Examiner's report

F8 Audit & Assurance

December 2015

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 the syllabus topics. Section B had four written questions worth 10 marks each and two longer written questions worth 20 marks each, designed to test the candidates' understanding and application of audit and assurance in more depth.

Specific Comments

Section A

It was pleasing to see that once again almost all candidates attempted all of the questions. Candidates preparing for the next F8 examination are advised to work through the pilot paper, past exam papers and sample questions discussed below, to carefully review how each of the correct answers were derived. 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 question 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

When evaluating the results of analytical procedures, which of the following factors could explain a reduction in the gross profit margin?

A An error resulting in the overstatement of closing inventory
B A change in the sales mix
C An increase in trade discounts received from suppliers

This question tested candidates' ability to evaluate the results of analytical procedures; in this case a reduction in the gross profit margin, and then to identify which factor from those listed in the question could explain this result. This question was not well answered by candidates. Candidates are advised to review each of the possible factors in turn and determine whether the factor could possibly be an explanation for the analytical procedure result.

Answer A - The overstatement of closing inventory would result in a reduced cost of sales figure, and consequently would result in an increase in gross profit and therefore gross profit margin.

Answer B – The sales mix is the proportion of different products or services that comprise the total sales of the company. Therefore when a company sells a range of products or services at different margins, the sales mix will affect the overall margin achieved. If a greater proportion of sales comprise lower margin products or services, the overall margin will fall.

Answer C – Trade discounts are offered by suppliers to their customers at the time of purchase, for example when goods are purchased in bulk, or, to retain loyal customers. The discounted price reflects the actual cost of the goods therefore purchases are recorded net of the trade discount. Consequently, an increase in trade discounts would result in a reduced cost of sales figure, and therefore an increase in gross profit and gross profit margin.

Therefore the correct answer is B

Example 2

Which of the following control activities would be appropriate to ensure COMPLETENESS of purchase invoices?

(1) A responsible official reviews and approves each purchase invoice prior to posting into the system.
(2) Use of batch control processing for the entry of purchase invoices.
(3) The purchase clerk recalculates the additions on purchase invoices prior to posting to the system.
(4) Assigning a sequential number to each purchase invoice on receipt and undertaking sequence check reviews.

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

This question tested candidates' knowledge of control activities and their understanding of financial statement assertions. This question was not well answered by candidates. The key to passing this type of question is to consider each control activity in turn and to identify what the control activity has been designed to achieve and if it would satisfy the objective as set out in the question. The objective of the control will often relate to specific financial statement assertion such as completeness.

Activity 1 – A review of purchase invoices prior to posting is undertaken to ensure that only **valid** purchase invoices are recorded. This procedure therefore confirms authorisation. This procedure will not confirm that all invoices are posted; it only ensures that those invoices reviewed and posted are valid genuine expenses, and so does not confirm completeness.

Activity 2 – Batch control totals are an example of an input control for data processing tasks. Batch control processing for the entry of purchase invoices involves checking a manually produced figure for the total value of purchase invoices against that included in the system. By confirming the expected value against the total that has been input, this control will help to ensure that all purchase invoices have been input and will therefore ensure the **completeness** of purchase invoices.

Activity 3 – Recalculating the additions on purchase invoices confirms the **accuracy** of each invoice. This activity does not ensure that all of the invoices have actually been posted into the system and so does not confirm completeness.

Activity 4 – Assigning a sequential number to each invoice and then undertaking a sequence check review after posting, to ensure there are no breaks in the sequence ensures that all invoices have been posted into the system and hence confirms **completeness** of purchase invoices.
Therefore the correct answer is C (2 and 4 only)

Future candidates should take note that they must be able to relate a control activity with its related objective and therefore assertion.

Section B

The six written questions in Section B tested in more depth candidates understanding of the audit and assurance syllabus, which is structured around the following topics:

- 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 internal and external audit, and, an understanding of both corporate governance and professional ethics.

Questions on the function of an audit and distinguishing between internal and external audits tend to be more factual, knowledge based questions whereas questions discussing corporate governance and professional ethics tend to be based on a scenario and candidates are required to identify and explain the areas of importance from the scenario and provide recommendations for each issue.

The scenario based ethics question in the December 2015 exam was well answered by the majority of candidates. The question required candidates to identify and explain a set number of issues from the scenario and give relevant recommendations to counter the risks identified.

Many candidates planned their time appropriately and focused on providing the requested number of points in sufficient detail. One mark was available for each well explained issue. As in previous sittings, while many candidates were able to identify relevant issues from the scenario, candidates often did not explain the issues correctly, or in sufficient detail, therefore most candidates scored ½ marks rather than one mark for each issue. Therefore, a candidate who identified an issue and stated the type of threat in line with the ACCA Code of Ethics and Conduct scored ½ mark, and 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 their own work" is not sufficient. Candidates needed to comment on the possibility of the auditor "overlooking errors" or "not being diligent in their review" i.e. why is reviewing your own work a problem in order to obtain the full mark.

The recommendations to counter each issue were generally clear. However, candidates are advised to read the scenario carefully as steps to reduce certain threats are different for a listed and unlisted company.

The presentation of candidates' answers was generally of an appropriate standard. The majority of candidates used a two-column format using the first column to identify and explain the threat and the second column to provide a safeguard to mitigate the threat. This enabled candidates who used this format to ensure they produced a full answer with an allocated safeguard for every identified threat and to ensure they had enough points to score the marks available.

In addition, the December 2015 exam contained an additional factual question in this area of the syllabus. The question required an understanding of the roles of internal audit. This question was generally well answered by candidates. However a minority of candidates confused internal audit with an audit committee.

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 financial statements.

December 2015 examined a number of topics from this area of the syllabus including gaining an understanding of the entity, engagement letters and audit risks and responses.

Firstly candidates were tested on their knowledge of engagement letters and the information necessary to gain an understanding of a new audit client.

Candidates were required to provide an explanation of factors that indicate an engagement letter for an existing client should be revised. This factual question required an understanding of ISA 210 *Agreeing the Terms of Audit Engagements*. Candidates' performance in this question was unsatisfactory. A significant number of candidates incorrectly stated a change in audit fees would necessitate a revision in the engagement letter. Many candidates also incorrectly stated a change in the engagement partner would necessitate a change in the engagement letter and therefore did not understand an engagement letter is signed on behalf of the audit firm.

Candidates were also required to list six matters, which should be included in an audit engagement letter. As in part (a), this was a factual question requiring ISA 210 knowledge. Candidates' performance was mixed. Many candidates identified audit scope, objective, management's responsibilities and auditor's responsibilities as relevant points for inclusion. However, some candidates incorrectly focussed on general items, which are not listed in ISA 210; e.g. name of company, address, date, signature etc. Many candidates incorrectly listed 'fees' and did not identify that the engagement letter includes the basis of audit fees or any billing arrangements. A minority of candidates incorrectly listed the five elements of an assurance engagement; practitioner, intended user, responsible party, subject matter, criteria.

Candidates were then asked to identify five sources of information to gain an understanding of the new client presented in the scenario and describe how the auditor will use this information. Candidates' performance in this area was mixed.

Candidates who identified a source of information the auditor could use and then described the information that could be extracted from that source, generally scored well. Some candidates however did not identify the source of information and instead discussed information they would need on an audit (e.g. supplier statements). Many candidates' provided weak sources, for example "comparison of prior year figures with current year figure". Many candidates incorrectly included as a source the prior year audit file and/or the permanent file even though the scenario stated it was a new client. Where candidates listed the previous auditor as a valid source of information, the use of the information was often incorrect as it was often based on whether or not to take on the client (a decision that has already been made) rather than reviewing their working papers for issues.

Candidates were also presented with a question at this sitting based on a manufacturing company and asked to assess audit risk and responses. 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). In the December 2015 exam the question required five audit risks to be identified, explained and a suitable response. Performance in the audit risk question in December 2015 again was mixed.

It was encouraging that candidates generally identified the issues correctly from the scenario. However, candidates sometimes did not explain how each issue could impact on the audit risk and therefore were not awarded the full mark. To explain the audit risk candidates need to state for each issue if this could result in a balance being over stated, under stated, misstated, misclassified, a going concern problem or refer to a relevant assertion. In addition, many candidates misunderstood the implication of the inventory being counted before the year-end and thought the problem was the lack of staff for the count as opposed to the roll forward adjustments which would be necessary.

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 it should set out an approach the audit team will take to address the identified risk, the responses given were sometimes either too weak (e.g. in response to the directors' bonus being based on profits a weak response was to "audit the profit or loss account") or, did not address the issue (e.g. in response to the unreconciled differences on the bank reconciliation, a weak response was to "obtain a bank confirmation')

It was pleasing to note that few candidates discussed business risks. A minority of candidates however did propose, in relation to the director's bonus being based on profits, the inappropriate response that the auditor should inform management not to base bonuses on profit levels in the future.

It was also 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.

The December 2015 paper contained an additional small requirement which required an understanding of ISA 250 '*Consideration of Laws and Regulations in an Audit of Financial Statements*'. The performance in this area in the December 2015 exam was unsatisfactory. Candidates often focussed on management's responsibilities rather than auditor's responsibilities. In addition, many candidates did not relate their answers specifically to laws and regulations or the requirements of the specified ISA.

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). In common with prior sittings where there is a test of control requirement, performance in the internal control question in December 2015 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. The scenario in the exam will always contain more issues than required to be discussed and it was therefore encouraging that candidates generally applied effective exam technique and focused on providing answers which identified the required number of issues as noted in the question.

Most candidates were able to provide good recommendations to address the deficiencies. However, often the recommendations did not clearly address the specific control weakness identified.

As noted in previous examiner's reports, the tests of controls provided by candidates were often not well explained (e.g. just using the word "check" if the control is operating), and did not address the control identified, or, were not practical (e.g. "observe" cash being banked daily). Candidates are reminded that being able to provide appropriate and relevant audit procedures is a key area of the syllabus and practice in this area is crucial.

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.

Candidates were firstly asked to explain four factors, which influence the reliability of audit evidence. One mark was available for each factor; candidates were required to either fully explain the factor or compare that factor to another source. This question was generally well answered. A minority of candidates did not fully describe each factor e.g. they noted written evidence was reliable but did not explain why it was reliable, or alternatively, did not make a comparison such as written evidence is stronger than oral evidence. It was pleasing that candidates planned their time carefully and generally only described the required number of factors.

Candidates were further provided with a short scenario based question and were required to describe audit procedures that would be performed before and during an inventory count (8 marks) and audit procedures in relation to research and development costs (4 marks). As in previous sitting and as noted in previous examiner's reports the provision of audit procedures relevant to particular circumstances was not well attempted by the majority of candidates.

Most candidates were able to identify that the count procedures should be obtained before the inventory count, however a significant number did not expand to explain the purpose of obtaining this information or the importance of the auditor reviewing the adequacy of these instructions. Candidates often then listed further details to be obtained e.g. location of count, assembling the audit team, whether to use an expert etc. A number of candidates referred to third party inventory however this was not mentioned in the scenario and therefore any related procedures were not valid. Only the better candidates suggested looking at prior year audit files or, considered the materiality of the sites and control issues at sites.

Most candidates did note that during the count the auditor should observe the counters to ensure the instructions were being followed. However a significant number of candidates then proceeded to list the count procedures that the company's counting team should follow thereby straying into management responsibilities rather than the procedures relevant to the auditor. Some candidates correctly suggested undertaking test counts, while only a minority suggested obtaining copies of the completed count sheets. Overall it was disappointing that candidates did not seem familiar with the auditor's role at an inventory count.

In relation to research and development costs, some candidates correctly suggested that the auditor needed to ensure compliance with the capitalisation criteria in IAS 38 and also suggested recalculating the amortisation charge, but few candidates identified any other relevant procedures. Many candidates did not score any marks for this requirement. Although many candidates suggested a review of invoices, the procedure described was most often testing valuation or rights and obligations rather than to ensure correct classification.

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 audit reports, written representations and the final review and report.

December 2015 examined a number of topics from this area of the syllabus including going concern indicators and procedures and audit report modification.

Candidates were required to discuss the implication on the audit report if an issue surrounding research and development costs remained unresolved. This question was well answered by candidates in December 2015.Most candidates stated the issue, being that the project did not meet the capitalisation criteria, however few candidates explained the impact on the financial statements e.g. assets would be overstated and profit understated. The majority of candidates correctly calculated materiality, however a small number of candidates incorrectly calculated materiality based on the size of the project as a percentage of total research and development spend (i.e. 49%), thereby not considering the materiality of the issue to the financial statements as a whole.

Overall it was encouraging to note that audit report questions have shown a continued improvement in recent sittings.

The December 2015 exam also included a question concerning going concern assessment and required candidates to explain five potential indicators present within the scenario to indicate that the company is not a going concern (5 marks). Candidates were then asked to describe audit procedures to assess whether or not the company in question was a going concern. Overall most candidates were able to provide competent answers covering the going concern indicators, performance in relation to providing going concern procedures.

The majority of candidates identified the required number of going concern indicators from the scenario and explained how each could affect cash flows, profit etc. A minority of candidates incorrectly identified that as there were seven major customers then the company may be too reliant on them, rather than the going concern indicator of a reduction in sales from the major customers. A minority of candidates incorrectly based their answers on indicators that the company was a going concern and candidates are reminded to read the question carefully

Many candidates correctly identified appropriate going concern procedures such as reviewing forecasts, board minutes and obtaining written representations from management. However some candidates incorrectly included tests such as recalculating ratios or procedures to audit the figures in the financial statements such as receivable circularisations.