Examiner’s report
P7 Advanced Audit and Assurance
June 2011

ACCA

General Comments
Candidates’ performance in the June 2011 P7 paper was unsatisfactory. The paper was the first to be set in a new style (explained in Examiner’s articles in January 2011). Candidates did not appear to find the new style problematical. However, candidates’ lack of ability to apply their knowledge to the scenarios provided continues to contribute to the low success rate for this paper. And unfortunately many candidates simply failed to answer the specific question that had been set.

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 a short scenario, and several requirements. Of the section B questions, question 3 was the most popular, and question 5 the least popular.

Similar factors as detailed in previous examiner’s reports continue to contribute to the unsatisfactory pass rate:
- Failing to answer the specific question requirements
- Not applying knowledge to question scenarios
- Not explaining or developing points in enough detail
- Lack of knowledge on certain syllabus areas
- Illegible handwriting.

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 37 marks and involved a property development company which was a long-standing audit client. The candidate was placed in the role of a newly assigned audit manager, whose first task in requirement (ai) was to explain the matters that needed to be considered, and the financial statement risks relating to two issues. The planned audit procedures in response to the risks identified were also required. This requirement was for 16 marks. Candidates responded well to the new style of question requirement, whereby the specific requirement was provided in an email from the audit partner. The wording of the requirement should have been familiar as has been used in many past questions.

Most candidates recognised the loss-making nature of the contract described in the scenario, and correctly calculated the loss, and the majority then went on to discuss the financial statement risk that profit would be overstated if the loss were not recognised in full. However, having gone this far, many candidates then went on to consider other potential accounting issues and different financial reporting standards, leading to confused answers and often contradictory advice. The most common example here was where a candidate having stated that the loss should be recognised in full (“to be prudent”), they then went on to argue the opposite point in the next sentence - that according to revenue recognition principles only a part of the loss should now be recognised. No conclusion was provided and the contradictory comments clearly detract from the overall quality of an answer. Some candidates simply could not decide which financial reporting standard was most relevant, and applied several or all of the following to the contract in question: provisions (IAS 37), property, plant and equipment (IAS 16), development costs (IAS 38), inventories (IAS 2) and investment properties (IAS 40). It was common to see answers of this type stretching over many pages, when all that was needed was a succinct discussion of the loss making contract in the context of IAS 11, which could be done in a few short paragraphs.

The other common problem were answers which focussed on business risks rather than financial statement risks, leading to long discussions of cash availability, the company's reputation, and inevitably going concern problems.

The procedures recommended for the loss making contract were often too vague to score credit, e.g. many candidates recommended that the architect's plans should be obtained, but did not say what the auditor should do with them. Similarly, it was often recommended that the auditor should obtain the forecast of the development, but then failed to say what should be done with it. Candidates should note that obtaining a document is not in itself an audit procedure.

The second issue in requirement (ai) dealt with a significant business segment which management planned to sell, which should have lead candidates to discuss whether the business segment should be classified as a discontinued operation / held-for-sale disposal group at the year end. Most candidates did correctly identify this issue and could properly apply the IFRS 5 criteria to justify their answer. However, the same problems as noted above for the loss making contract equally applied here – many candidates seemed unsure which was the relevant financial reporting standard, and went on to discuss disclosure as an event after the reporting date (IAS 10) and /or provisions (IAS 37). This wasted time and meant answers were overly long and largely irrelevant. Few candidates could recommend any procedures other than "discuss with management" or "review board minutes"- which are relevant but must be explained to earn a mark. Again, some candidates continued their obsession with going concern matters here, discussing at length whether it was the right decision to sell off the business segment, and advising management to reconsider.

The UK and IRL adapted papers contained a different second issue – an operating lease which had characteristics of an onerous contract. Many did identify the onerous contract but could say little more than that a provision should be made. Many also ignored the question and discussed the lease as if it were a finance lease, leading to irrelevant discussion as to whether the asset in question was impaired. Again, there were a lot of discussions of business risks (not asked for), plenty of criticism of management's decision to purchase a new warehouse, and advice to potentially minimise the losses incurred. Candidates really need to focus on audit issues .

On the whole, the answers to (ai) were unsatisfactory, with most lacking focus and containing a lot of irrelevant discussion. Candidates did not need to write a lot to score very well on this requirement, and it was a shame to see candidates wasting so much time on irrelevance. This shows how important it is to read the question carefully and to spend a little time thinking and clarifying the audit issues instead of rushing to put pen to paper as soon as possible.

The second task, in requirement (aii) required candidates to critically evaluate the audit planning that had been prepared by the previous audit manager, for 11 marks. Most candidates scored well on this requirement, especially given the wholly applied nature of the question and requirement. The ethical issues in particular were usually well explained, the quality control issues less so. Some candidates tended to use a logical approach – working through the scenario to discuss each issue in turn. However some candidates talked generically about independence issues without really explaining the point, e.g. just stating "familiarity is a problem", "we must be independent", and there were many calls for the previous audit manager to be disciplined for her "incompetence". But on the whole this was one of the best answered requirements for many candidates.

There were 2 professional marks available in connection with requirement (a). Most candidates attempted the briefing notes format by including an appropriate heading and introduction. Candidates are reminded that resources are available on ACCA's website providing guidance on the importance of professional marks.

Requirement (b) was for 8 marks, and dealt with related parties. Requirement (bi) required candidates to explain the limitations which mean that auditors may not identify related parties and related party transactions, for 4 marks. On the whole answers were satisfactory, with most candidates able to explain that knowledge is confined to management, and that transactions at nil value are impossible to detect from accounting systems. Some answers found a variety of ways to say "they are difficult to find out about" without actually explaining the limitations. Requirement (bii) asked for audit procedures specific to related party transactions described in the scenario, for 4 marks. Answers were often unsatisfactory here, as many candidates ignored the question requirement and just provided a rote-learnt list of procedures to identify related party transactions in general, not focussing on the transactions in the scenario. Even those that did think about the scenario provided inadequate procedures e.g. "check the lease is market rate"- but not explaining how the auditor should do this.

Question Two
This question was for 27 marks, and was largely based on going concern. The answers to this question were generally unsatisfactory.

The candidate was placed in a role as audit manager of a new client, with the first task in requirement (ai) being to review draft extracts from financial statements and a cash flow forecast to identify and explain matters which may cast significant doubt on the company's ability to continue as a going concern. The majority of candidates seemed to ignore this instruction, providing an answer that did little more than work down the statement of financial position, calculating the materiality of each balance, and discussing the accounting treatment of each item, saying nothing about going concern. Only when turning to the cash flow forecast did these answers say anything about going concern, and then the comments were usually restricted to the likelihood of the company receiving a loan and a subsidy. Some candidates tended to get confused when looking at the cash flow forecast and tried to apply financial reporting rules e.g. by arguing that the income from the government grant should be deferred.

However, there were some sound answers focussing entirely on going concern matters, providing relevant calculations, e.g. the total amount of debt due to be paid in 12 months, and discussing ratios such as the current and quick ratios to provide discussion points. Some answers saw that the parent company would be unlikely to provide a further loan to its loss making subsidiary when it already has a loan advanced which is unlikely to be paid back, and that on this basis surely the company could not continue in operations.

The second task, in requirement (aii) was to recommend audit procedures to be carried out on the cash flow forecast. Most candidates could provide at least a few well explained procedures – the most common focussing on the loan from the parent company and the government grant. Some procedures were not well explained e.g. "check the price of the financial asset" without saying how this could be done. Some answers provided procedures for the assets and liabilities on the draft statement of financial position, which was not asked for. Most candidates identified the extreme optimism of the cash flow forecast and that the closing cash position was negative, but not many candidates could recommend sound procedures to verify the claims of management regarding cash receipts from customers, which was a key issue.

Finally, there were 2 professional marks available for requirement (a). The majority of candidates attempted to achieve these marks by using an appropriate format but often no conclusion was provided.

Requirement (b) dealt with the impact of multiple going concern uncertainties on the auditor's report, for 7 marks. Although some candidates scored well on this requirement, the majority again failed to answer the question as set, and discussed every conceivable auditor's report that could be issued for a client with going concern problems. The question stated that "the use of the going concern assumption is appropriate", yet many candidates ignored this and spent a lot of time discussing what should happen if the use of the going concern assumption were NOT appropriate. Most candidates earned a few marks by discussing the use of emphasis of matter paragraphs, but often the description of the paragraph was brief. Only a minority correctly focussed their answers on the requirement for management to disclose significant uncertainties in the notes to the financial statements, and that the adequacy of these disclosures would drive the auditor's opinion on the financial statements. Overall answers were very inadequate.

The UK and IRL adapted papers contained a different requirement (b), which dealt with a new syllabus topic – auditing aspects of insolvency. Specifically the requirement was to explain the procedures involved in placing a company into compulsory liquidation (4 marks) and to explain the consequences for creditors, employees and shareholders (3 marks). Most candidates had obviously studied this new topic and consequently scored well. There was sometimes confusion between compulsory and voluntary liquidation, and often the order of payment of assets in the event of liquidation was incorrect. However, most candidates made a satisfactory attempt at this requirement.

Question Three
This was the most popular of the optional Section B questions, probably because 10 of the 18 marks available were related to audit acceptance and ethical issues – both of which are topics which candidates seem to be comfortable with. However, the remaining 8 marks dealt with the requirements of ISA 510 on opening balances, and unfortunately candidates' obvious lack of knowledge of this syllabus area meant that for many this was actually an inadequate choice of question.

Requirement (a) involved a new potential new audit client, and candidates were asked to identify and explain the matters that should be considered in deciding whether to accept the audit appointment. Candidates who had practised previous similar exam questions would have been well prepared, and there were many sound answers. Candidates were comfortable in discussing the specific ethical issues relevant to the scenario including self-review, confidentiality and conflicts of interest, and it was good to see a good number of answers refer to the requirements of ISA 210 on audit preconditions, which had been the subject of a recent Examiner's article.

Some answers were not made specific to the scenario, and discussed general matters such as resourcing, fees and engagement letters. It was interesting to see so many candidates being overly critical of the client's part-qualified accountant, who was often accused of incompetence, lack of integrity, and even fraudulent activities. As all candidates taking this paper are themselves part-qualified accountants maybe a little more insight into this person's role in the client's accounting function would be appropriate.

Requirement (b) dealt with opening balances and was inadequately answered by the majority. Some candidates could explain the audit procedures required by ISA 510, but few could recommend more than a couple of specific procedures in relation to the opening balance of inventory as specified in the requirement. Many answers gave procedures for non-current assets, receivables and cash which were not asked for, and many forgot that the company in the question had not been audited before, leading to irrelevant discussion of "previous auditor's working papers". Many suggested impossible procedures e.g. "reperform last year's inventory count" and very few picked up on the major issue of obsolescence given the company's inventory comprise calendars and diaries.

Question Four
This was the second most popular of the optional questions, and focussed on due diligence. The scenario described a potential acquisition being planned by an audit client of your firm.

Requirement (a), for 6 marks, required an explanation of three benefits of an externally provided due diligence review to the audit client. This was reasonably well answered, though many answers were not made very specific to the scenario and tended to discuss the benefits of any due diligence review rather than an externally provided one. Also, a significant number of candidates provided more than three benefits, which was a waste of time.

Requirement (b), for 12 marks asked for additional information to be made available for the firm's due diligence review. Answers were satisfactory, and the majority of candidates did not struggle to apply their knowledge to the scenario, usually providing some very focussed answers dealing well with the specifics of the question scenario.

Most answers seemed to use a logical approach – working through the information provided to generate answer points, and this meant that on the whole most of the key issues from the scenario were covered in the answer. A small proportion of answers also included irrelevant discussions of the type of report that would be provided to the client, or a discussion of ethical issues which were not asked for.

Question Five

This was the least popular of the optional questions, focussing on audit reports and group audit issues. The scenario described a group audit in which the component auditors suggested a qualified audit opinion on a subsidiary's financial statements due to an alleged material misstatement concerning a provision.

Requirement (a), for 10 marks, asked candidates to identify and explain the matters that should be considered and the actions that should be taken by the group audit engagement team in forming an opinion on the consolidated financial statements. Most candidates gained marks by calculating the materiality of the provision to the group and to the individual financial statements of the subsidiary. However, few determined the materiality of the component itself to the group.

Candidates are usually happy to be critical of auditors in question scenarios, but in this case when it was actually appropriate to raise concerns over the evidence (or lack of it) obtained to support the qualified opinion, very few answers tackled this issue. However, some candidates did waste time criticising the extract audit report that had been provided – this was not asked for – and implied that candidates had not read the question requirement at all. Only some candidates picked up on the fact that an adjustment could be made at group level to avoid any qualification in the consolidated financial statements, and that pressure could be put on the subsidiary's management to adjust in the individual financial statements as well.

Few candidates provided any "actions" at all, which was unsatisfactory as some relatively easy marks could have been gained by suggesting a detailed review of the component auditors working papers, requesting evidence from the subsidiary's management to support their accounting treatment, or discussing the matter with those charged with governance.

Requirement (b) asked candidates to explain the principle audit procedures that should be performed on the consolidation process, for 8 marks. Many candidates clearly knew the consolidation process very well, but had trouble expressing this knowledge in terms of audit procedures. Many answers simply described what should happen in a consolidation, and thought that by including the words "check" or "ensure" every so often that would be enough e.g. "check goodwill calculation", "ensure all subsidiaries included" but didn't actually say how these things should be done. However, despite these problems most answers were satisfactory. Taking a step back to consider the effectiveness of controls over the whole process was rarely considered.

The UK and IRL requirement (b) was different, and concerned a subsidiary that had been disposed of during the year. The requirement was to comment on the matters that should be considered and the evidence that should be found in a review of audit working papers. Candidates responded well to this, and most earned marks by calculating materiality, discussing the appropriate accounting treatment in the consolidated financial statements, and could provide several examples of relevant evidence.

Repeating a comment made in the previous Examiner's report, answers to question 5 (a) were unsatisfactory, given that audit reports is a regularly examined syllabus area.

Conclusion

As seen in previous sittings, what makes the difference between a pass and a fail script is usually the level of application skills which have been demonstrated. Candidates who answer the specific question requirement, and tailor their answers to the scenarios provided are likely to do well. At this sitting a large proportion of candidates simply failed to answer the actual question requirement, especially in Q2(ai).

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 t about which accounting standards are being used in answering questions.