# Examiners' report

# P7 Advanced Audit and Assurance June 2008



#### Introduction

The results from the second sitting of the new syllabus indicate an improvement in the quality of answers provided. However, the average mark was disappointing, and it was clear that a significant minority of candidates had failed to properly read or understand the question scenarios provided, leading to answers that demonstrated few application skills, often contained totally irrelevant discussions, and displayed a lack of commercial awareness. Candidates are encouraged to read this Examiner's Report in detail, to ensure that they do not repeat these common failings when sitting this challenging paper.

# General comments on the paper

The overall structure of the paper has not changed since the December 2007 sitting, though the mark allocations between Sections A and B differ slightly.

The examination comprised two compulsory questions in Section A for 66 marks. This was split between question 1 - 34 marks, and question 2 - 32 marks. Section A questions provided a comprehensive scenario, with a number of requirements based on the details provided in the case study scenario.

Section B was for the remaining 34 marks on the paper, and three optional questions for 17 marks each were provided. There was a reasonable spread in the choice of these optional questions, with none of the questions seeming to be particularly unpopular. Question 3 was marginally the most popular question, and Question 5 marginally the least popular.

The pass rate continues to be unsatisfactory. The factors contributing to this disappointing fact include:

- Failure to read and understand the question scenario.
- Poor time management and inadequate general exam technique,
- Inability to answer the specific question requirements, and
- A demonstration of a lack of technical knowledge, practical or commercial awareness, or common sense.

These comments are expanded below in a question by question discussion of the performance of candidates in this exam sitting.

### Question 1

This 34 mark question was based on a scenario with the context of a potential new audit client for the audit firm, in which the candidate was given the role of a senior audit manager. The question focussed on the analysis of business risk, and financial statement risk, and also required an assessment of acceptance issues in the form of notes to be used by an audit partner. Risk assessment is a key part of the syllabus, as highlighted in the Examiner's Approach article, and this part of the question should not have been a surprise to candidates. The issues that should be considered in deciding whether to take on a new client have been regularly tested under the old syllabus.

On the whole, there were some strong answers to this question, with many excellent answers to requirement (a) in particular, with a significant minority of candidates achieving full marks in this part of the question. However, failure to read and understand the scenario or the question requirements meant that many answers were disappointing.



Requirement (a) asked the candidate to 'identify and explain principal business risks' facing the potential new audit client, Medix. The scenario contained a wide variety of business risks, and the best answers covered a broad range of risks facing the company. Most candidates identified and then attempted to explain each issue in turn, which was pleasing to see. For example, rather than just stating 'Medix needs to raise finance' as a business risk, some answers went on the explain that the finance being sought carries a variable interest rate, which could cause fluctuating payments and therefore create further financial risk to Medix. On the whole the answers were tailored to the specific risks being faced by Medix, rather than being a list of general business risks which could be applied to almost any entity. This is encouraging, as it is essential to apply knowledge to the facts of the scenario provided to score well in this type of question. Many candidates used headings to give their answer a clear structure. The best answers grouped similar identified business risks together and gave an indication of the relative importance of each collection of risks. For example, the lack of finance facing the company should have been identified as more important than foreign exchange risk.

However, some common problems in answers to requirement (a) included:

- Confusion between business risk and financial statement risk discussing the impact of the business risk on the financial statements was NOT a requirement of (a),
- Providing recommendations or solutions to the risks again NOT a requirement of the question,
- Discussion of audit risk, for example, the fact that this is a potential new audit client giving rise to detection risk again, this was NOT a requirement of (a),
- Trying to link every risk identified to a going concern risk it is true that Medix had a number of serious business risks which could culminate in business failure, however, candidates should appreciate that there are many risks which business face prior to going out of business,
- Identification of risks which are unlikely to materialise, for example, a large number of answers discussed the risk of the potential death of the scientist, resulting in lost intellectual capital, or the plane crashing and destroying inventories, and while I agree these events could happen; there are plenty of other, more pressing risks to be discussed.

One of the main problems noted with requirement (a) is that many candidates spent too long on this section, at the expense of time that would have been better spent on the optional questions. Candidates should be aware that failing to attempt four questions, as required, is unlikely to lead to success in this paper.

Requirement (b) produced the worst answers to Question 1. The first part of the requirement asked for a discussion of the relationship between business risk and financial statement risk. Most candidates attempted a definition of the two terms, but the discussion of the link between them was weak. This was somewhat surprising, given that in answering requirement (a), many students wasted time describing the impact on the financial statements caused by the business risks that they had identified for Medix, which is exactly what requirement (b) was asking for. Some candidates drifted into a description of 'top down auditing', which did not answer the question requirement, though was awarded credit if the discussion demonstrated an understanding of the link between the two types of risk. Candidates are reminded that in questions which relate to auditing concepts, it is recommended that the answer begins with a definition of the concept. In this case, marks were awarded for definition of the terms and any relevant supporting example provided.

In (bii), candidates were asked to 'identify and explain potential financial statement risks'. Some sound answers were given here, where candidates understood the financial reporting implications of Medix's breach of planning regulations, and clearly explained the risk in terms of specific balances in the financial statements being under or overstated, or the risk of non-disclosure. However, many answers simply stated that the company 'might need to make a provision', or should 'consider the value of the property', comments which are much too vague to score well. It was however pleasing to see that in many answers which discussed the company's going concern problems; this was linked to the specific financial statements risks of non-disclosure, or the incorrect basis of



preparation of the financial statements. Reference to the correct financial reporting standards generated half a mark each (though candidates should be aware that this is capped).

The final requirement produced an extreme range of answers in terms of quality. There were some maximum marks, where the answer was focussed on the case study scenario, and where a broad range of issues has been discussed and a logical conclusion had been reached. At the other end of the spectrum, some answers, showed very little, if any, application to the scenario. In many cases these answers appeared rushed, indicating that too much time had been spent on requirement (a). Candidates must make sure that they allocated their time carefully within questions. Here the same amount of time should have been spent on (c) as it was on (a), though this rarely appeared to be the case. Common weaknesses in answers to (c) included:

- Failure to produce the answer in the required format meaning that full professional marks could not be awarded.
- Listing general acceptance considerations, often as questions ('have we got shares in the client? Do we have any personal relationships with the client?') rather than making the comments specific to Medix.
- Making comments wholly inappropriate to the scenario. An example of this is where many answers urged the
  audit partner to 'make contact with the previous auditor to find out matters we should be aware of'. This
  shows that many candidates simply failed to read the question carefully enough, as approximately one third
  of the information provided in the scenario comes from a discussion that has already taken place with the
  outgoing auditor in which his reasons for vacating office were outlined.
- Answers which concentrated on what the outgoing auditors had done wrong rather than problems for the
  new audit firm. This is relevant to an extent (ability to rely on opening balances) but some answers focussed
  almost exclusively on the failings of Mick Evans (the outgoing auditor), and some even requested that his
  'incompetence' should result in his being reported to ACCA. (The discussion of Mick Evan's 'failure to audit
  properly' was usually linked to the small size of his accounting and audit practice a wholly inappropriate
  argument.)
- Lack of prioritisation many answers listed the fact that Medix's managing director appears to be carrying out a fraud or involved in money laundering as being no more or less significant than, for example, the fact that the audit firm should have relevant industry experience. At this level it is important to try to prioritise issues, which will then help to reach a logical conclusion.
- Failure to reach a conclusion as to whether or not the appointment should go ahead note that requirements containing the verb 'assess' should contain a conclusion. There were enough risks provided in this case study that should lead at least to the conclusion that this would be a high risk assignment which must be very carefully considered by the audit partner. Failing to reach a conclusion restricts the professional marks that can be awarded.

### Question 2

This question featured an expanding group of companies, a scenario which should not have been a surprise given the recent Examiner's article published in *student accountant* which dealt with group auditing. It was therefore very disappointing to see that question 2 tended to be the worst attempted on the paper. Group audit is an important part of the syllabus and candidates should expect to see it examined on a regular basis.

Requirement (a) focussed on due diligence, and asked for a report describing the purpose of a due diligence investigation, and comparing the scope of such an investigation with that of an audit. Some candidates seemed not to know what a due diligence investigation involves, and common descriptions ranged from 'a verification of the truth and fairness of the financial statements' to 'a determination of the going concern status of a company'. Although most answers picked up on the fact that due diligence is carried out in a potential business combination (a fact which was itself given in the question scenario), very few answers discussed the fact-finding nature of the investigation, and that the result of the investigation can help the management make a decision about whether or not to go ahead with the acquisition (which again is given in the scenario).



Comparison of the scope with that of an audit was poorly attempted. Most candidates simply discussed 'negative assurance' compared with 'true and fair view', and hardly any answers mentioned the fact that due diligence is forward looking, and makes use of a wide range of information about the company being investigated.

Some answers were extremely disparaging in their attitude towards due diligence investigations, many claiming that it would be 'very expensive and not as good as an audit' and that 'you don't even get an opinion' or 'you can't place any reliance on due diligence'. These comments display a lack of commercial awareness. The tone of the report should have been more positive towards the benefits of such investigations — ultimately the directors in the scenario should be provided with a report which encourages them to initiate due diligence on the target company Maxwell, but many answers would have persuaded the directors even more against it.

Candidates seemed to make a better attempt at the required format in this question compared with question 1. One point that should be made clear is that whatever the format required in the question, candidates should NOT write their name anywhere in their answer. It is suggested that 'audit manager' (or equivalent – depending on the question scenario) should be used instead of any actual name.

Requirement (b) was probably the worst answered section of the whole paper. Requirement (bi) asked for 'matters to consider' and 'evidence you would expect to find' regarding the cost of an investment made during the year. The wording of the requirement should be familiar, as this type of question has appeared regularly in advanced audit examinations. However, most candidates were completely unable to restrict their answer to the cost of investment as shown in the scenario, and most launched into a discussion of the accounting treatment of goodwill. This was NOT asked for. Candidates at this level in their examinations should be able to distinguish between the cost of an investment in the parent company's financial statements, and the goodwill which arises on consolidation. The requirement clearly referred to the financial statements of the parent company and no marks were awarded for irrelevant discussions of net assets acquired or goodwill impairment or amortisation, as these balances only arise in the group consolidated financial statements. The correct approach would have been to consider the three components of the cost of investment given in the question in turn, and for each of them, identify the matters to consider (for example, completeness, accuracy in measurement, recognition) and then to specify associated audit evidence. Even those answers which did take this approach usually got the accounting treatment wrong, with many candidates arguing that deferred and contingent consideration should not be recognised until the time it is paid. Only the best answers considered the probability of Dylan achieving revenue targets (and thus triggering future payment of the contingent consideration), and discussed the use of an appropriate discount factor in the calculations.

Requirement (bii) was also not well answered. The majority of candidates seemed not to know the contents of a consolidation schedule, or how to audit it. However, those candidates who had read the relevant article in student accountant tended to score well on this requirement. However even these answers were not always tailored to the scenario. For example, some answers described an audit procedure to determine the accuracy of the calculation of the minority interest in the group, despite the scenario clearly stating 'all subsidiaries are wholly owned.' Making irrelevant comments not only wastes time in the exam, but also detracts from the overall quality of an answer.

Some answers to this requirement digressed into general matters that a group auditor should bear in mind (organising group audit instructions, checking the competence of other auditors in the group). Again, such comments were irrelevant.

Thankfully, requirement (c) was well attempted by the majority of candidates, and it was clear that those candidates who had taken time to read the Examiner's article scored well on this current issue. Most answers provided a good definition and a reasonably balanced selection of 'pros and cons' of joint auditing. However, a significant minority of answers clearly did not read or understand the term 'joint audit', and instead chose to discuss group audit arrangements, with the relationship between the principal and other auditors in the group a



common digression. Other answers suggested that a joint audit is when internal and external auditors join forces to come to an opinion. This requirement differentiated clearly between strong and weak candidates.

#### Question 3

This question contained a short scenario focussing on the audit of related party transactions. P7 will continue to test financial statement areas that are relatively hard to audit, and areas which are the subject of specific auditing standards, in this case ISA 550 *Related Parties*. Answers to this question varied widely in their quality. Despite this question being technically quite challenging, it was the most popular of the optional questions.

Requirement (a) asked candidates to discuss the difficulties facing auditors in the identification of related parties and related party transactions. Some answers started with a definition of related parties and went on to discuss the various factors which create problems for the auditor, including the complex and sometimes subjective way of deciding whether a party is related to an entity, the specific issues with materiality not being based on a monetary amount, and the fact that knowledge may be confined to the highest level of management within an entity. Weaker answers simply stated that the directors will try to hide the existence of related party transactions, and often went on to stress that related party transactions are almost always fraudulent, masking illegal activities or creative accounting. Only a handful of candidates mentioned the existence of ISA 550, which provides guidance to auditors in this area.

Requirement (b) asked for matters to consider and further audit procedures in relation to a related party transaction which had not been disclosed in the financial statements, and for which minimal audit evidence had been gathered. Despite the clue given in requirement (a), a surprising number of candidates did not mention that the transaction described in the scenario appeared to be a related party transaction. Those that did pick up on this fact failed to develop or explain the point fully, and although there were many comments along the lines of 'the transaction should be disclosed', hardly any answers provided an indication of what exactly should be disclosed and why (losing relatively easy marks for not stating the various disclosure requirements of IAS 24 *Related party disclosures*), or that a lack of disclosure would result in qualification of the audit opinion by disagreement.

A large minority of candidates focussed on the fact that the receivable should be provided for, which is reasonable, but then went on to suggest that not providing for the balance would lead to a qualified opinion, despite the amount being clearly immaterial by reference to monetary amount. Many answers seemed not to understand that receivables are contained within current assets, with a worrying number of scripts stating that 'if the receivable is written off, the current assets should also be written off'. On the whole the answers to (bi) were confused, resulting in inadequate answers to (bii), where audit procedures should have been recommended. Very few candidates suggested that the auditor should try to understand the nature of the transaction in question ('normal' trade receivable or loan), with procedures usually restricted to vague comments like 'inspect invoice' – but what it is being inspected for, and would there even be an invoice? Or 'speak to management' – but about what, and who would the discussion be with? Answers to audit procedure questions must be much more specific.

Requirement (c) was often not attempted; however, relatively easy marks were available for commenting on possible weaknesses in the auditor's quality control procedures which failed to spot the related party issue in the previous year, and the over-reliance on a management representation as a source of evidence. Some answers resulted from a mis-reading of the requirement, and commented on Pulp's poor credit control function. Some candidates seemed to want to punish this year's audit senior for the deficiencies in the audit which happened in the previous year, and which the audit senior had spotted, leading to the inevitable comments about 'punishing' the senior for his incompetence. Better answers discussed a need for the training of audit staff with respect to related parties, and the need for a thorough review of this relatively high risk section of the audit.



#### Question 4

This question provided three short scenarios, based on ethical and professional issues, and required a discussion of the issues raised, and the action to be taken with regard to each scenario.

Requirement (a) produced mixed responses. The best answers briefly discussed a range of ethical and professional issues. Most discussed the fact that not raising an invoice for this year's audit, and not yet receiving payment for last year's audit is a threat to independence, but only the better answers developed this into the situation being akin to providing a loan to the client, or being perceived as performing the audit for free. It is crucial that in ethics questions, the reason WHY something is a threat to independence is fully explained. Some answers also considered the difficult ethical position that the audit firm was in – could the firm ethically withhold the audit report until some payment had been received from the client? Or should the report be issued despite payment not being received? Only the best answers discussed that it was the failings of the audit firm's own credit control procedures and quality control measures which had resulted in this tricky situation. Weak answers blamed the client entirely. Some answers discussed the urgent need to arrange a payment plan with the client, while weaker answers suggested that the auditors resort to legal action against their client or even 'send the bailiffs round' to recover some benefit from the situation.

Requirement (b) involved an audit manager who was benefiting from a rental agreement with her audit client which appeared to be at favourable terms. On the whole, answers here were satisfactory, with most candidates appreciating that the manager's integrity could be questioned due to the financial interest she is receiving from the client. Most answers also picked up on the fact that the threat is more severe as it is the audit manager who is receiving the benefit. The recommended actions tended to be relevant and specific, though as in question 3 (c), there were repeated requests to 'punish' the manager by reporting her to ACCA. (Though this did not affect the marking of the requirement, it was interesting to note that many candidates made the manager a man in their answer, despite the scenario clearly referring to her as a female manager.)

The answers given to requirements (a) and (b) were usually the same length, despite there being more marks available for (a). Again, candidates are reminded to be careful with time allocation within each question that they attempt.

The answers to requirement (c) were generally inadequate. Most candidates seemed not to appreciate that auditors often make recommendations to clients, and that as long as the client is aware that a commission will be received by the audit firm, the practice is generally seen as acceptable. Many answers seemed horror-struck at the situation as described, and again there were repeated requests to discipline whoever had raised the invoice, without any attempt to consider why the invoice had been raised. Only the best answers identified the threat to objectivity, the potential self-review threat posed by the situation, and the need to carefully consider the quality of the services offered by the recommended software supplier.

## Question 5

The final question on the paper covered reporting issues – specifically reports to those charged with governance, and the use of liability disclaimer paragraphs. This was marginally the least popular of the option questions, which is a little surprising given the recent Examiner's article on the subject of reporting findings from the audit to those charged with governance. Candidates should be aware that the syllabus section on 'Reporting' is not confined to the audit report, but includes other outputs from the audit, as well as reports given for non-audit engagements. Therefore it should not be assumed that every P7 exam will include a question specifically on audit reports.

Part (a) required candidates to identify the main purpose of including management letter points (often referred to as 'findings from the audit') in a report to those charged with governance, and provided a brief scenario, from which candidates needed to recommend matters that would be included in such a report. However, some candidates simply repeated facts from the scenario and provided very little comment of their own as to why the



matters they identified should be included. There were very few references to the existence of ISA 260 *Communication with Those Charged with Governance.* 

The first matter dealt with in the scenario involved a deterioration of internal controls with regard to capital expenditure. Most candidates calculated the materiality of the breakdown in controls in question, but an alarming minority calculated this incorrectly, which led them to believe that the control weakness had led to a material mis-statement in the financial statements, which was technically incorrect, especially as the scenario stated that there were no material errors found during audit procedures on property, plant and equipment. The second matter, a material breach of financial reporting standards was generally well dealt with, although again there were a surprisingly large number of mistakes in the calculation of materiality.

It was the final matter in the scenario, which dealt with inefficient responses by the client to requests for information from the audit firm, which prompted the weakest answers to requirement (a). The most common mistake made by candidates was to assume that the client had caused a limitation in the scope of the audit, leading to speculation that the client was 'trying to hide something' or that a fraud was being perpetrated, and developed into a call for a disclaimer of audit opinion. Only a handful of candidates appreciated the importance of co-operation between internal and external auditors, and that failure to provide information to the external audit team not only delays the audit process, but also casts doubt on the efficiency and effectiveness of the internal audit team, and could potentially result in an increased audit fee. This is a crucial matter to raise with those charged with governance, who ultimately are responsible for the actions of the internal auditors who report to them.

Requirement (b) asked candidates to comment on a request made by the client, a listed company, for the audit firm to type the financial statements. This is not specifically prohibited by ethical guidelines, and the point of the requirement was to test the candidates' ability to think on their feet about a relatively common request. The issue is that the auditor could be perceived to be involved with the preparation of the financial statements or to be taking management decisions; however, with appropriate safeguards a typing service could be provided. As the client in this case was a listed company, some candidates suggested that even with safeguards, it may be a safer decision to explain to the client the threats and decline to provide the service.

The final requirement covered auditor's liability, in the context of asking for the content of a liability disclaimer paragraph, and the arguments for and against the use of such paragraphs. Auditor's liability is a topical issue and it was disappointing to see that roughly half of the candidates who chose to attempt this question had no comprehension of the concept of the liability disclaimer. Most of these answers instead discussed an opinion modified due to limitation in scope, while others made much of a paragraph which explains the responsibilities of auditors compared to managers. Those candidates who correctly identified the liability disclaimer (a paragraph used to clarify that the auditor's report is intended to be used by the shareholders of the company as a whole, and thus the auditors accept no responsibility towards third parties) tended to do very well, with clear arguments for and against the use of such paragraphs discussed. Many strong answers referred to the Bannerman case which prompted the widespread use of these paragraphs, and some even mentioned ACCA's views on the use of the paragraph (though this was not necessary to score full marks).

## **Conclusions**

This sitting produced some sound scripts, and generally the performance was an improvement on the December 2007 sitting. The improvement seems to stem from candidates being more willing to apply their knowledge to the case study scenarios provided, and there is clear indication that reading Examiner's articles makes a difference to the quality of certain answers. However, there is much room for improvement. A significant number of candidates do not read the question scenarios in enough detail, resulting in answers which lack focus, and digress into wholly irrelevant areas. Many candidates lose out on relative easy marks by not producing answers in



the required format, not reaching conclusions, not referring to relevant auditing or financial reporting standards, and not attempting parts of questions. Candidates must appreciate that exam technique as well as technical knowledge is a key to success, and it is only by practising past exam questions and considering the content of Examiner's articles that they will learn how to apply their knowledge to the type of scenarios provided in the exam.