Examiners' report
P7 Advanced Audit and Assurance
December 2007

Introduction

The results from the first sitting of the new syllabus indicate that many candidates prepared thoroughly for the examination, achieving reasonable marks across the questions attempted. However, the average mark was disappointing, and it was clear that a significant minority of candidates had failed to study the syllabus in sufficient detail, resulting in answers that were vague, sometimes technically incorrect, and often failed to answer the actual requirements that had been set. 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 examination comprised two compulsory 30 mark questions in Section A, and three further 20 mark questions in Section B from which candidates chose two questions.

Only a very small minority of candidates failed to attempt the correct number of questions. It seems that having only four questions to answer, and the inclusion of reading time, has allowed candidates to improve their time allocation substantially.

There was a reasonable spread in the choice of optional questions in Section B. The most popular choice was Question 4, the least popular was Question 3.

The pass rate for the paper is disappointing. Many factors appear to contribute to this, including:

- Failing to answer the specific question requirements
- Failing to apply knowledge to the scenarios provided
- Lack of technical knowledge – both assumed knowledge from previous papers, and knowledge specific to P7
- Lack of commercial awareness and even a lack of common sense

The comments for each question on the paper explain the above in the context of specific question requirements.

Question 1
This 30 mark question tested the candidates' ability to perform an audit risk assessment at the planning stage of an audit, to suggest audit procedures relevant to a provision, and to discuss quality control issues with particular relevance to a small firm of Chartered Certified Accountants. This style of question had been seen repeatedly under the previous syllabus, so the type of question scenario and indeed the requirements should not have been a surprise to candidates. In addition, the Examiner's Approach article highlights that audit planning and risk assessment is a key area of the syllabus. It was therefore pleasing to see many candidates scoring well on part (a), displaying sound analytical skills, showing a clear understanding of the concept of audit risk, and an ability to apply their understanding to the scenario provided. However, many candidates clearly misunderstood the concept of audit risk, and confused audit risk with business risk, leading to wholly inappropriate comments. Examples of this included:

- Suggesting 'foreign exchange' as an audit risk with no discussion of the potential for misstatement of liabilities or exchange gains or losses in the financial statements.
- Suggesting 'going concern' as an audit risk, but with no explanation of the impact of this at the transaction or disclosure level.
- Suggesting 'potential for litigation or claims' as an audit risk, with no indication of how this could result in liabilities or the need for disclosure within the financial statements.

It is disappointing that at this level candidates seem unable to distinguish between audit risk and business risk, meaning that a significant minority of candidates failed to answer the question requirement. In addition, many candidates wasted valuable time in the examination by producing a detailed discussion of the coal mining industry, how the industry is in decline, and how environmentally unfriendly the industry is. This may be true, but it does not answer the question. Firstly, these comments could be classified as business risks, but they are not audit risks, and so are irrelevant. Secondly, your client is not actually a coal mining business, it is a engineering firm which designs, manufactures and installs machinery – a fundamental fact that it appears a lot of candidates did not pick up on.

In addition, some candidates included irrelevant discussion of audit acceptance issues in their answer to part (a), with comments such as 'do we have enough competent staff', 'we need to sign an engagement letter', and 'we need to decide on a fee level' commonly seen. Candidates need to make sure that they read the question carefully and understand the 'time line' in the question. Here, your firm has already been appointed auditor, and you are in the process of planning the audit. It is too late to be wondering whether your firm should have accepted the appointment, and how much you might charge for the engagement.

Some financial data was provided in the scenario, and many candidates used the figures to ascertain the materiality of some of the financial statement balances that were discussed. However, just stating 'we need to consider materiality' earns no marks when it is possible to actually calculate it from information in the scenario.

The marking guide for part (a) included 2 professional marks. The requirement was to prepare briefing notes, and professional marks were awarded where candidates used an appropriate format, such as a clear heading indicating that the document was indeed briefing notes, a brief introduction and conclusion, and the use of headings and sections within the document to display a logical structure. Candidates should be aware that ignoring the instruction to produce the answer in a certain format means that the professional marks cannot be awarded.

In part (b) candidates were required to suggest audit procedures relevant to an estimated warranty provision. There were some sound answers here, indicating that many candidates had prepared well for this type of requirement. However, there were many vague suggestions, such as 'get a management representation', 'get an expert opinion' and 'compare with industry average'. All of these suggestions are not specific enough to answer the requirement, and in the case of an industry average I would be surprised if such a statistic existed, and if it did, how appropriate any comparison between Island Co's provision and an industry average would be.

The final section of the question focussed on quality control. On the whole answers were reasonable for the first part of the requirement. My first comment here would be to remind candidates to read the requirement carefully, and when asked for FOUR quality control procedures, they should restrict their comments to FOUR procedures. It is a waste of time to write any extra. Additionally, candidates should have picked up on the fact that they should have discussed procedures relevant to the individual audit engagement. Hence, discussions of firm-wide quality control procedures, such as appointing an ethics partner, and conducting firm-wide training on ethics were totally irrelevant. Candidates must only answer the specific question that has been set.

The final requirement was by far the least well answered in Question 1. Candidates were asked to discuss the particular problems faced by small firm of Chartered Certified Accountants in implementing quality control procedures. Although some candidates provided a logical discussion and some reasonable, practical recommendations, many candidates displayed an appalling lack of tack and professionalism in answering the question, seeming to condemn small firms as totally incompetent, and having no ability to produce good quality work at all. Typical comments along these lines included:

- 'small firms cannot attract competent staff'

- ‘small firms have no resources’
- ‘small firms focus on getting new business and ignore quality controls’

…and the most common suggestion as to how small firms can overcome these alleged ‘problems’ was for small firms to merge with each other and thus avoid being small.

Candidates must appreciate that these types of comments are wholly inappropriate and display a real lack of any kind of commercial awareness.

Question 2
This question was based on a pharmaceutical company, and information was provided in relation to the company’s research and development activities, and its payroll function, which had been outsourced during the year. There was also some data regarding the company’s key performance indicator targets, which had to be met in order for the company to receive a substantial amount of government funding.

Part (a) concerned the outsourced payroll function, with candidates required to discuss the matters to be considered in planning the audit of payroll. This was a broad requirement, and many candidates produced good answers covering a variety of ‘matters’, including the materiality of the payroll expense, the audit approach to be considered, and the need to contact, and very likely visit, the service organisation providing the payroll function. The best answers used the data provided to perform some simple analytical review, leading them to discuss why the salary expense figure had decreased from the previous year, when the turnover had increased. It was however disappointing to see that very few candidates really discussed in any depth the requirements and guidance contained in ISA 402 *Audit Considerations Relating to Entities Using Service Organisations.* Some answers to part (a) simply stated a list of audit procedures relating to payroll, totally ignoring the fact that the function was now outsourced, and many answers provided a list of pros and cons of outsourcing which clearly was not asked for. Some candidates assumed that they would be able to rely on Propay’s records without any further work, some thought that they could rely on the work of Propay’s auditors, neither of which is true.

Professional marks were awarded in part (a) for the breadth of topics discussed, and for displaying a sensible prioritisation of the issues contained in the scenario, including an appreciation that outsourcing would have a significant impact on the planning and the execution of the audit of payroll.

Part (b) focussed on the audit of development costs which had been capitalised as an intangible asset. The answers were on the whole rather disappointing. Requirement (bi) required a discussion of matters to be considered in deciding on the appropriateness of capitalising the development costs. Most candidates could reel off the criteria for capitalisation under IAS 38 *Intangible Assets*, which is relevant, but few candidates then went on to apply the criteria to the scenario provided. It is very important that candidates appreciate that at this level of professional examination, few marks can be awarded for the rote-learning and regurgitating of facts, such as accounting standards criteria, without any application to the question. Candidates who discussed the possible impairment of the development intangible asset due to a competitor’s actions performed well, as did candidates who questioned the continued availability of government funding which was dependent on KPI targets being met. Examiners do not provide detailed information such as this in scenario questions for no reason – the information is there to be read, understood, and used in answering the question. Some answers didn’t contain any relevant points from the question scenario.

Answers were also unsatisfactory for requirement (bii), where candidates were asked for the evidence they would seek to support the assertion that the capitalised development costs related to projects that were <u>technically feasible</u>. Most candidates ignored this requirement and instead gave a list of evidence that would be relevant to other assertions, for example, that the development was commercially viable (market research being the most common source of evidence quoted here), or that the projects’ costs were separately identifiable (the evidence commonly referred to here was the mysterious ‘management approval’). Technical feasibility is nothing to do with commercial viability or management approval. Candidates should have asked themselves 'what would give me evidence that Sci-Tech can actually make this product' (e.g. scientific test results), not 'will they be able to sell this product' (e.g. positive results from market research).

Requirement (c) focussed on audit procedures relevant to the amortisation of capitalised development costs. Many candidates appeared to have confused this with the previous requirement, or simply gave unclear examples of audit procedures along the same lines as discussed above with reference to question 1(b), for example 'get management representation', 're-perform calculation', and 'compare with industry average'. As discussed above, these vague comments are not detailed audit procedures and are not worthy of credit at this stage in the professional examinations.

The final section of the question covered the provision of an assurance engagement on the company's published KPIs. The inclusion of this part of the syllabus in a compulsory question should not have been a surprise, as the Examiner's Approach article clearly states that non-audit assignments are likely to feature in every examination. In addition the Examiner's articles *Continue to Rest Assured*, and in particular *Clear Thinking* both covered the issue of KPIs being increasingly disclosed by companies. It was clear that those candidates who had taken the time to read through these articles as part of their preparation for the examination performed well here. However, there were common mistakes. Many candidates seemed to misread 'key performance indicator' as 'prospective financial information' and the word 'target' as 'future', and proceeded to provide a wholly inappropriate discussion of gathering evidence in relation to forecasts. Some candidates focussed on the KPIs being 'immaterial' and therefore not worth auditing. Only the best scripts identified that KPIs are hard to define, and suffer from a lack of evidence.

In answering the final requirement, which invited candidates to suggest procedures used to verify the number of serious accidents reported, the marks awarded to scripts were polarised. Many candidates seemed to think that the auditor has access to absolutely any kind of evidence that they could wish for. Common sources of evidence referred to included:

- The private medical records of employees
- Police reports on 'dangerous' incidents
- Hospital admissions data
- Interviews with ambulance drivers / paramedics / doctors
- Death certificates

Candidates need to appreciate that although the auditor will have access to books and records held by their client, they will not be able to access external and possibly highly confidential information as a means to gather evidence. The above examples show of a lack of commercial, or even, common sense.

Question 3
This question provided a short scenario based on an assurance assignment in the context of an approach by your client to a bank in order to raise finance for a planned expansion of operations.

In requirement (a), candidates were asked to explain the matters that would be discussed at a planning meeting with their client. There were some sound answers here, with many candidates displaying awareness of the practical issues that would be raised at such a meeting, such as determining the nature of information that management would be able to supply in order to substantiate their figures, and discussing the level of assurance that could be provided.

However, answers were often blighted by two common factors. Firstly, many comments were vague, examples of common vague points being 'discuss terms with management', 'outline the scope of work' and 'agree a fee for the assignment'. These comments on their own do not answer the requirement which is to EXPLAIN the matters to be discussed. Candidates need to be much clearer in exactly what they mean – what does 'discussing terms' actually entail? How do you 'outline the scope of work'? Answers that are not even full sentences will rarely score well.

The second common problem comes back to the issue that candidates lack commercial sense. The vast majority of answers to requirement (a) stated that at the meeting they would discuss 'whether we are competent to take on the work'. Surely this is not something you would raise at a meeting with your client having just agreed to do the work. Similarly many candidates wanted to 'ask the management if they are competent to produce the figures'. I think that most clients would be quite insulted to be interrogated as to their competence in drafting some basic budgeted figures.

Finally many candidates wanted to discuss at the meeting matters such as 'do we have the experience to perform the work'. Again, I would think that the client would be surprised to learn that you may not be knowledgeable enough to conduct the assignment, especially considering that you are the auditor of their business. I would urge candidates to stop and think, and consider if the matters they are suggesting discussing at the meeting are tactful, commercial, professional, and fit in with the scenario provided.

Requirement (b) invited candidates to ask some questions – specifically to state the enquiries they would make regarding the adequacy of the finance being requested from the bank. The point here was the adequacy of the finance i.e. candidates should have been asking questions in relation to missing capital or revenue expenses. Many answers here were reasonable, and appreciated that the budget did not contain expenses for items such as finance costs, staff training, installation and delivery costs and a contingency fund for potential cost over-runs. Some answers also contained very specific information requests, such as quotes for the machinery, and planning permission for the construction of the factory. However some answers suffered from vagueness, and the inevitable request for a management representation.

Some answers also confused requirements (a) and (b) with answers even sometimes combining the two requirements into one answer. It is important that candidates read all question requirements before starting to answer the first requirement, as this should clarify exactly what has been asked for in each requirement, and enable the candidate to separate their comments accordingly between the requirements. It is never appropriate to 'merge' answers for different requirements.

Requirement (c) covered forensic accounting, a new syllabus area. It was pleasing to see that the majority of candidates who attempted Question 3 had prepared for this topic, could provide a sound definition, and could apply their knowledge to the brief scenario provided. However, only a few candidates actually questioned that a fraud was taking place and discussed that the alleged loss of inventory could have been caused not by theft, but by errors in the inventory recording system.

Question 4
This was the most popular question from Section B. It is therefore disappointing that on average it had the lowest mark of the choice questions. The question focussed on professional ethics and money laundering.

Requirement (a) asked candidates to define money laundering and to state procedures relevant to money laundering that should take place on the acceptance of a new audit client. Candidates appeared to have prepared for the topic of money laundering, as the definitions were usually sound. Unfortunately, few candidates could provide many, if any, specific procedures. Many answers provided a discussion of the firm-wide money laundering arrangements that should be made, and in particular there were many extensive descriptions of the role of the Money Laundering Reporting Officer (MLRO) – all of which has nothing to do with the procedures specific to the acceptance of a new client. Some candidates referred to the need to contact Fisher Co's existing auditors, an irrelevant point as Fisher Co had only recently been incorporated. A significant minority of answers suggested that Fisher Co should appoint an MLRO, totally misunderstanding the facts of the scenario, i.e. that

Fisher Co is a potential audit client, not a firm of auditors. Only the best answers discussed 'know your client' procedures, and the need for clarification in the engagement letter of matters to do with money laundering. Unfortunately, when procedures were referred to, candidates seemed to think the audit firm would have unrestricted access to police records, as there were frequent descriptions of the need to verify that Marcellus Fisher was not known to the police for criminal behaviour in the past.

Requirements (b) and (c) both focussed on ethics, providing brief scenarios as a context. Requirement (b) described a situation in which an audit junior had been providing advice to a client's internal audit team, following the discovery of a number of errors in the accounting system. Some answers described a range of issues, including the potential existence of a fraud and the resulting impact on the audit, the lack of supervision and direction of the audit junior, and the appropriateness of your firm conducting a review of the accounting systems. However some answers focussed almost exclusively on the alleged wrong-doings of the audit junior, with repeated requests that he be disciplined by his firm, removed not only from this audit team but from all audits conducted by the firm, and also reported to ACCA for his bad behaviour. The junior was also often advised that he had made the wrong career choice and would be much more suited to a job in an IT department. The real issue here was the lack of quality control over the audit. Why hadn't his senior asked him where he was for three hours when he was supposed to be carrying out audit work? Why hadn't be been briefed as to the limit of his authority and responsibility? Unfortunately few candidates spotted these issues as they were too focussed on taking action against the junior.

This attitude spilled over into answers to requirement (c), where the scenario described two audit juniors who had appeared to rush an inventory count in order to go to a party at the invitation of the client. Answers were again focussed on recommending various types of disciplinary action against the juniors, instead of discussing the deeper issues of a lack of direction and supervision. Few candidates mentioned the major problem in the offering of a gift of inventory wasn't so much that the client was trying to hide a fraud, but more that it would disrupt the count procedures.

Candidates should remember to allocate their time carefully between question requirements. Most scripts contained answers to requirements (a), (b) and (c) of a similar length, when it clear that the mark allocation differs significantly for requirement (b).

Question 5

This question tested knowledge of audit reports, and also the differences between an audit and a review of historical information.

Requirement (a) produced very mixed results. Some answers displayed a sound knowledge of audit reports, could differentiate between 'material' and 'pervasive' in the context of audit reports, and knew the purpose of an emphasis of matter paragraph. On the whole, however, answers to requirement (a) were inadequate. Common problems in requirement (a) included:

- A total lack of understanding about the use and purpose of an emphasis of matter paragraph – candidates appear to think that an emphasis of matter paragraph can be used by the auditor whenever there is an issue that they want to bring to the attention of the readers of the audit report, when in reality the paragraph is very limited in its use.
- An inability to comment on the appropriateness of the report suggested by the audit senior in the question – candidates must be able to reach an opinion of their own and to say if they agree or disagree with the view of someone else.
- A fixation with creating a provision where this would be the incorrect accounting treatment – candidates must be guided by the information in the scenario and not interpret the information in such a way to fit the answer that they would like to write.

- A fixation with the going concern concept – the discontinuation of a business segment does not mean that the entire company is going to cease to trade.

Requirements (b) and (c) were better. Most candidates could provide benefits for a small company in choosing to have a financial statement audit. One weakness here was a reluctance to make the answer specific to the question. The scenario gave lots of information specific to Hugh Co that could have been used in the answer, but many candidates chose to ignore the scenario and instead provide a list of benefits that could be equally relevant to any small company. A second weakness with reference to requirement (c) was a lack of points made specifically contrasting the level of assurance, as directed in the question requirement. However, on the whole these weaknesses did not detract heavily from the quality of answers provided to the final requirements of the examination.

Conclusion

There were some sound scripts, indicating that candidates had prepared well for the examination, had read the Examiner's articles, and had practised past questions. However, there is much room for improvement, as indicated by the pass rate. Candidates are encouraged to think carefully before choosing this paper as it is practical in nature and relies heavily on commercial sense as well as technical knowledge. If a candidate decides to attempt this challenging paper, they must be prepared to study thoroughly, which means not only becoming conversant with the technical content of the syllabus, but also with the assumed knowledge from prior papers. They must also understand the importance of practising exam standard questions, and appreciate the essential guidance which is contained in the Examiner's articles.