to confirm completeness.
– Review any correspondence with tax authorities to assess whether there are any additional outstanding payments due; if so, agree they are included in the year-end accrual.
– Review any disclosures made of the income tax accrual and assess whether these are in compliance with accounting standards and legislation.

17 (a) Fraud responsibility

Loganberry & Co must conduct an audit in accordance with ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

In order to fulfil this responsibility, Loganberry & Co is required to identify and assess the risks of material misstatement of the financial statements due to fraud.

They need to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud through designing and implementing appropriate responses. In addition, Loganberry & Co must respond appropriately to fraud or suspected fraud identified during the audit.

When obtaining reasonable assurance, Loganberry & Co is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.

To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISA 240 requires that a discussion is held within the team. For members not present at the meeting, Blackberry Co's audit engagement partner should determine which matters should be communicated to them.

(b) Audit risks and auditor's response

Audit risk	Auditor's response
Blackberry Co values its inventory at the lower of cost and net realisable value. Cost includes both production and general overheads. IAS 2 *Inventories* requires that costs included in valuing goods and services should only be those incurred in bringing inventory to its present location and condition. Although production overheads meet these criteria, general overheads do not. If these are included in inventory cost, then this will result in over-valued inventory.	Discuss with management the nature of the overheads included in inventory valuation. If general overheads are included, request management remove them from the valuation to be included in the draft financial statements. Review supporting documentation to verify those overheads deemed to be of a production nature are valid.
The company is planning to undertake the full year-end inventory counts after the year end and then adjust for movements from the year end. If the adjustments are not completed accurately, then the year-end inventory could be under or overstated.	The auditor should attend the inventory count held after the year end and note details of goods received and despatched post year end, in order to agree to the reconciliation. During the final audit, the year-end inventory adjustments schedule should be reviewed in detail and agreed to supporting documentation obtained during the inventory count for all adjusting items. The audit team should increase the extent of inventory cut-off testing at the year end and at the date of the count.
A patent has been purchased for \$1·1m and this grants Blackberry Co the exclusive right for three years to customise their portable music players to gain a competitive advantage in their industry. Management has expensed the full amount paid to the current year statement of profit or loss. In accordance with IAS 38 *Intangible Assets*, this should have been included as an intangible asset and amortised over its three-year life. As the sum has been fully expensed and not treated in accordance with IAS 38, intangible assets and profits are understated.	The audit team will need to agree the purchase price to supporting documentation and confirm the useful life is three years as per the contract. Discuss with management the reason for fully expensing the \$1·1m paid, and request they correct the treatment. The correcting journal should be reviewed and the amortisation charge should be recalculated in order to ensure the accuracy of the charge and that the intangible is correctly valued at the year end.
During the year Blackberry Co has raised new finance through issuing \$1·2m of shares at a premium. This needs to be accounted for correctly, with adequate disclosure made and the equity finance needs to be allocated correctly between share capital and share premium. If this is not done, then the accounts may be misstated due to a lack of disclosure or share capital and share premium may be misstated.	The audit team should confirm that proceeds of \$1·2m were received and that the split of share capital and share premium is correct and appropriately recorded. In addition, the disclosures for this finance should be reviewed in detail to ensure compliance with relevant accounting standards and local legislation.

Audit risk	Auditor's response
In November 20X7, it was discovered that a significant teeming and lading fraud had been carried out by four members of the sales ledger department. There is a risk that the full impact of the fraud has not been quantified and any additional fraudulent transactions would need to be written off in the statement of profit or loss. If these have not been uncovered, the financial statements could be misstated. In addition, individual receivable balances may be under/overstated as customer receipts have been misallocated to other receivable balances.	Discuss with the finance director what procedures they have adopted to fully identify and quantify the impact of the teeming and lading fraud. In addition, discuss with the finance director, what controls have been put in place to identify any similar frauds. Review the receivables listing to identify any unusual postings to individual receivable balances as this could be further evidence of fraudulent transactions. In addition, the team should maintain their professional scepticism and be alert to the risk of further fraud and errors.
During the year Blackberry Co outsourced its sales ledger processing to an external service organisation. A detection risk arises as to whether sufficient and appropriate evidence is available at Blackberry Co to confirm the completeness and accuracy of controls over the sales and receivables cycle and balances at the year end.	Discuss with management the extent of records maintained at Blackberry Co for the period since February 20X8 and any monitoring of controls undertaken by management over sales and receivables. Consideration should be given to contacting the service organisation's auditor to confirm the level of controls in place.
The sales ledger processing transferred to the service organisation from 1 February 20X8. If any errors occurred during the transfer process, these could result in sales and receivables being under/overstated.	Discuss with management the transfer process undertaken and any controls put in place to ensure the completeness and accuracy of the data. Where possible, undertake tests of controls to confirm the effectiveness of the transfer controls. In addition, perform substantive testing on the transfer of information from the old to the new system.
In December 20X7, the financial accountant of Blackberry Co was dismissed and is threatening to sue the company for unfair dismissal. If it is probable that Blackberry Co will make a payment to the financial accountant, a provision for unfair dismissal is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Blackberry Co has not done this, there is a risk over the completeness of any provisions or contingent liabilities.	The audit team should request confirmation from the company's lawyers of the existence and likelihood of success of any claim from the former financial accountant.
No supplier statement or purchase ledger control account reconciliations have been performed in the period from December 20X7 to the year end. This a key control which is being overridden and as such there is an increased risk of errors within trade payables and the year-end payables balance may be under or overstated.	The audit team should increase their testing on trade payables at the year end, including performing supplier statement reconciliations, with a particular focus on completeness of trade payables. Request management prepare a year-end purchase ledger control account reconciliation. The audit team should undertake a detailed review of this reconciliation with a focus on any unusual reconciling items.
A current asset of \$360,000 has been included within the statement of profit or loss and assets. It represents an anticipated pay out from liquidators handling the bankruptcy of a customer who owed Blackberry Co \$0·9m. The sum of \$0·9m was written off in the prior year accounts. However, the company has not received a formal notification from the liquidators confirming the payment and this would therefore represent a possible contingent asset. To comply with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, this should not be recognised until the receipt is virtually certain. With no firm response to date, the inclusion of this sum overstates profit and current assets.	Discuss with management whether any notification of payment has been received from the liquidators and review the related correspondence. If virtually certain, the treatment adopted is correct. If payment has been received, agree to post-year end cash book. If receipt is not virtually certain, management should be requested to remove it from profit and receivables. If the receipt is probable, the auditor should request management include a contingent asset disclosure note.

18 (a) Substantive procedures for research and development

- Obtain and cast a schedule of intangible assets, detailing opening balances, amounts capitalised in the current year, amortisation and closing balances.
- Agree the closing balances to the general ledger, trial balance and draft financial statements.
- Discuss with the finance director the rationale for the three-year useful life and consider its reasonableness.
- Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm it is in line with the amortisation policy of straight line over three years and that amortisation only commenced from the point of production.
- For the nine new projects, discuss with management the details of each project along with the stage of development and whether it has been capitalised or expensed.
- For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss.
- For those capitalised as development, agree costs incurred to invoices and confirm technically feasible by discussion with development managers or review of feasibility reports.
- Review market research reports to confirm Gooseberry Co has the ability to sell the product once complete and probable future economic benefits will arise.
- Review the disclosures for intangible assets in the draft financial statements to verify that they are in accordance with IAS 38 *Intangible Assets*.

(b) Substantive procedures for depreciation

- Discuss with management the rationale for the changes to property, plant and equipment (PPE) depreciation rates, useful lives, residual values and depreciation methods and ascertain how these changes were arrived at.
- Confirm the reasonableness of these changes, by comparing the revised depreciation rates, useful lives and methods applied to PPE to industry averages and knowledge of the business.
- Review the capital expenditure budgets for the next few years to assess whether the revised asset lives correspond with the planned period until replacement of the relevant asset categories.
- Review the non-current asset register to assess if the revised depreciation rates have been applied.
- Review and recalculate profits and losses on disposal of assets sold/scrapped in the year, to assess the reasonableness of the revised depreciation rates.
- Select a sample of PPE and recalculate the depreciation charge to ensure that the non-current assets register is correct and ensure that new depreciation rates have been appropriately applied.
- Obtain a breakdown of depreciation by asset categories, compare to prior year; where significant changes have occurred, discuss with management and assess whether this change is reasonable.
- For asset categories where there have been a minimal number of additions and disposals, perform a proof in total calculation for the depreciation charged on PPE, discuss with management if significant fluctuations arise.
- Review the disclosure of the depreciation charges and policies in the draft financial statements and ensure it is in line with IAS 16 *Property, Plant and Equipment*.

(c) Substantive procedures for directors' bonuses

- Obtain a schedule of the directors' bonus paid in February 20X8 and cast the schedule to ensure accuracy and agree amount disclosed in the financial statements.
- Review the schedule of current liabilities and confirm the bonus accrual is included as a year-end liability.
- Agree the individual bonus payments to the payroll records.
- Recalculate the bonus payments and agree the criteria, including the exclusion of intangible assets, to supporting documentation and the percentage rates to be paid to the directors' service contracts.
- Confirm the amount of each bonus paid post year end by agreeing to the cash book and bank statements.
- Agree the amounts paid per director to board minutes to ensure the sums included in the current year financial statements are fully accrued and disclosed.
- Review the board minutes to identify whether any additional payments relating to this year have been agreed for any directors.
- Obtain a written representation from management confirming the completeness of directors' remuneration including the bonus.
- Review the disclosures made regarding the bonus paid to directors and assess whether these are in compliance with local legislation.

(d) Impact on auditor's report

One of the new health and beauty products Gooseberry Co has developed in the year does not meet the recognition criteria under IAS 38 *Intangible Assets* for capitalisation but has been included within intangible assets. This is contrary to IAS 38, as if the criteria are not met, then this project is research expenditure and should be expensed to the statement of profit or loss rather than capitalised.

The error is material as it represents 6·9% of profit before tax (0·44m/6·4m) and 1·2% of net assets (0·44m/37·2m) and hence management should adjust the financial statements by removing this amount from intangible assets and charging it to the statement of profit or loss instead. IAS 38 requires costs to date to be expensed; if the project meets the recognition criteria in 20X9, then only from that point can any new costs incurred be capitalised. Any costs already expensed cannot be written back to assets.

If management refuses to amend this error, then the auditor's opinion will need to be modified. As management has not complied with IAS 38 and the error is material but not pervasive, then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would be needed after the opinion paragraph and would explain the material misstatement in relation to the incorrect treatment of research and development and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

Section B

			Marks available	*Marks awarded*
16	**(a)**	**Key controls and tests of control** (only 5 controls required)		
		Separate HR department set up employees	2	
		Pre-printed joiners forms	2	
		Data processing checks on bonus information	2	
		Use of clock cards and process supervised	2	
		Direct transfer between clock card and payroll systems	2	
		Exception reports for changes to payroll data	2	
		Security process over cash	2	
		SOD over pay packets	2	
		Restricted to	10	
	(b)	**Control deficiencies, and control recommendations** (only 5 issues required)		
		Production bonus set by supervisor	2	
		No independent checks on wage calculations	2	
		No monitoring of student loan payments	2	
		Holiday requests not always authorised	2	
		Lack of SOD in payroll department	2	
		Pay packets not delivered by independent staff/no evidence of distribution	2	
		Monthly management accounts not analysed	2	
		Max 5 issues, 2 marks each	10	
	(c)	**Internal audit assignments**		
		Value for money	1	
		Financial/operational review	1	
		Monitoring assets	1	
		Regulatory compliance	1	
		IT systems	1	
		Cash controls	1	
		Fraud investigation	1	
		Restricted to	5	
	(d)	**Substantive procedures – tax payable accrual**		
		Compare to prior year and investigate differences	1	
		Agree to TB and payroll records	1	
		Reperform accrual calculation and discuss with management	1	
		Agree subsequent payment to cash book and bank statement	1	
		Review correspondence with tax authorities	1	
		Review disclosures	1	
		Restricted to	5	
	Total marks		30	

			Marks available	Marks awarded
17	**(a)**	**Fraud and error**		
		ISA 240 responsibilities	2	
		Respond appropriately	2	
			4	
	(b)	**Audit risks and responses** (only 8 risks required)		
		Inventory valuation	2	
		Inventory count after year-end date	2	
		Accounting treatment of patent	2	
		Share issue	2	
		Sales ledger fraud	2	
		Use of service organisation	2	
		Transfer of data to service organisation	2	
		Claim for unfair dismissal	2	
		Key controls not performed	2	
		Contingent asset	2	
		Max 8 issues, 2 marks each	16	
	Total marks		**20**	

			Marks available	Marks awarded
18	**(a)**	**Substantive procedures – Research & development**		
		Cast and agree closing balance to TB and draft FS	1	
		Discuss amortisation policy with management and assess reasonableness	1	
		Recalculate amortisation charge/commenced in line with production	1	
		Discuss new projects and stage of development	1	
		For research costs agree invoices and to profit or loss	1	
		For development costs agree to invoices and confirm meets criteria	1	
		Review market research to confirm ability to sell	1	
		Review disclosures in line with IAS 38	1	
		Restricted to	5	
	(b)	**Substantive procedures – depreciation**		
		Discuss reasons for change with management	1	
		Compare to industry averages and knowledge of business	1	
		Review capex budgets to assess revised lives appropriate	1	
		Agree new rates to non-current asset register	1	
		Recalculate profit/loss on disposal and consider new rates	1	
		Recalculate depreciation charge for a sample of assets	1	
		Perform a proof-in-total on depreciation charge	1	
		Review disclosure is in line with IAS 16	1	
		Restricted to	5	
	(c)	**Substantive procedures – directors' bonuses**		
		Cast schedule of bonuses and agree to TB	1	
		Confirm bonus accrual as current liability	1	
		Agree bonus payments to payroll records	1	
		Recalculate bonus payments in line with contracts	1	
		Confirm post year-end payment to bank statement	1	
		Review board minutes for additional sums	1	
		Obtain written representation confirming completeness	1	
		Review disclosures in line with local legislation	1	
		Restricted to	5	
	(d)	**Impact on auditor's report**		
		Discussion of issue	1	
		Materiality calculation and conclusion	1	
		Type of modification required	2	
		Impact on auditor's report	1	
			5	
	Total marks		**20**	

F8 Examiner’s commentary on March/June 2018 sample questions

This commentary has been written to accompany the published sample questions and answers and is written based on the observations of markers. The aim is to provide constructive guidance for future candidates and their tutors, giving insight into what the marking team is looking for, and highlighting common issues encountered by candidates who sat these questions.

Question 16

This 30-mark question was based on Raspberry Co, a company which operates an electric power station. This question tested candidates’ knowledge of key controls and control deficiencies, recommendations and tests of control, internal audit departments, and substantive procedures for accruals.

Part (a) for 10 marks required candidates to identify and explain from the scenario five key controls in respect of the payroll system described which the auditor may seek to place reliance on, and describe a test of control the auditor should perform to assess if each of the key controls is operating effectively. Candidates’ performance on this requirement was disappointing.

Questions such as this typically require the key control, which has also been examined in the past as a control strength, to be identified (½ mark each), explained as to why it is a key control (½ mark each) and a test of control provided (1 mark). The scenario in the exam contained more key controls than were required to be discussed and it was disappointing that many candidates did not identify the required number of controls noted in the question. Candidates are encouraged to familiarise themselves with the requirements of ISA 330 *The Auditor’s Responses to Assessed Risks* which states that tests of controls should only be performed on controls which are suitably designed to prevent, or detect and correct, a material misstatement, to help them consider what constitutes a key control.

Although a number of candidates identified, for ½ mark each, the key controls of separate human resources and payroll departments, supervision of the clocking-in process, and segregation of duties in the preparation of the pay packets, many candidates did not clearly explain the control and so were not awarded the second ½ mark. To explain why the control is key, candidates must explain how the control will prevent or detect and correct a misstatement. For example, to explain the fact that the company operates a separate human resources and payroll department as a key control candidates must state ‘it would reduce the risk of fictitious employees being set up’ to be awarded the ½ mark, explanations such as ‘this is good segregation of duties’ was not a sufficient explanation to be awarded credit.

A significant number of candidates incorrectly included control deficiencies in part (a). For example, identifying that ‘the senior payroll manager agrees BACs payments to the payroll’ was not awarded credit as a key control as there was a lack of segregation of duties, as if errors were noted the senior payroll manager also amended the records, which would have prevented the auditor from placing reliance on this control. This point should actually be included as a deficiency in part (b).

In common with previous diets, candidates continue to find tests of control challenging. Many candidates confused substantive procedures for tests of control and tests were often vague or incomplete. For example, ‘look at the bonus listing’ without saying why, i.e. ‘for evidence of review’, or ‘observe the clocking in process’ without reference to the overview of the process by the security staff. Tests of control are very commonly tested and future candidates need to ensure that they have undertaken adequate question practice.

It was pleasing many candidates followed the instructions to set their answer out in two columns being Key control and Test of control.

Part (b) for 10 marks required candidates to identify and explain from the scenario five deficiencies in respect of the payroll system and provide a recommendation to address each of these deficiencies. Many candidates performed well in this requirement.

Internal control deficiency questions such as this typically require internal control deficiencies to be identified (½ mark each), explained (½ mark each) which must cover the implication of the deficiency to the company and a relevant recommendation to address the deficiency (1 mark).

The scenario in the exam contained more issues than were required to be discussed and it was pleasing that many candidates identified the required number of issues noted in the question.

However, some candidates did not clearly understand/explain the implication of the deficiency. Candidates are required to explain the implication to the business to be awarded credit. For example, a candidate who correctly identified the deficiency 'wage calculations generated by the system are not checked' (identification ½ mark awarded), no credit was awarded for the explanation 'this could lead to errors'. Candidates must clearly explain the implication to the business of any system errors not being identified such as 'wages may be over/under calculated' or 'wages may be overpaid' or 'loss of employee goodwill', to be awarded the ½ explanation mark.

Many candidates were able to provide good recommendations to address the deficiencies identified. However, some of the recommendations were not described in enough detail, for example, in relation to management accounts not analysing budget versus actual for wages and salaries, a recommendation 'management accounts should be amended to include an analysis of wages and salaries' was awarded ½ mark, for the full 1 mark candidates needed to go on to say 'and this should be compared to budget' or 'should include a commentary'.

It was pleasing that many candidates followed the instructions to set their answer out in two columns being control deficiency and control recommendation.

Internal controls questions remain a highly examinable area and future candidates need to ensure that they have undertaken adequate question practice.

Part (c) for five marks required candidates to describe assignments the internal audit department of Raspberry Co would carry out. Up to 1 mark was awarded for each well described point. Performance was mixed.

Some candidates only listed the assignments rather than describing them and therefore were awarded ½ mark for each. Candidates are again reminded to pay attention to the verb used in the requirement to ensure they are providing sufficiently detailed answers.

Common misunderstandings by a number of candidates were 'the internal auditor prepares the financial statements' and 'internal auditors implement the controls'.

Some candidates described the differences between internal and external audit, which was not the purpose of the requirement. Further, some candidates included many examples of financial/operational controls which the internal audit department could test, however, this only demonstrated one type of assignment so was awarded only 1 mark overall.

In addition, some candidates described assignments, which would not be relevant to an electric power station client, for example 'internal auditors undertaking mystery shopping'.

This is principally a knowledge area, which has been tested in previous diets. Candidates must practise past exam questions, ensure they study the breadth of the syllabus and ensure their responses are relevant to the scenario.

Part (d) for five marks required candidates to describe substantive procedures the auditor should perform to confirm the year-end accrual for tax payable on employment income. One mark was awarded for each well described procedure. Performance on this requirement was disappointing.

The most common procedure provided by candidates was an analytical review against prior year/budget and a review of any significant differences and this was awarded full credit.

However, the substantive procedures were often vague, for example, ‘agree payment’ rather than ‘agree to the post year-end cashbook’. Candidates are once again reminded that a well described substantive procedure will clearly detail the source of the evidence. Other examples of procedures which were not adequately described included: ‘review correspondence with tax authorities’ (awarded ½ mark), for the full 1 mark candidates needed to also state ‘to assess whether there are any outstanding payments due’ as a well described procedure must clearly detail the purpose of the test. Similarly, ‘review adequacy of disclosures’ (awarded ½ mark), for the full 1 mark candidates needed to also state ‘for compliance with accounting standards/relevant legislation’.

In addition, many candidates did not focus on the year-end accrual and noted general substantive procedures for tax, which did not gain credit.

Candidates are reminded to read the question requirement carefully and to ensure that they are not only answering the question set but also fully describing each substantive procedure.

Question 17

This 20-mark question was based on Blackberry Co, a manufacturer of portable music players. This question tested the areas of fraud and error, and audit risks and responses. Candidates’ performance was mixed.

Part (a) for four marks required candidates to describe the auditor’s responsibilities in relation to the prevention and detection of fraud and error. One mark was awarded for each well described point. Some candidates performed very well on this requirement and clearly had an excellent understanding of the requirements of ISA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, however, a number of candidates described management’s responsibilities rather than auditor’s responsibilities and therefore did not answer the requirement of the question.

In addition, although many candidates understood that the auditors are not responsible for preventing fraud, some candidates were not clear that the auditor is also not responsible for detecting all errors due to fraud/error. A number of candidates described substantive procedures to detect fraud/error, and again these were not awarded credit as the question asked for ‘the responsibilities’ of the auditors.

This is a knowledge area, which has been tested in previous diets. Candidates are again reminded to read the question requirement carefully and to ensure that they are only answering the question set.

Part (b) for 16 marks required candidates to describe eight audit risks and to explain the auditor’s response to each in planning the audit of Blackberry Co. Performance on this question was mixed.

Marks were awarded for identification of each audit risk (½ mark each), explanation of each risk (½ mark each) and an appropriate auditor’s response to each risk (1 mark each).

The scenario contained more than eight risks so it was pleasing that most candidates planned their time carefully and generally only attempted to list the required number of points.

As in previous diets, although candidates identified the risks, many of them did not adequately explain the risk. To explain the audit risk candidates need to state the area of the financial statements impacted with an assertion (for example, cut-off/valuation, etc), or a reference to over/under/misstated, or a reference to inherent/control/detection risk. For example, candidates often correctly identified the financial accountant suing for unfair dismissal, this was awarded ½ mark for identification, however, no further credit was awarded for the explanation that 'costs may not be included'. To be awarded the ½ explanation mark candidates need to clearly state the implication, for example, that 'provisions may be understated', or 'provisions may not be complete'.

Candidate performance in relation to auditor's responses continues to be mixed. While an auditor's response does not have to be a detailed audit procedure, rather an approach the audit team will take to address the identified risk, the responses given were often too weak such as 'discuss with management'. This is not a sufficient response to deal with any identified audit risk and candidates need to be able to use their knowledge of audit procedures to provide a valid response which would adequately address the risk identified.

Future candidates must take note audit risk is and will continue to be an important element of the syllabus and must be understood. Candidates must also ensure that they include adequate question practice as part of their revision of this key topic.

Question 18

This 20-mark question was based on Gooseberry Co, a company which develops and manufactures health and beauty products and distributes these to wholesale customers. This question tested candidates' knowledge of substantive procedures for research and development, depreciation and directors' bonuses, and auditor's reports.

Part (a) for five marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Gooseberry's research and development expenditure. Performance on this requirement was mixed.

One mark was awarded for each well described substantive procedure. Hence for a five mark requirement, candidates should have provided at least five substantive procedures. Disappointingly this was not the case, as some answers only contained one or two procedures for each area and these were often not well described, resulting in a maximum of ½ mark each. Candidates are severely limiting the opportunity to score marks and are reminded to ensure that they employ effective exam technique.

Many procedures were vague, often not giving the source for the test, or stating 'ensure' without explaining how the test would achieve this. For example, 'recalculate expenditure' rather than clearly stating 'recalculate the amortisation charge and confirm it is in line with the company's policy'. Only a minority of strong candidates demonstrated an understanding of IAS 38 *Intangible Assets* and tailored their answer around these criteria.

Part (b) for five marks required the candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to depreciation. Performance on this requirement was disappointing.

As in part (a), one mark was awarded for each well described substantive procedure. Disappointingly often the substantive procedures were either not well described, or were not related to depreciation. A significant number of candidates did not clearly answer the specific requirement of the question to describe depreciation substantive procedures. Although many candidates were able to correctly suggest recalculating the depreciation charge, candidates often described more general property, plant and equipment substantive procedures including confirming additions and disposals. In addition, many candidates referred to procedures which were not relevant to the requirement or the scenario, for example, verifying the credentials of the valuer, to audit the revaluation of the property, plant and equipment, suggesting that candidates have rote learned a list of procedures from previous questions. Candidates are advised to read the question scenario and requirements carefully and tailor their answer accordingly.

In general, there was clear evidence of a lack of tailoring of knowledge to the specific scenario provided. Candidates have clearly learned that the depreciation charge should be compared to the prior year. However, this substantive procedure is not relevant if there is a change in the useful life of the assets in the year as was detailed in this scenario.

As addressed in previous examiner's reports candidates must strive to **understand** substantive procedures. Learning a generic list of tests will not translate to exam success, as they must be applied to the question requirement.

Part (c) for five marks required the candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the directors' bonuses. Performance on this requirement for many candidates was pleasing. As in part (a) and (b), one mark was available for each well described procedure.

Many candidates were able to correctly suggest agreeing the bonus payment to the payroll records/payslips, agreeing the bonus criteria to the directors' service contracts, and agreeing the bonus payment to the post year-end cash book/bank statement. A number of candidates also correctly described agreeing the amounts paid for each director to the board minutes.

Some candidates did not describe the substantive procedures in sufficient depth, for example, no credit was awarded for 'ensure the bonus is paid' as this provides no source or clear indication as to how this would be achieved. Candidates are reminded that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures.

Part (d) for five marks required a discussion of an issue and the impact on the auditor's report if the issue remained unresolved. The issue presented related to $440,000 of development costs which had been incorrectly capitalised by the client.

Auditor's report questions have shown a gradual improvement in recent diets so it is disappointing that performance for this question was mixed.

Marks are awarded for a discussion of the issue (1 mark), assessment of the materiality of the issue (1 mark), a description of the type of modification (up to 2 marks) and the resultant impact on the auditor's report (1 mark).

It was disappointing that candidates often do not discuss the issue. In order to be awarded the mark for discussing the issue candidates should not just re-write the fact from the question. Candidates need to explain the effect of the item being incorrectly recorded, i.e. this overcapitalisation results in assets/liabilities/profit being over/understated. Many candidates described the issue as 'development costs are incorrectly capitalised' which was a restatement of fact and were not awarded credit. To be awarded marks candidates should have noted 'the costs should have been expensed to the statement of profit or loss' (½ mark) and therefore 'profit/assets are overstated' (½ mark).

It was pleasing that most candidates correctly calculated materiality (½ mark) and concluded whether this was material (½ mark).

Candidates attempted to identify the type of modification and the impact on the report, however, many answers were incomplete, for example, many candidates did not refer to a 'material misstatement' or a 'basis for qualified opinion paragraph'.

A number of candidates described the impact on the auditor's report if the issue was resolved and also if the issue remained unresolved. The question clearly asked for the impact if the issue remained unresolved. Once again, candidates are advised to read the question requirements carefully.