Examiners' report

P7 Advanced Audit and Assurance December 2008



General Comments

The December 2008 paper was challenging, including a question for the first time on forensic investigations, and requirements dealing with complex financial reporting issues. Some candidates rose to the challenge. However, the majority of candidates continue to fail to meet the high standard set by this paper. The comments contained in this Examiner's Report will provide an insight into what candidates did well, and what they did not do well, in this sitting of the paper. Future candidates should take careful note of these comments.

The examination comprised two compulsory questions in Section A. This was split between question 1-34 marks, and question 2-26 marks. Both of the Section A questions contained a detailed case study, with a number of requirements based on the scenario provided.

Section B contained three questions, each for 20 marks. Candidates were required to choose two of these questions to attempt. These questions contained a brief scenario, and a number of requirements. Question 5 was the most popular, question 3 the least popular. Only a very few candidates failed to attempt the correct number of questions, and most candidates answered all question requirements for the questions they attempted. This is an improvement on previous sittings, when it was common to see requirements not attempted.

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

- Failing to answer the specific question requirements
- Failing to apply knowledge to the scenario provided
- Lack of technical knowledge of auditing concepts and the requirements of ISAs
- Not making enough different comments given the mark allocation for a requirement
- Poor exam technique, particularly bad time management.

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

Question 1

This 34 mark question was set in the scenario of a company operating a chain of hotels. Extracts from the draft financial statements were provided, including notes which gave additional information about certain figures. The question requirements focused on financial statement risk, audit procedures, and key performance indicators.

There were some sound answers to this question, where the candidate had taken time to think carefully about the exact question requirements, so producing a specific answer addressing the actual requirement. However, many answers were unsatisfactory, especially given that risk assessment is a key syllabus area and has been regularly tested in Section A of this paper.

Requirement (a) asked the candidate to 'identify and explain financial statement risks to be addressed when planning the final audit'. This requirement should not have been a surprise, as financial statement risk had appeared in the previous exam, and a recent examiner's article had discussed how financial reporting issues impacted on the auditor at the planning stage of the audit. Most candidates approached the requirement in a logical manner, working through the information provided in the scenario, and for each point from the case study attempting to provide an explanation of the financial statement risk. Many candidates demonstrated a sound knowledge and understanding of the relevant financial reporting issues, and many could apply that knowledge in an audit context to come up with specific financial reporting risks. It was also encouraging to see less confusion in scripts between business risk, audit risk, and financial statement risk than in previous sittings.



However, some common failings in answers to requirement (a) are noted below:

- Describing a financial reporting issue but then failing to develop the point to provide a financial statement risk. For example, most candidates appreciated that the property sale discussed in note (iii) of the scenario was some kind of financing arrangement and was not a genuine sale. However, too few candidates then went on to discuss the risk of non-current assets being potentially understated due to the properties being incorrectly removed from the statement of comprehensive income (balance sheet), or the risk of depreciation expenses and finance charges being understated, clearly hoping that one would be correct.
- Clutching at straws many candidates seemed not to know what the exact financial statement risk was, and so put that the risk was 'over or understatement' of a balance.
- Vague answers many candidates simply explained a risk as 'risk of incorrect accounting treatment' or 'risk
 that accounting standard not followed'. These answers unfortunately highlight to markers a lack of
 knowledge rather than an application of knowledge.
- A propensity for asking questions was apparent in many scripts. For example a risk explained by asking 'is the accounting treatment for the provision correct?' or 'has the property been valued correctly?' These are not financial statement risks and are definitely not explanations of such risks.
- Failure to think about the figures provided. Very few candidates looked at the trends shown by the draft financial statements. For example, only a small minority recognised that after removing the share -based payment and property repair expenses from operating expenses, the company's underlying operating expenses had decreased by 13.5%, whereas revenue had increased by 24.8%. This should have prompted a discussion that either revenue was overstated, expenses understated, or both.
- Lack of basic accounting knowledge. One of the more worrying features of many answers to Q1(a) was a display of inadequate basic accounting knowledge. For example, many claimed that 'the repairs should be a provision not an expense' or that 'the revaluation should be a reserve, not on the balance sheet'. At this level such comments severely detract from the quality of an answer.

Requirement (b) asked candidates to describe principal audit procedures in respect of specific assertions relevant to the share- based payment expense, and deferred tax asset. It was encouraging to notice that almost all candidates at least attempted this part of the question, whereas in previous sittings, requirements to do with audit procedures were often left out. Most candidates received some credit for their comments.

However, candidates still fail to answer the specific requirement. Requirement (bi) focussed on the <u>measurement</u> of the expense, (bii) on the <u>recoverability</u> of the asset. Unfortunately, the majority of candidates ignored the assertions and instead provided procedures irrelevant to the requirement, for example, on the calculation of tax rather than the likelihood of it providing a future benefit to the company.

The second problem was that many so-called procedures provided were not actually audit procedures at all, but a vague hint as to what the auditor might do. For example, there were many 'procedures' along the lines of 'check calculation of share -based payment expense' – yes, the auditor would need to do this, but <u>how</u>? The 'how' is the audit procedure. Other examples of inadequate answers include 'ensure appropriate disclosure' and 'check last year's figure' – both are too vague and not relevant to the assertions required.

Finally, many candidates seemed not to understand the nature of the items in question. Some seemed to think that the deferred tax asset was a tangible asset, with many claims that it should be 'physically verified to ensure existence', and for the share- based payment, the auditor should 'count the share certificates' even though the



question is about share options rather then shares. Candidates must take a little time to stop and think about whether their answer is logical before putting pen to paper.

Requirement (c) tended to be either extremely well answered, or extremely inadequately answered. Sound answers provided specific key performance indicators (KPI) relevant to a chain of hotels, and clear sources of evidence. While inadequate answers did usually attempt to recommend KPIs relevant to hotels, they would usually describe the policies that a company should have in place rather than the KPI that would measure the success of such a policy. For example, there were many calls for the company to be environmentally friendly, for example by recycling waste. This is a policy. A relevant KPI might be to increase the proportion of waste recycled by 30% in the next 12 months.

Those candidates who took the time to think carefully came up with the required number of KPIs and evidence, and there were some maximum marks awarded for this requirement. However, a significant minority of candidates failed to give even one KPI, and many provided no specific sources of evidence at all. For example, a candidate may have identified a staff turnover rate as a KPI, which is fine, but then went on to say that evidence would be to 'check with human resources'. This is much too vague to gain credit. Some answers seemed a little far fetched – for example, a potential KPI being the 'courtesy displayed to royal guests in the hotel', and some answers irrelevant to a hotel chain – a potential KPI being 'deaths due to toxic gasses escaping from the factory'. Candidates should remember that most of the marks awarded in the paper are for application skills. Such comments indicate that no application to the scenario provided has been performed.

Question 2

This question provided the first opportunity for candidates to display their knowledge of forensic investigations, which was introduced to the syllabus from December 2007. It was apparent that many candidates had read and understood the recent relevant examiner's article, and these candidates often produced sound answers.

Requirement (a) asked for definitions of forensic accounting, forensic investigation, and forensic auditing. There were many sound displays of this factual knowledge, though some candidates who did not know the difference between the three tended to write the same thing for each one.

Requirement (b) was the core of the question. A scenario was provided in which a potential fraud had been discovered, and a report was required, describing the objectives of a forensic investigation, and explaining the steps involved. Encouragingly, the vast majority of candidates produced their answer in an appropriate format and included an introduction and conclusion, enabling at least some of the professional marks available to be awarded. The majority of answers successfully described the objectives of a forensic investigation, and most adequately explained the steps involved in such an investigation. It was clear that most candidates appreciated that this is a very different engagement to an audit, with many mentioning the potential role as an expert witness, and the importance of evidence being admissible in court. However two common problems detracted from the quality of many answers for this requirement:

Firstly, providing tactless and unnecessary comments regarding whether the assignment should be accepted. For example, discussing whether the firm had sufficient competence to perform the work (presumably this is the case, as the question stated that 'you are a manager in the forensic investigation department of your firm', or considering whether there were any ethical issues to consider prior to acceptance (presumably not given that the question stated that Crocus Co is not an audit client)). Such comments show that candidates had failed to read and understand the scenario. However the more significant issue is that such comments would not be made in a report to a potential client, they are internal issues, inappropriate for an external communication.

Secondly, the procedures suggested where often too vague, or not even procedures at all. It was common to see 'procedures' suggested such as 'obtain a list of the current payroll' or 'use CAATs to get payroll data on those made redundant'. What the investigator should do with this information was not discussed. Some candidates



recognised that information about the system in use and the ownership of the bank account should be gathered before the suspect was interviewed, but few recognised this as a priority.

As in Q1(c), some candidates got a little carried away with the scenario, providing some far-fetched discussions of getting DNA evidence and blood samples, and using the police to 'hunt and capture' the suspect. Such comments are clearly based more on popular TV shows than the scenario provided, and can detract from an otherwise professional answer.

Requirement (c) was not often well answered. This requirement asked for the application of the fundamental ethical principles to the provision of a forensic investigation service. The best answers went through each ethical principle in turn, explaining its specific application to this type of service. Some candidates recognised the vital importance of confidentiality in the context of a fraud investigation, and others realised the significance of acting with utmost integrity when dealing with criminal activity.

However, many answers were just not applied in any way, making little or no reference to forensics. A significant number of candidates simply wrote the principles down with a brief definition of each, not answering the question requirement at all.

A lot of candidates were unable to identify the fundamental ethical principles, and focussed purely on independence.

Question 3

This was the least popular of the optional questions, though it was attempted by approximately half of the candidates. The question dealt with a high profile topical issue – the recognition of items in financial statements at fair value, and the auditing implications of this.

Requirement (a) was a discussion as to whether having items recognised at fair value would lead to an increase in audit risk. A small minority of answers were sound, referring to the current trend in financial reporting for fair value accounting, and linking this to the various elements of audit risk. Some answers used examples to illustrate their comments, and some referred to the current economic climate and inactive markets which make determining a fair value difficult. Such answers display not only technical knowledge, but also commercial awareness of an important issue.

However, many answers to (a) focussed incorrectly on materiality, and while many were strong on the financial reporting issues, this was not often successfully linked to audit risk implications. The recent examiner's article on financial reporting issues for the auditor had clearly not been read by many candidates.

Requirement (b) provided a brief scenario setting the scene of an audit client which has revalued several investment properties. Requirement (bi) asked for a recommendation and explanation of enquiries that should be made before relying on the work of an external valuer. Most candidates successfully recommended enquiries, but a number then failed to explain the reason for the enquiries. Candidates should take care to follow the question requirement carefully, as failing to provide an explanation when one is asked for will severely restrict the marks that can be awarded.

Requirement (bii) asked the candidate to 'identify and explain principal audit procedures to be performed on the valuation of the investment properties'. Answers here were unsatisfactory. This requirement was the most misread of all on the paper. Many answers repeated the points made in (bi). Most ignored the fact that procedures relevant to <u>valuation</u> had been asked for, and instead provided a list of general procedures covering other assertions, in particular existence, and rights and obligations. Some scripts provided a heading for every single assertion and one procedure for each assertion. Candidates must follow the instructions given in the requirement,



in order to give a focussed answer. Unfortunately many candidates wasted a lot of time here on writing completely irrelevant answers.

Question 4

This question focussed on ethics and practice management. Answers tended to be inadequate overall. This is disappointing, given that ethics is regularly tested, and that many candidates seem to think that the ethics question is the 'easy question'. The question placed the candidate into the scenario of an audit firm which is facing increased competition, and has three possible strategies for dealing with a loss of revenue and an overstaffed audit department. Candidates were asked to identify and explain the ethical and practice management implications of each of the three possibilities. Problems mainly arose from candidates not answering the part of the requirement dealing with practice management, and simply not explaining their comments in enough depth.

The scenario relevant to requirement (a) described a business opportunity for which an audit client required funding. The audit partner had been contacted to see if the audit firm would make an investment, either in convertible debentures, or the establishment of a joint venture company. Most candidates spotted the obvious ethical problems of making loans to clients, and of having a mutual financial interest. However few candidates really explained why this is a problem. Many candidates would simply state a type of threat – 'self- interest' and 'intimidation' being the most common, with little attempt to explain how the threat arose and if anything could be done to mitigate the threat. Stronger candidates responded well to the practice management issues, discussing whether the audit firm has the relevant skills for such a business venture and whether attention would be better focussed on attracting new audit and assurance clients. Unfortunately there were the inevitable requests for the audit partner to be 'disciplined' or 'struck off' because the client had approached him or her with the business opportunity.

Requirement (b)'s scenario discussed the audit firm potentially setting up a recruitment advisory service. Similar problems appeared here, with many candidates stating threats but not explaining them. Some candidates devoted much of their answer to the fee based on salary, maintaining that it was a contingent fee, banned under ethical guidelines. The best answers explained the potential management, self-interest and familiarity threats and how they could be avoided using safeguards. Some answers also considered practice management issues such as a commercial evaluation of the proposal (i.e. how much demand would there be for this service) and also the costs of setting up the service.

Requirement (c) tended to be unsatisfactorily answered. Many candidates simply repeated the same comments they had made for requirement (b), seeming not to realise that the two were entirely different proposals. This shows the importance of explaining the threats, as similar threats may indeed arise from the possibilities described in (b) and in (c), but why they arise and the implication for the audit firm is completely different. The better answers focussed on the issue that ethical risk is increased due to the seniority of those who may be seconded to clients.

Generally the answers to question four lacked any depth in either the analysis of the question scenarios, or the quality of explanations provided. Candidates should consider that ethics questions are often very practical in nature, placing the candidate in a real-life audit firm scenario. It is difficult to score well on these questions with little practical experience or commercial awareness.

Question 5

This was the most popular of the Section B questions, with approximately 80% of candidates choosing this question. The question focussed on going concern issues, and the implication for the audit report of the non-disclosure in the financial statements of going concern problems. This is a very topical matter, and many candidates produced sound answers to the question. Unfortunately, requirement (c) was often inadequately



answered, and many scripts displayed an appalling lack of knowledge of the impact of going concern issues for the audit report.

Requirement (a) asked candidates to 'compare and contrast the responsibilities of management, and of auditors, in relation to the assessment of going concern'. Most candidates made a good start by correctly defining the going concern concept, and by stating management's responsibility for assessing going concern as a fundamental accounting principle when preparing the financial statements. Most candidates then correctly described the auditor's responsibility for evaluating management's assessment of going concern. Many candidates also provided a sound description of procedures used to assess going concern. The main deficiency in answers to this requirement was the lack of any kind of comparison of the responsibilities of management and auditors, despite the fact that the requirement began with 'compare and contrast'. The other problem was that many candidates did not restrict their answer, as requested, to the assessment of going concern, but digressed into issues such as corporate governance and maintaining shareholder value.

Requirements (b) and (c) were based on a short scenario describing a company facing going concern problems that should be disclosed by way of note to the financial statements. Requirement (b) asked candidates to consider why the directors may be reluctant to provide such a note. Many answers were provided here. However, some candidates failed to provide more than a couple of reasons, which is not enough for the mark allocation.

Requirement (c) was rarely well answered, and many candidates obviously do not understand the different types of modifications to audit reports at all, let alone the implication for the audit report of non-disclosure of going concern issues. There was a tendency in (ci) to go straight for an adverse opinion, without any discussion of the level of significance of the non-disclosure. There was also confusion over the use of an adverse opinion and a disclaimer of opinion. Some candidates put down all possible types of audit opinion as their answer in the hope that one of them would be correct.

In (cii) very few candidates suggested that the auditor should consider the adequacy of the note if the directors agree to provide one. For (cii) most candidates did mention the emphasis of matter paragraph, but seemed unclear as to whether the inclusion of the paragraph in an audit report resulted in a qualification or a modification. Some candidates confused an emphasis of matter paragraph with an 'except for' opinion, and seemed to provide the same answer for (ci) and (cii).

In this advanced audit paper it is inexcusable that students do not know these basic facts about the audit report. It is strange that most candidates elected to answer this question on audit reports when clearly they did not have the technical knowledge to answer such a question. Candidates should also remember that writing one or two sentences is unlikely to be sufficient to answer an eight mark question requirement.

Conclusion

This sitting seemed to polarise candidates. There were many sound scripts, attributable to candidates answering the specific question requirement and demonstrating and applying a good level of technical knowledge. Candidates who had obviously read examiner's articles and reports also tended to perform very well.

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.