



Examiners' report

P7 Advanced Audit & Assurance

June 2009

General Comments

This paper challenged candidates to think practically and commercially in a variety of situations, including tendering for a transnational audit engagement, appraising a modified audit report, evaluating business risks for an established client, and considering the ethical implications of a client lacking integrity.

Some candidates displayed sound technical knowledge, sound application skills, an ability to communicate ideas with clarity and above all the capacity to answer the specific question requirements. Unfortunately most candidates did not rise to the challenge, resulting in scripts that lacked focus, were too brief, and failed to adequately address the specific requirements of the questions.

The examination comprised two compulsory questions in Section A, split between question 1 – 34 marks, and question 2 – 32 marks. Both questions contained a case study scenario, and a number of requirements covering different syllabus areas.

Section B contained three questions, each for 17 marks. Each optional question included a short scenario, and several requirements. Of the section B questions, question 3 was the least popular, and question 4 the most popular.

The vast majority of candidates attempted the correct number of questions. However, the examiner would like to remind candidates that attempting all of the section B questions is likely to severely detract from the quality of answers provided.

The overall pass rate continues to be disappointing. The factors contributing to the poor pass rate for this sitting include:

- Failing to answer the specific question requirements
- Providing answers that are not tailored to the question scenario
- Not explaining answers in sufficient detail
- Making too few comments given the mark allocation of a requirement
- Illegible handwriting in some cases – this problem seems to have increased since the last sitting.

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 34 mark question was set in the scenario of a large company operating restaurants, using 4 distinct brand names, and facing challenges such as onerous regulatory requirements, a declining profit margin and a reduction in cash. The question requirements focused on gaining business understanding, business risk evaluation, and audit procedures.

Some candidates performed well overall, especially those who spent an appropriate amount of time on each of the question requirements. However, a significant proportion of candidates either failed to answer the final requirement, or produced extremely brief answers to the final requirement.

Requirement (a) asked candidates to prepare briefing notes to identify and explain aspects of a client's business that should be considered in gaining an understanding of the business, and to recommend necessary procedures to gain that understanding. Professional marks were available for the clarity, format and presentation of the answer. Most candidates attempted the first part of the requirement well, being able to identify various aspects that contribute towards business understanding, such as relevant laws and regulations, and industry factors such

as suppliers and competitive forces. Fewer candidates recognised the need to understand the internal control environment, and fewer still mentioned the importance of understanding the relevant financial reporting framework and performance measures of the client. Only a very few candidates were aware of the relevance of ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, on which the question requirement was based. In terms of procedures, most candidates recognised the importance of a meeting with management, but fewer commented on the need for analytical procedures, or a visit to the client to observe activities. In addition, the procedures were usually not well explained, for example, enquiries of management had to be inferred from 'I will have a chat with the directors', and inspection from comments 'read press cuttings' and 'get a copy of the organisational chart'.

Most candidates attempted to produce their answer in the form of briefing notes, using appropriate headings and a clear structure. Candidates however tended not to gain the professional mark available for the clarity of their answer, because explanations were often confused, repetitive, or non-existent. Some candidates did not separate their answers into (ai) and (aia), which, as well as making the answer hard to mark, meant that professional marks were hard to award, as the answers were often confusing and would not have been clear enough for the audit team to follow.

Regarding the use of professional language, candidates need to bear in mind that professional marks are awarded partly for the quality of language used. This requirement asked for briefing notes to be used at a meeting with your audit team. So comments such as 'you need to google the client', 'the client may be facing massive risks that need to get sorted', and 'ask the client whether they have any integrity' will detract from the quality of the answer provided.

A final comment on (a) – many answers seemed disproportionately long given the marks available. This usually meant that the answers to (b) and (c) were rushed and not detailed enough to score well. Candidates are reminded of the need to carefully allocate time between question requirements.

Requirement (b) asked for an evaluation of business risks facing the company. Risk assessment is a key part of the syllabus, as highlighted in the Examiners' Approach article, and this part of the question should not have been a surprise to candidates. It was therefore pleasing to see the majority of candidates perform reasonably well on this requirement.

The scenario contained a variety of business risks, and most candidates covered a range of these risks in their answer. Candidates who performed well on this requirement tended to identify and explain the various business risks in the specific context of the question. For example, identifying that non-compliance with health and safety regulations is a major risk, and then going on to explain that in the event of non-compliance, the company may face monetary penalties, or the revocation of an operating license. Some candidates considered that the current economic climate means that fewer people are spending money in luxurious restaurants, posing a risk to the City Sizzler chain in particular. Most candidates used headings to provide a logical structure, and the best answered ended with a conclusion as to the overall level of risk exposure, and a prioritisation of risks.

However, there were some common weaknesses to the business risk evaluation, outlined below:

- Failure to use the financial information provided to identify risks – candidates should have used the figures provided to calculate profit margins, consider the declining level of cash, and to calculate the trend in revenue for each of the brands
- Focussing on financial statement risk, which was NOT a requirement of the question, for example, discussion of the impact on the financial statements of provisions, impairment, etc was not relevant to the requirement
- Trying to link every risk identified to a going concern risk – it is true that Chompers 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

- Some risks that amounted to general speculation, for example ‘the risk of lorries from the busy road crashing into restaurants and killing people, leading to a loss of customers and revenue’. There were enough clear indications of risk in the scenario to make such speculation unnecessary.

Requirement (c) tended to produce the weakest answers to this question. (ci) asked for principal audit procedures relevant to the amount capitalised in relation to the construction of new restaurants. Few candidates could suggest anything other than ‘check the relevant invoices’ or ‘check the amount was approved’. These comments are simply not specific enough to be given credit. Some candidates suggested procedures based on verifying the capitalised borrowing costs to finance agreements, and analytical procedures such as comparisons of the amounts capitalised in each restaurant.

(cii) asked for audit procedures in relation to the amount recognised as an expense for advertising of a brand. Most candidates here failed to read the requirement, and the scenario, both of which stated that the advertising costs had been expensed. Most candidates however, ignored this fact and discussed the merits of recognising the amount as an intangible asset, which as well as being completely irrelevant is also technically incorrect. Only the best answers provided any relevant audit procedures at all for this expense.

Candidates are reminded to restrict their comments to those which are specific to the question requirement; in this case ONLY principal audit procedures were required in both parts of (c). Therefore discussions of materiality, relevant financial reporting standards, and implications for the audit opinion were irrelevant. Again, most procedures, when provided, were too vague to be awarded credit, typical examples being ‘check for the accuracy of the expense’, or ‘check correct classification of the expense’.

Finally, candidates should remember that written representations from management as a source of audit evidence should generally be reserved for situations where evidence is not available from other sources. It was disappointing to see that for both (ci) and (cii), management representations were commonly recommended as a principal audit procedure, usually along with ‘check for board approval’.

Question Two

This question featured a large global group of companies, with ambitious expansion plans, which was listed on several stock exchanges. As mentioned in previous Examiners’ Reports and articles, group audit issues are considered to be an important part of the syllabus, so candidates should consider the comments made on this question carefully.

Requirement (a) was a short factual requirement, not related to the detail of the question scenario, which asked candidates to explain four reasons why a firm of auditors may decide not to seek re-election as auditor. There were two main problems with answers to this requirement. Firstly, too few candidates actually provided an explanation of the reasons they gave. For example, an answer stated that the auditor had a disagreement with the client over something in the financial statements. While this is indeed a reason why the auditor may chose not to seek re-election, it is not an explanation, which would entail going on to say that the disagreement had caused a breakdown in the working relationship between the auditor and client, and that the auditor had lost faith in the competence and /or integrity of management.

Secondly, the requirement asked for FOUR reasons. It is a waste of time and effort to provide more than the required number of reasons.

The second requirement focussed on the audit tendering process, and asked for matters to be included in a tender document to be presented to the Dragon Group. This requirement seemed to polarise candidates. Those candidates who tailored their answer to the question scenario tended to do well, with a significant proportion achieving close to the maximum marks available. However, candidates who provided a list of points to be included in ANY tender, regardless of the information provided about the prospective client, and about your audit

firm, scored inadequately. In other words, it is important to apply knowledge to score well, as is true for any scenario-based question.

Sound answers to (b) appreciated that the point of the tender document is to sell your audit firm's services to the client, and recommended points to include such as the global positioning of both audit firm and prospective client, the specialism of the audit firm in retail, and the firm's ability to potentially provide services relating to the expansion plans of the group, such as due diligence.

Weak answers simply stated vague comments: 'we should discuss fees', 'we should set a deadline,' etc. Some answers confused a tender document with an engagement letter, and included points more suited to that document, such as a statement of responsibilities or a legal disclaimer.

Inadequate answers to (b) were those that seemed to confuse the requirements with those of (c). Candidates are reminded that it is important to read ALL of the requirements of a question before beginning their answer, to avoid such confusion. Examples of statements commonly seen in answers to (b) which are more relevant to (c) are:

- 'are we competent to audit the group'
- 'can we audit the goodwill and foreign exchange transactions which are complex'
- 'will any of our audit staff want to go abroad to work'
- 'do any of our partners hold shares in Dragon Group'.

These comments definitely do not belong in a tender document, which should highlight the audit firm's capabilities to service the prospective client, rather than question the firm's competence or ability to take on the assignment. Such comments indicate a failure to read and understand the question requirement, as well as a lack of commercial awareness.

Requirement (c) asked candidates to evaluate the matters that should be considered before accepting the audit engagement. Answers here were weak, despite this being a regularly examined syllabus area. Most answers were not tailored to the question, and just provided a list of questions or actions, such as 'get permission to contact previous auditor', or 'check the integrity of management', and 'do we have the skill to audit foreign currencies'.

Providing a list of such comments will not generate enough marks to pass the question requirement.

Better answers discussed, amongst other points:

- the risk posed by the numerous stock exchange listings of the potential client, and whether the audit fee would be enough to compensate for that risk
- the practical difficulties entailed in co-ordinating an audit of more than 20 companies across many different countries
- the tight deadline imposed by the potential client, especially in light of this being a first year audit, and the learning curve that the audit firm would need to go through.

Some candidates appeared to think that the audit would be too much trouble – a sizeable number of scripts contained comments such as 'auditing a company far from our main office would be tedious and inconvenient'. I would suggest that most audit firms, on being successful in a tender for an audit as significant as this, would consider the inconvenience worthwhile.

Requirement (c) had 2 professional marks associated, awarded for the clarity and presentation of the evaluation provided. It was not necessary to present the answer in a particular format, the presentation mark was awarded to candidates who used headings and a logical structure. An evaluation should contain prioritisation, and a conclusion, but very few candidates suggested that some of the matters they had considered were more important than others, and even fewer concluded as to whether the firm should accept the appointment as group auditor.

Requirement (d) was the worst answered on the paper. Clearly, very few candidates had studied the issue of transnational audits, and answers displayed a lack of knowledge. (di) asked for a definition of transnational audit, and an explanation as to why the term was applicable to the Dragon Group audit. Only a small minority of candidates could provide the correct definition, the rest guessing from the scenario that it was 'an audit covering many countries', or 'an audit performed by several audit firms from different countries', neither of which is true. (dii) asked for two features of a transnational audit that contribute to a high level of audit risk. Answers again appeared to be based mainly on guesswork, with common suggestions being 'language difficulties' and 'communication barriers'. However, some candidates could identify variations in auditing standards and financial reporting frameworks as issues contributing to high risk, but these points were rarely developed to their full potential.

Question Three

The first part of this question was a standard audit evidence question of the type seen in numerous previous examinations. Requirement (a) asked candidates to comment on the matters that should be considered, and the audit evidence they should expect to find in respect of finance leases of land and buildings (ai), and financial assets (aia). Nearly all candidates correctly calculated and concluded on the materiality of both items, and considered the financial reporting implications of the information provided.

In terms of the finance leases, most candidates identified the correct financial reporting standard, and discussed the classification of the lease as finance or operating lease. Some candidates could provide nothing further, but better answers continued on to describe the factors that should be considered in lease classification, referring not just to 'substance over form', but to the specific indicators that risk and reward had passed to the lessee. Only a small minority of candidates discussed whether the lease should be unbundled into the separate land and buildings elements.

The evidence points tended to be quite brief for this requirement, usually limited to 'check the lease document', 'check lease approved by management' and the inevitable 'get management representation that it is a finance lease'. Such comments are much too vague, and better answers provided more specific pieces of evidence that should be sought, such as a recalculation of minimum lease payments, and a review of the clauses of the lease in terms of responsibility for insurance and repairs to the assets.

(aia) was generally unsatisfactorily answered, and the information given in the question was often mis-interpreted. Candidates tended to know the number of the relevant financial reporting standard for financial assets, but not the technical content of that standard. Despite the question clearly stating that the assets are all investments in listed companies, a significant proportion of candidates chose to base their answer around investment properties, and others seemed to think the assets were some kind of inventory, to be valued at the lower of cost and net realisable value. Even those candidates who appreciated that the assets were investments were confused by terminology, frequently stating that 'fair value through profit and loss' and 'held for trading' are contradictory, which is not the case. Most candidates thought that the revaluation gain should not be recognised in profit for the year, which again is not the case.

The evidence points were also inadequate for this requirement. Even a candidate lacking knowledge of the financial reporting issues for investments in listed companies should be able to suggest confirming the year end share price to an external source of information on share prices, such as the financial times, but unfortunately few candidates could even provide this as a piece of evidence.

Requirement (b) was unsatisfactorily answered by almost all candidates. This asked for the principal analytical procedures that should be used to gather evidence in a review of interim financial information. Candidates are repeatedly reminded that non-audit engagements are part of the syllabus, and likely to feature regularly in the examination. However, few candidates seemed to know the purpose of a review of interim financial information,

which meant that their answers lacked clarity. Most answers could only suggest a comparison with the prior period, and hardly any answers mentioned the disaggregation of data, or comparison with budget. Only a handful of candidates seemed aware of the existence of ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, on which the requirement is based.

Some candidates confused a 'review of interim financial information' with an 'interim audit', despite the short scenario describing a review of interim financial information for the avoidance of any such confusion.

Question Four

This was the most popular of the optional questions, and was based on ethical and professional issues. As noted in previous Examiners' Reports, candidates seem to think that the 'ethics question' is an easy option, but the performance of candidates in this question continues to be disappointing.

Requirement (a) asked candidates to explain the term 'professional competence and due care' and to outline how firms can ensure the principle is complied with. Some answers to this requirement were sound, including a clear definition, and a number of practical suggestions, such as the provision of training for staff, study support for trainees, and the establishment of appraisals and monitoring procedures. A proportion of candidates achieved maximum marks for this requirement. However, some candidates could not provide a definition other than 'professional competence is when you are competent to take on a professional engagement,' which does not add anything to what is given in the question. Due care was sometimes badly defined as just 'being careful' or 'acting professionally'.

Part (b) was based on a short scenario, in which your audit client has been found to be manufacturing dangerous goods, and has failed to recall those goods. Requirement (bi) asked for the issues raised, and the actions necessary in respect of the dangerous goods. Answers were often limited to brief comments relating to the client's lack of integrity, and the need to recall the products. Many candidates missed the main point of the requirement, which was the auditor's duty to maintain confidentiality, and whether that duty should be breached in this case in the public interest. Only the better answers considered the potential impact of the events on the financial statements, or the risk to the audit firm's reputation if the situation is not handled appropriately. A significant proportion of candidates focussed entirely on what the client should do in this situation, (better quality control, sack the production manager, put a notice in newspapers, etc), and hardly mentioned the ethical and professional issues relating to the audit firm at all.

Requirement (bii) focussed on the invitation to audit a competitor of your audit client. Although the mark allocation for (bii) was lower than that of (bi), most candidates wrote the same, or more, for (bii). Answers here tended to be adequate, with the majority of answers identifying the problems of conflict of interest, and client confidentiality, and most were able to recommend appropriate actions such as full disclosure of the situation, and the use of separate teams for the two clients if the audit appointment were to go ahead.

Question Five

The final question of the paper focussed on audit reports, and fraudulent financial reporting, which had been discussed in a recent examiner's article. Requirement (a) asked for an explanation of the term 'fraudulent financial reporting', with some examples to illustrate the explanation. Answers on the whole were reasonable, and in terms of illustration, a range of examples were usually provided.

Requirement (b) was a critical appraisal of extracts from an audit report, which contained an adverse opinion due to disagreement, and an emphasis of matter paragraph concerning the non-disclosure of the earnings per share figure. Answers were on the whole unsatisfactory. As noted in previous examiners' reports, candidates seem not to understand the concepts underpinning the qualification of an audit report, and have even less comprehension of the use of an emphasis of matter paragraph.

Looking initially at the adverse opinion, most candidates correctly suggested that a disagreement had indeed occurred, and that an adverse opinion may be too harsh, meaning that an except for qualification would be more suitable. Fewer went on to criticise the audit report for its lack of quantification of the amount of the material misstatement.

Most candidates did not appraise the wording of the extract, but there were easy marks to be gained here, for example, for suggesting that the title of the financial reporting standard should be written in full, and the lack of reference to note or page numbers where more information about the redundancy costs could be found in the financial statements. Few candidates suggested that the description of the disagreement was inadequate, though it was deliberately so. The best answers rightly criticised the use of the word 'feel' in an audit report, as well as it being inappropriate to put forward the views of the directors in the report.

Regarding the emphasis of matter paragraph, a significant proportion of candidates did not attempt this part of the requirement. Those that did gained credit for briefly explaining the correct use of such a paragraph, but fewer went on to say why its use in this situation was inappropriate. Many candidates did not appreciate that the company in the question was listed, so disclosure of the earnings per share figure would be required.

Finally, many candidates were extremely concerned about the audit report containing both an adverse opinion and an emphasis of matter paragraph, missing the point that the opinion and the emphasis of matter paragraph dealt with two completely separate issues.

Requirement (c) asked for an explanation of the matters to be considered in deciding who is eligible to perform an engagement quality control review for a listed client. Answers tended to be very brief, often in a bullet point format. The majority of answers mentioned that it should be a partner with experience who should perform the review. Though most candidates could suggest that the reviewer should be independent of both the audit team, and the audit client, few could suggest why.

Conclusion

This sitting produced some sound scripts, but on the whole there has been little, if any, improvement in the quality of answers. Candidates must consider the comments made in this report while preparing for an attempt at this challenging paper.

Unfortunately the majority of candidates continue to produce answers that lack focus, do not actually answer the question requirements, display inadequate technical knowledge and very little application, and in some cases are technically incorrect. These candidates are encouraged to improve their examination technique by practicing as many past exam questions as possible, and by taking on board the comments made in examiner's articles and reports.

All candidates are reminded that current issues are important to this paper, and questions on topical matters will be regularly tested. In order to pass this examination it is important to read widely and make use of on-line resources, such as those provided in the student section of ACCA's website.