Examiner's report

P7 Advanced Audit and Assurance
December 2011

General Comments
Candidates' performance in the December 2011 P7 paper was again unsatisfactory. The paper was quite practical, involving analytical review and an audit completion review, as well as typical requirements involving audit evidence and audit reports.

The examination comprised two compulsory questions in Section A, and three questions in Section B of which two should be attempted. Both Section A questions were based on detailed scenarios, and contained several requirements covering different syllabus areas.

Each optional 18 mark question in Section B included one or more short scenarios, and several requirements. Of the section B questions, question 4 was the most popular.

Similar factors as detailed in previous examiner's reports continue to contribute to the unsatisfactory pass rate:

- Failing to answer the actual question requirements
- Not applying knowledge to specific points from the question scenarios
- Not answering all question requirements
- Lack of knowledge on certain syllabus areas
- Illegible handwriting and inadequate presentation.

The rest of this report contains a discussion of each question, highlighting the requirements that were answered well, and the areas that need improvement.

Specific Comments

Question One
This question was for 39 marks, and was based on an audit planning scenario, as is typical for question one. The audit client had provided financial information in the form of a statement of financial position and a statement of comprehensive income, extracted from management accounts, along with accompanying notes. Less written background information had been provided than in some previous audit planning questions, encouraging candidates to focus their answer on the financial information provided.

The first requirement, for 23 marks, was to perform preliminary analytical review, and then to identify and explain principal audit risks. A reasonable proportion of candidates responded quite well to the requirement regarding analytical review, with most at least calculating some simple trends, usually focussing on revenue and expenses. Sound answers calculated a range of trends and / or ratios, and used this analysis to explain a range of audit risks relevant to each of the elements of the financial statements. Some answers mainly ignored the analytical review, and just discussed audit risks. This certainly would generate some marks, but many of the audit risks could only be clearly identified and explained by reference to some analytical review. It was very common for some answers to calculate a trend but then just state the trend in words, e.g. calculating that revenue had decreased by 12% and then just stating that "revenue has gone down" with no discussion of any risk at all. Some answers identified an audit risk but then failed to explain why it is an audit risk, e.g. many candidates calculated that the warranty provision had decreased by 20%, and went on to suggest a risk of understatement of the provision. This is correct, but it does not really explain the risk (an answer should link the movement in the provision to the movement in revenue and explain the risk on that basis). The weakest answers contained incorrectly calculated trends, little or no discussion of audit risk and very inadequate presentation.

Candidates also need to avoid repetition - many answers discussed going concern as an audit risk, which was correctly identified, but rather than discuss it as a discrete risk, it was just referred to as a risk at the end of every paragraph. This wastes time, and also detracts from the professionalism of the answer.

Many candidates also wasted time at the start of their answers by writing a page or more discussing irrelevant matters such as a definition of audit risk and its components, general descriptions of how to plan an audit, and describing how to calculate materiality in great depth. Candidates should note that such discussions do not earn marks and are not a suitable "introduction" to an audit risk question. Another waste of time was to suggest audit procedures for each area being discussed. It was not uncommon for a candidate to calculate a trend, identify a risk, and then spend half a page discussing what they thought would be a good audit strategy for the risk identified, or to suggest a number of specific audit procedures. None of this is asked for, and so does not earn marks.

The other common problem were answers which focussed on business risks rather than audit risks, leading to long discussions of operational or financial problems that the client was facing, but again failing to develop the point into a specific audit risk.

There were two risks specific to items which appeared to have been incorrectly accounted for – a share based payment scheme, and a leased asset. Many candidates produced reasonable answers, especially regarding the leased asset, explaining why the accounting treatment seemed incorrect, resulting in a clear conclusion as to the relevant audit risk. However, some answers focussed entirely on explaining the accounting treatment and failed to develop the point into an audit risk. Looking at accounting issues in general, many candidates clearly have a sound knowledge of financial reporting standards, which is essential for this paper. But candidates should be aware that simply quoting financial reporting rules is not enough – they need to apply the rules to the scenario and to the specific question requirement in order to score marks. The share based payment scheme was a difficult issue, but relatively easy marks were available for discussing the inherent risk created by the complexity of the accounting treatment.

The second requirement, for 8 marks, related specifically to the share- based payment plan and the leased asset, asking candidates to recommend the principal audit procedures to be performed in respect of the two items. Specifically, procedures relating to the recognition and measurement of the share -based payment plan, and the classification of the lease were required. Unfortunately answers to this requirement were inadequate. Most candidates could do little more than repeat the necessary accounting treatment, and then request a management representation that the correct treatment has been carried out. Some answers recommended a wider range of procedures, but some were often irrelevant to the specific requirement, e.g. not focussing on the classification of the lease.

The procedures recommended were often too vague to score credit, e.g. many candidates recommended that the lease document should be obtained, but did not say what the auditor should do with it, other than sometimes suggesting a "review". Candidates should note that obtaining a document is not in itself an audit procedure.

There were 2 professional marks available in connection with requirement (a). Most candidates attempted an appropriate format by included an appropriate heading and introduction, and it was pleasing to see a reasonable proportion of answers including a conclusion as to the overall level of audit risk identified. When producing figures as for the required analytical review, it is good practice to present the trends and ratios calculated in a tabular format, which can then be referred to in the main body of the answer. Candidates are reminded that resources are available on ACCA's website providing guidance on the importance of professional marks.

The second task, in requirement (b), required candidates to comment on practice management and quality control issues raised by another audit manager's suggestions to help the audit firm's profitability, for 6 marks. Most candidates scored well on this requirement, working through the manager's suggestions and commented that each would impact on quality control in a detrimental way. There were fewer comments on practice management issues, but a lot of candidates at least mentioned that the suggestions could in fact lead to the audit firm losing audit clients rather than gaining new clients. Many answers correctly made the link between quality control and ethical issues, but some took this too far, and almost exclusively discussed general ethical issues rather than the specifics of the question scenario.

It was encouraging to see that many candidates allocated their time well while answering Q1. It was rare to see requirement (b) not attempted, which allowed candidates to obtain some of the more straight forward marks on this question.

Question Two

This question was for 25 marks, and was based on audit completion issues. The candidate was placed in a role as audit manager of a client, with the first task in requirement (a) of reviewing the notes left by the audit senior in relation to three specific matters. Specifically, the requirement was to assess the audit implications of three matters (inventory valuation, provision for a legal case, and a loan made to a related party) – considering the adequacy of the evidence obtained, explaining any adjustments necessary to the financial statements, and describing the impact on the audit report if those adjustments were not made. Further audit procedures were also asked for. This was for 15 marks.

Candidates responded well to the practical nature of this question, and a proportion of answers scored very well. These answers went through each of the three issues, and logically answered each part of the requirement, starting with a consideration of materiality (the materiality level was given in the question), then commenting on the appropriateness of the audit evidence already obtained and suggesting further audit procedures, and finally discussing the impact of the issue on the financial statements and the audit report. There was a lot to do for the marks available, and students who realised this, made their answers succinct, but well explained, and avoided irrelevant matters. Good answers commented that the first two audit issues were immaterial by monetary value on an individual basis, but when aggregated the total adjustment to the financial statements would become material, therefore having an implication for the auditor's opinion.

However, there were several common weaknesses in answers. First, a sizeable proportion of candidates did not realise that a materiality level had already been determined and given in the question. They then incorrectly calculated materiality on the wrong basis, leading to irrelevant discussions of qualifications to the auditor's opinion for the first two issues in isolation. Second, many candidates did not answer the full set of requirements for each issue, with the most common problem being that no further audit procedures were recommended at all, limiting the marks available.

A further issue was that a significant number of candidates who had correctly identified that a matter such as the inventory valuation was immaterial in isolation then went on to state that the audit opinion should be modified because of that issue. This type of comment indicates that the candidate either does not understand when an audit opinion should be modified, or lacks the courage to base their comment on audit report implications on what they have already discussed. A number of candidates suggested that a breach of an accounting standard of any kind was "material by nature". This raises the concern that such candidates have no clear understanding of what is meant by materiality.

It is concerning that many candidates do not seem to have the fundamental knowledge needed on audit reports. Many answers confused qualified opinions with disclaimers, suggested adverse opinions for immaterial matters, and even more thought that an Emphasis of Matter or Other matter paragraph could be used to communicate just about any audit issue at all with shareholders. Candidates should be aware from reading past papers and examiner's reports that audit reports is a very important part of the paper P7 syllabus, and can be examined in the compulsory questions. There is therefore no excuse for a lack of knowledge in this area.

Candidates are also encouraged to take time to carefully read through the scenario. Reading too quickly and not stopping to think before starting to write their answer may have caused a lot of candidates to mis-understand the information given about materiality, as discussed above, and also about the loan made to the financial controller, which many candidates suggested should be reclassified as a current liability rather than a current asset.

Requirement (b) focussed on matters to be reported to the audit committee, and was for 8 marks. A brief description of four matters that had arisen on the audit was given, and candidates were required to explain the matters that should be brought to the attention of the audit committee. Most candidates seemed comfortable with some of the issues in this requirement, especially the parts on ethical issues, and on control deficiencies. The main problem was that a lot of answers failed to really explain why the client's audit committee would need to be informed of such matters, and instead just discussed how the audit firm should react to the issues raised (e.g. the audit team need to be trained on ethical matters – not something of relevance to the client's audit committee). Some answers tended to repeat the information from the question with no further development, and then say "the audit committee need to be told about this". Regarding the issue to do with a potential change in accounting policy most answers just stated the accounting treatment they thought would be necessary (usually incorrectly) but did not view this as an issue that the audit client would need some advice on.

2 professional marks were available for the requested briefing notes, and the vast majority of candidates attempted to produce their answer in the required format. This is an improvement on previous sittings.

The UK and IRL adapted papers had slightly different wording in the question requirement, and the requirements were not split into (a) and (b). This less prescriptive requirement allowed for a potentially slightly wider range of matters to be discussed, and candidates responded very well to this.

Question Three

This question focussed on the audit issues pertaining to fair values and estimates, and contained three short scenarios. Unfortunately for many candidates it was an inadequate choice of question, as answers to at least two of the three parts of the question were generally unsatisfactory.

The first scenario, for 8 marks, described an audit client involved in energy production, and the accounting issue was a provision for decommissioning of its nuclear power stations. The requirement (a) was to comment on the matters that should be considered, and to explain the audit evidence that should be found in a file review in respect of the decommissioning provision. This is standard wording for a requirement and should have been familiar to candidates.

Candidates performed best on this requirement of question three, but answers were still lacking in substance. Many answers discussed the appropriate accounting treatment for the provision correctly, including the issue of measuring the provision at present value. But few identified that the reduction in the provision was a key issue, or that estimates generally give rise to audit risk due to their subjective nature, especially when dealing with a provision that will not give rise to a cash outflow for another 20 years. Most of the evidence that was suggested should be on file focussed on an expert's report and the inevitable written representation from management that the provision had been correctly accounted for. Very few answers used the approach of ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* in challenging the assumptions used by management in developing the estimate of decommissioning costs. Few answers considered the lack of disclosure of the provision, or that a provision may not even be needed at all.

Requirement (b) focussed on the use of an auditor's expert in obtaining evidence in respect of the fair value of a portfolio of financial instruments. Unfortunately very few answers performed satisfactorily on this requirement, which was to explain the procedures that should be performed in evaluating the adequacy of the auditor's expert's work, for 5 marks.

Most answers ignored the requirement as given in the question and instead discussed how the audit firm should evaluate the independence and competence of the expert – though the question stated that this had already been confirmed by the audit firm. This is a classic example of candidates answering the question they would like to have been asked, rather than what was actually asked for, and meant that many answers scored no marks at all on this requirement.

The few who answered this requirement appropriately tended to score highly, with answers mirroring the requirements of ISA 620 *Using the Work of an Auditor's Expert*, discussing e.g. the need to evaluate the assumptions used by the expert, to confirm the work accords with instructions given by the auditor, and to verify the reliability of the source data used by the expert.

Requirement (c) dealt with changes in accounting policies and estimates. The scenario described an adjustment put through a client's financial statements as a result of a change in accounting estimate – the extension of the useful life of 120 properties. For 5 marks the candidates were required to explain the impact on the auditor's report of the accounting treatment of the change in the accounting estimate. However, most candidates instead of focussing on whether the accounting treatment was correct (it was not) and the implications for the audit report, focussed on whether the client should have been "allowed" to change the estimate of useful lives and whether this amounted to some kind of fraud. This led to irrelevant discussions that failed to answer the question requirement. Few candidates understood that the accounting treatment was incorrect, but those that did tended to explain their point well and link it to a potential qualification of the audit opinion. Some candidates described how this qualification would impact on the auditor's report, as asked for, by describing the paragraphs used to explain the reason for the qualification. As in Q2 however, many answers displayed a lack of understanding of auditor's reports, with many claiming that an Emphasis of Matter or Other Matter paragraph should be used to highlight the "lack of integrity" or "fraudulent reporting" that they alleged was occurring.

Question Four

This was the most popular of the optional questions, and focussed on a forensic investigation into a fraud that had been uncovered at an audit client. One of the requirements focussed on ethical issues, probably explaining the popularity of this question.

Requirement (a), for 6 marks, required an assessment of the ethical and professional issues raised by the request from the audit client to investigate the fraudulent activity. Most answers were satisfactory, identifying the main ethical threats (advocacy, self-review etc) raised by the scenario and explaining them to an extent. Some answers also discussed whether the audit firm would have the necessary skills and resources to perform such a specialist piece of work. Some answers however tended to focus on why the audit firm had not discovered the fraud during the previous audit, and the possibility of the audit firm being sued for negligence or the need to "discipline" the audit manager. Some answers also contained irrelevant discussions of the responsibilities of management and auditors in relation to fraud, and other answers used the fundamental principles as a framework for their answer, probably as this had been set on a previous exam paper, but with a completely different question requirement.

Requirement (b), also for 6 marks, asked candidates to explain the matters that should be discussed in a meeting with the client, in terms of planning the forensic investigation. Some answers were very satisfactory, covering a wide range of matters including the timeframe, the required output of the investigation, access to the client's accounting systems amongst others. Some answers however tended to simply list out the procedures that would be performed in conducting the investigation, or explain to the client's management the controls that should have been in place to stop the fraud in the first place.

Requirement (c), also for 6 marks, focussed more theoretically on the debate over whether audit firms should be prohibited from providing non-audit services to their audit client. Although most candidates seemed prepared for a question of this type, most approached the question by discussing the pros and cons of audit firms offering non-audit services to their clients, rather than discussing whether prohibition would be desirable. There is some overlap between the two approaches, but the way that candidates tackled this requirement indicated that a rote-learnt answer had been provided, rather than evidence of candidates thinking on their feet and coming up with their own opinion on the matter. A lot of answers simply explained several ethical threats and concluded that because threats may exist auditors should not provide non-audit services to their clients. This is not a broad enough response to the question requirement.

Question Five

The final question was in two parts. Requirement (a) for 12 marks was based on a scenario which described matters arising as an audit was drawing to a close. There were essentially three matters to deal with – a potentially incorrect accounting treatment, a going concern issue, and an inconsistency in the chairman's statement (director's report for UK and IRL adapted papers). The requirement was to consider the implications of these issues on the completion of the audit and for the auditor's report, and to recommend any further actions to be taken by the auditor. Answers on the whole were satisfactory. Most answers successfully identified and explained the three issues, with most answers focussing more on the accounting treatment of research and development costs, which potentially needed an adjustment. In answering this requirement candidates tended to be more comfortable with the audit report implications than in Q2, usually correctly identifying the use of an Other Matter paragraph regarding the inconsistency, and an Emphasis of Matter paragraph regarding the going concern issue. The only area which many answers failed to deal with was the further audit procedures needed regarding the development costs and the going concern issues.

Requirement (b), for 6 marks contained two short requirements concerning the auditor's report. The first issue concerned whether the auditor's report should be issued prior to receiving written representations from management, and the second dealt with whether an auditor's report should refer to a matter in the previous year's financial statements, which caused a modification of the previous year's auditor's opinion, but which had since been resolved. Candidates were more comfortable with the first issue, usually correctly identifying that the written representation is a necessary piece of audit evidence, and that a verbal confirmation is not sufficient. On the second issue many answers were just too brief – often little more than a few words – usually saying that no reference need be made. These requirements were fairly knowledge based, and it was apparent that a lot of candidates who chose to attempt question 5 did so on the basis of requirement (a) and not requirement (b).

The UK adapted paper had a different second scenario in requirement (b), focussing on the pros and cons of audit reports cross-referencing to the Auditing Practices Board's website. Answers were satisfactory, with candidates providing a proper evaluation and sometimes a conclusion to the matter.

Conclusion

As concluded in previous examiner's reports, candidates must develop their application skills to perform well in paper P7. Of course, underpinning knowledge of auditing and financial reporting standards is essential, but candidates must be able to apply their knowledge and properly analyse the information provided in question scenarios. Candidates must also take time to carefully read not only the scenario, but the question requirements as well. As in the previous sitting, many candidates who failed to achieve a pass mark did so through not answering the question requirement as set.

UK and IRL candidates are reminded that the syllabus now examines International Financial Reporting Standards rather than UK and Irish accounting standards. Notes should not be made in answer booklets about which set of accounting standards are being used in answering questions.