Examiner's report
F8 Audit and Assurance
June 2016

General Comments

There were two sections to the examination paper and all the questions were compulsory. Section A consisted of 12 multiple-choice questions (one or two marks each), which covered a broad range of syllabus topics. Section B had four written questions worth 10 marks each and two longer written questions worth 20 marks each; testing the candidates' understanding and application of audit and assurance in more depth.

Specific Comments

Section A

It was very pleasing to see that once again almost all candidates attempted all of the questions. Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F8 syllabus, rather than attempting to question spot. The following two questions are reviewed with the aim of giving future candidates an indication of the types of questions asked, guidance on dealing with exam questions and to provide a technical debrief on the topics covered by the specific questions selected.

Sample Questions for Discussion

Example 1

Which of the following statements regarding an engagement letter are correct?

(1) It must be reissued every year
(2) It includes the exact fees to be charged
(3) It includes the details of the limitations of an audit
(4) It identifies an applicable financial reporting framework

A 1 and 2 only
B 3 and 4
C 1, 2 and 4
D 2 and 3

This question tested candidates' knowledge of engagement letters, this was not answered well by the majority of candidates. Engagement letters are an important part of the appointment process and is an area frequently tested. The question contained four statements relating to engagement letters and candidates were required to assess which were correct. This question tested candidates' knowledge of ISA 210 *Agreeing the Terms of Audit Engagements.*

Statement 1 was incorrect as engagement letters are not required to be reissued annually as they can be used for more than one year. The letter however, should be reissued if there is any indication that management do not understand the scope and objective of the audit or if there is a significant change within the business or legal and regulatory requirements. Statement 2 is incorrect as rather than including the exact fees, engagement letters contain details of the fee arrangement. If exact fees were included, engagement letters would not be able to roll from one period to another as audit fees often change annually.

Statement 3 is correct, the engagement letter represents a contract between the company and the audit firm. Within the auditor responsibilities section, a statement detailing the limitations of an audit is included. Statement 4 is correct, the engagement letter sets out the financial reporting framework used by the directors in preparing the financial statements. Additionally this framework is used by the auditors when reviewing the financial statements.

Therefore the correct answer was B options 3 and 4. The most common incorrect answer given was C which included incorrect statements 1 and 2.

Example 2

Which of the following represents an indicator which may cast doubt over the going concern status of a company?

(1) A significant decrease in the gearing ratio
(2) The loss of a major customer
(3) Taking the full credit period available before paying suppliers
(4) A change from credit to cash on delivery terms by suppliers

A 1 and 2 only
B 1, 2 and 4
C 1, 3 and 4
D 2 and 4 only

This question tested the area of going concern and was not well answered by candidates. The question required candidates to assess which of the options were indicators that the company may not be a going concern.

Option 1 was an incorrect answer, if the gearing ratio had increased rather than decreased then this could be a going concern indicator. Option 2 was correct, losing a major customer could lead to reduced sales and cash flows. Option 3 was incorrect, taking the full credit period given by suppliers is sensible business practice and not an indicator of cash flow problems. Option 4 was correct, if a company is struggling to pay for its goods, suppliers can refuse to supply any further goods or require cash at the point of delivery. The correct answer was D, options 2 and 4. The most common incorrect answer given was B which included correct options 2 and 4 but also option 1.

Section B

The six written questions in Section B tested candidates' understanding of the audit and assurance syllabus:

- Audit framework and regulation
- Planning and risk assessment
- Internal control
- Audit evidence
- Review and reporting

Audit framework and regulation

This area of the syllabus requires; an understanding of the functions of an audit, being able to distinguish between the scope of internal and external audit, and, an understanding of both corporate governance and professional ethics.

Performance in the scenario-based ethics question in the June 2016 exam was satisfactory. Candidates were asked to identify and explain a set number of issues from the scenario and give relevant recommendations to counter the risks identified.

It was pleasing that candidates planned their time carefully and generally only listed the required number of issues. One mark was available for each well explained issue. As in previous sittings, while it was pleasing that candidates were able to identify relevant issues from the scenario, candidates often did not explain the issues correctly, or in sufficient detail, therefore many candidates scored ½ mark rather than one mark for each issue. Therefore, a candidate who identified an issue and stated the type of threat scored ½ mark, to be awarded the second ½ mark the candidate had to explain why this caused an ethical problem. The explanation was often weak, for example explaining the threat of "self-review`' as "the auditor will be reviewing his own work" is not sufficient, the candidates needed to comment on the possibility of the auditor "overlooking errors" or "not being diligent in their review" to obtain the full mark.

The recommendations to counter each issue were generally clear. However, there were some common errors such as recommending that the review partner who held shares in the client should be removed from the audit, as opposed to needing to sell the shares as it's prohibited for a partner to hold client shares. Additionally, most candidates did not recognise that for listed clients tax computations cannot be prepared, except in an emergency situation. These mistakes may have arisen due to a lack of knowledge or simply due to a failure to read the scenario carefully.

The presentation of candidates' answers was pleasing. Most used a two-column format; the first column to identify and explain the issue and the second column to give a recommendation to improve the issue.

In addition, the June 2016 exam contained an additional factual question in this area of the syllabus. Performance on this question was mixed.

The question required knowledge of the five elements of an assurance engagement and stronger candidates were able to identify the elements and explain each with sufficient detail. However, many candidates were unable to provide adequate explanations of the elements. A number of candidates misunderstood the question and either discussed reasonable and limited assurance engagements or provided a list of items contained within an engagement letter such as scope and responsibilities.

Planning and risk assessment

This area of the syllabus requires an understanding of how the auditor obtains and accepts audit engagements, obtains an understanding of the entity and its environment, assesses the risk of material misstatement and plans an audit of the financial statements.

Questions on assessing audit risks tend to be scenario based; the candidates having to identify and explain the risks from a scenario and give an auditor's response to address the risks. Other questions in this area of the syllabus tend to be more factual, knowledge based questions and hence depend on the ability of students to recall their knowledge in the exam.

As noted in previous Examiner's Reports a fundamental factor in planning and assessing the risks of an audit of an entity is an assessment of audit risk, and this remains a highly examinable area. Audit risk questions typically require a number of audit risks to be identified (½ marks each), explained (½ marks each) and an auditor's response to each risk (1 mark each). Performance in the audit risk question in June 2016, as in many previous exams continues to be mixed.

The scenario contained more issues than were required to be discussed, a significant minority identified more issues then necessary, often combining risks into one point. This approach sometimes resulted in a lack of detail in the risk and also led to unfocused auditor responses. In addition, a large number of candidates often did not explain how each issue could result in an audit risk or impact on the financial statements and therefore were not awarded the explanation ½ mark. To explain audit risk candidates need to state the area of the financial statements impacted with an assertion (e.g. cut off, valuation etc.), or, a reference to under/over/misstated, or, a reference to inherent, control or detection risk. Misstated was only awarded if it was clear that the balance could be either over or understated. In addition, many candidates misunderstood the implication of payroll being outsourced, failing to understand that there was an increased detection risk with regards to access to outsourced records and the risk of data being incorrectly transferred to the service organisation.

The provision of relevant auditor's responses continues to be a poorly attempted area and candidates are once again reminded to ensure that this area of the syllabus is adequately studied and practised. 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 sometimes either too weak e.g. "discuss with management" or, did not address the issue due to a failure to understand the risk (e.g. in response to a possible understated provision, an incorrect response was to "undertake going concern testing').

In comparison to recent exam sessions, it was disappointing that a significant minority of candidates discussed business risks and therefore concentrated their responses on what management should do rather than the auditor (e.g. in relation to the plant and machinery ordered pre year end, an inappropriate response was that the auditor should contact the supplier to ensure the delivery was on time).

Further it was pleasing to note that many candidates presented their answers well using a two-column approach with audit risk in one column and the related response in the other column

In addition there was a knowledge-based question in this area of the syllabus in the June 2016 exam. This question required a definition of audit risk and its components. This question was generally well answered with candidates demonstrating reasonable knowledge of the area tested. Some candidates failed to maximise their marks as their explanation of inherent risk was incomplete. In key knowledge areas such as this, candidates must be technically correct in order to score full marks.

Internal control

This area of the syllabus requires both an ability to describe and evaluate internal controls techniques and audit tests, and, also an ability to make appropriate recommendations.

Internal control questions typically require internal control deficiencies to be identified (½ marks each), explained (½ marks each), a relevant recommendation to address the control (1 mark), and, often a test of control the external auditor would perform to assess whether each of these controls, if implemented, is operating correctly (1 mark). Internal controls questions remain a highly examinable area and in common with prior sittings, performance in the internal control question in June 2016 was mixed.

Candidates were able to identify the internal control deficiency from the scenario however some candidates did not clearly explain the implication of the deficiency. Additionally some candidates did not understand or incorrectly identified deficiencies, e.g. renting space in the warehouse to third parties or completing inventory count sheets in ink.

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

Most candidates were able to provide good recommendations to address the deficiencies. However some of the recommendations were either poorly described, did not clearly address the specific control weakness identified or were impractical suggestions.

The tests of controls that the auditor could perform were often not well explained by candidates (e.g. "ensure the bays are flagged" without saying how the auditor would ensure this or just using the word "check" or "observe", did not address the controls identified or were substantive audit procedures rather than tests of control.

It was pleasing to note that many candidates presented their answers well using a three-column approach with internal controls deficiencies in one column, the related recommendation in the other and the related test of control in the third column.

Audit Evidence

This area of the syllabus requires a description of the work and evidence obtained by the auditor required to meet the objectives of audit engagements and the application of International Standards on Auditing.

A key requirement of this part of the syllabus is an ability to describe relevant audit procedures for a particular class of transactions or event. Overall performance in this key syllabus area in the June 2016 exam was disappointing.

The June 2016 exam contained a number of questions in this syllabus area. A scenario based question where candidates were required to describe audit procedures in relation to property plant and equipment and equity. Performance was particularly disappointing for equity. Most candidates were unable to tailor their knowledge of general substantive procedures to the specific issues in the question requirements, or provided test of controls rather than substantive procedures or provided vague tests. 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 – procedures must be tailored to the specific requirements of the question.

In addition candidates were required to describe procedures for obtaining evidence and to provide an example for each, relevant to the audit of bank balances. The identification of procedures was on the whole satisfactory, however the explanation of these was often inadequate, with some candidates giving examples of the procedures rather than a description. Some candidates incorrectly provided financial statement assertions. With regards to bank procedures, the performance on this was mixed. A number of candidates did not match the bank test to the correct type of procedure e.g. checking the bank reconciliation for an analytical review procedure.

Additionally the June 2016 exam contained a question on factors the auditor should consider in relation to the company's use of a payroll service organisation. Performance on this question, where it was attempted was very disappointing. The minority of candidates who attempted this question, incorrectly focused on the competence, independence and qualifications of the service organisation. Alternately candidates focused on payroll substantive procedures and tests of control.

Review and reporting

This area of the syllabus requires an understanding of how consideration of subsequent events and the going concern principle can inform the conclusions from audit work and are reflected in different types of auditor's report, written representations and the final review and report.

Performance in June 2016, discussing the accounting treatment from a scenario and identifying the impact on the auditor's report, showed a continued improvement by candidates. Questions historically in this area of the syllabus have required a discussion of the accounting issue, a materiality calculation, an assessment of the type of report modification and the impact on the auditor's report. Additionally, this question asked for audit procedures to address each issue.

It was disappointing that some candidates did not fully discuss the accounting issue, however it was pleasing that most attempted to calculate the materiality of the issues in the scenario, although some did not use the financial information given in the scenario. In addition many assessed one of the issues as material rather than pervasive, despite the issue amounting to over 80% of profit before tax.

Performance was disappointing for the procedures to address each accounting issue. Many of the procedures were impractical or too vague such as "obtaining written representations from management". Performance on the impact on the auditor's report was satisfactory, most candidates were able to identify for each issue whether a modification was required and, if so, the type of modification required.