Examiner's report

P7 Advanced Audit & Assurance
December 2009

General Comments
This paper tested topics from across the P7 syllabus, including analytical procedures, financial statement risk assessment, quality control, money laundering, procedures relevant to an audit engagement and a prospective financial information (PFI) assurance engagement, the International Audit and Assurance Board (IAASB) Clarity Project, and subsequent events. The paper contained detailed scenarios on which many of the requirements were based.

Some candidates produced excellent scripts. However, the majority of candidates produced answers which did not answer the specific question requirements, and some important areas of the syllabus appear to be mis-understood by many.

The examination comprised two compulsory questions in Section A, both worth 34 marks. Both Section A questions were based on a case study, and contained several requirements covering different syllabus areas.

Section B contained three questions, each for 16 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, a surprising number of candidates only attempt one of the section B questions, obviously imposing a limit on the marks that can be awarded for the script.

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 relevant to the question scenario
- Not explaining points in sufficient detail
- Making too few comments given the mark allocation of a requirement
- 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 focussed on the planning of the audit of a listed company which operates a chain of supermarkets, and had expanded during the year, geographically, and by establishing a financial services division. The question requirements focussed on analytical procedures and an evaluation of financial statement risk.

In a departure from previous sittings, question one was answered inadequately by a majority of candidates. Many candidates seemed to lack a basic understanding of the use of analytical procedures at the planning stage of the audit. On the financial statement risks, many answers were vague, and despite being lengthy, did not address the question requirement.

Requirement (a) asked candidates to explain the reasons for performing analytical procedures as part of risk assessment, and to discuss the limitations of performing analytical procedures at the planning stage of the audit. For the first part of the requirement, most candidates could suggest that analytical procedures should help to identify risks, a point suggested in the question, but fewer identified that such procedures would help the auditor to develop business understanding. Most candidates used examples to illustrate their comments, as required, but on the whole the examples were weak and did not help to explain why the procedure was being carried out. The answers to the second part of the requirement were extremely disappointing. The vast majority of candidates seemed not to have read the last eight words of the requirement, so failing to discuss the limitations of analytical procedures at the planning stage of the audit. This lead to answers discussing the problems of analytical procedures in general terms, and many answers focussed on the limitations of analytical procedures as a substantive procedure.

A final comment on (a) – many answers seemed disproportionately long given the marks available. This usually meant that the answers to the other requirements of Question 1 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 candidates to explain and differentiate the terms 'audit strategy' and 'audit plan'. Some candidates performed well here, but some candidates mixed up the two terms or failed to differentiate between them. Many also re-used wording from the question requirement, for example 'the audit strategy is the strategy for the audit, 'the audit plan is the plan for the audit'. Clearly such comments add no value and cannot be awarded credit.

Requirements (a) and (b) were fairly brief in terms of mark allocation and were not based on the question scenario. Requirement (c) was based on the scenario, and asked candidates to explain the information required in order to perform analytical procedures during the planning of the audit of Papaya Co. For this requirement, candidates performed well if they applied their knowledge to the question scenario. However, the majority of candidates failed to do this, and instead produced a list of vague bullet points, referring to information that would be required for the planning of any audit. Most candidates listed prior year accounts, management accounts, a cash flow statement, and little else. Some candidates explained the need for segmental information, and the importance of budgets and industry comparisons for the newly established financial services division. Some candidates gave procedures rather than information required.

Requirement (d) asked for an assessment of financial statement risks, produced in the form of briefing notes. Some candidates performed well for this requirement, by producing briefing notes that identified and explained the specific financial statement risks for Papaya Co, and by prioritising these risks to reach an overall conclusion to the risk assessment. The financial statement risks created by brand names, segmental reporting, land impairment, and provisions for penalties were identified by most candidates, but not always well explained. Some candidates identified the risk, but gave no further comment other than 'it should be treated in accordance with the relevant accounting standard'. Candidate's understanding of the relevant accounting standard was sound for some issues – namely the provision, impairment, intangible assets and foreign exchange issues from the overseas division. However, some of the issues were not well understood – namely the inspection costs, and the forward exchange contract.

As ever, when asked for financial statement risks, some candidates incorrectly focussed on business risks. Irrelevant comments included comments on Papaya Co's business strategy ('can they afford the inspection costs', 'will the overseas expansion work'), or pure speculation ('they may have bribed officials overseas to set up the business in a foreign land').

Some candidates wrote at great length in answering requirement (d), but unfortunately quantity does not equate to quality. It was at times frustrating to see pages of writing scoring few marks, because points made were either irrelevant, technically incorrect, or not actually explaining the risk to the auditor. Many candidates provided numerous examples of substantive procedures or audit impacts ('we must discuss the court case with lawyers', 'we must see who can audit the overseas division'), again not relevant to the requirement.

Regarding professional marks, candidates' approach was extremely varied. The best candidates used a proper format, separated their notes into sections, each with a clear heading, and provided a conclusion which summarised the assessment of risk. However, many candidates made no attempt at a format, and simply produced a list of bullet points as their answer.

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 'the company might be going down the drain' (sic), 'we're gona have to go to the stocktaking', (sic) would not be used in a professional document and will detract from the quality of the answer provided.

Question Two

This question featured an audit engagement where the client company, Banana Co, which is a manufacturer of equipment, used in the construction industry. The requirements varied from audit procedures, to quality control, and money laundering. This question was the best answered on the paper.

The wording used in requirement (a) should have been familiar to candidates, as similar wording features regularly in P7 papers, and was also the focus of an examiner's article in late 2009. The requirement asked for the matters that should be considered, and the evidence that should be found in a file review, you being the audit manager in the question scenario. The two items that the requirement applied to were some training costs incorrectly capitalised into property, plant and equipment, and a trade receivables balance seemingly irrecoverable as a result of an event after the year end.

It was pleasing to see that many candidates appeared to have read and understood the examiner's article on audit evidence and matters to be considered, as the quality of answers was undoubtedly better than previous sittings. Most candidates could discuss the relevant accounting treatments with a degree of confidence, most determined materiality, and most could come up with several specific pieces of audit evidence. However, there were some answers, which tended to do the following:

- For (ai), focussed on evidence relating to the purchase of the machinery, rather than the training costs.
- For (ai), digressing into irrelevant matters such as related parties or intangible assets.

- For (aii), answers contained a contradiction – saying that the event after the year end was non-adjusting, but then saying that the receivable should be written off.
- For both parts of the requirement, incorrectly calculated materiality, or only calculated it in reference to assets, rather than profit.

Approximately 10% of answers agreed with the accounting treatment for the capitalised training costs, which is not allowed. A further disappointment was how few candidates considered any inventory held by Banana Co in relation to its insolvent customer, which would need to be considered in terms of obsolescence.

Requirement (b) focussed on the poor management of an audit, and the related quality control issues. Candidates were provided with comments from an audit junior; describing the problems encountered on the audit of Banana Co, and was asked to evaluate the audit junior's concerns. The vast majority of answers to this requirement were sound, with almost all candidates able to identify some, if not all, of the quality control issues in the scenario. The lack of a planning meeting, inappropriate delegation of work, poor direction and supervision were identified by most. Some candidates considered not only the most obvious issues from the scenario, but also the overall impact on the audit, and went beyond simply repeating points from the scenario. However, some candidates failed to really evaluate the quality control issues, and did little more than copy out sentences from the question, providing little explanation and development of the issue identified.

It was encouraging to see that, having asked for an evaluation of the scenario, a high proportion of candidates did provide a proper conclusion to their evaluation.
Requirement (c) was on money laundering. This topic seemed to polarise candidates. Well prepared candidates performed very well here, and while most candidates could at least define money laundering, a significant minority of candidates attempted this requirement inadequately, if at all. Some candidates did not attempt this requirement. Candidates are reminded that money laundering is a crucial issue that auditors must consider with every client engagement, and the anti-money laundering rules are an important part of the syllabus.

The requirement was in two parts, with (ci) asking for an explanation of the term money laundering, and examples of offenses; (cii) asked for an explanation of the policies and procedures that firms should adopt in relation to money laundering. Some weaknesses in answers are noted below:

- For (ci), failing to provide offenses that could be committed by the accountant, as required, or providing one long (sometimes pages long) example of a money laundering scheme.
- For (ci), not understanding the term 'tipping off' and actually suggesting that auditors must report instances of money laundering to management of their client.
- For(cii), discussing client due diligence ('Know Your Client') procedures in great detail, but mentioning no other policies or procedures.
- For (cii) discussing the requirement of ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, which is not relevant to the question requirement.
- For (cii), providing no demonstration of understanding the need for policies and procedures, e.g. stating that a Money Laundering Reporting Officer should be appointed, but failing to explain their role and the reason for appointing such a person.

There were 2 professional marks available for requirement (c). Approximately half of candidates made an attempt to use an appropriate format for briefing notes, but many made no attempt to gain these 2 marks at all.

Question Three

Question 3 was based on an engagement to provide an assurance report on prospective financial information, in the form of a three-month cash flow projection. This was by far the least popular of the optional questions in Section B, but those that did attempt the question tended to perform well.
Requirement (a) asked candidates to recommend the procedures that should be performed on the cash flow projection. The majority of answers produced many specific procedures, based on the information provided. Candidates that approached the answer logically and worked through each item on the cash flow forecast to derive appropriate procedures performed very well.

However, some answers were limited to enquiry with management, which restricted the marks that could be awarded. Some of the procedures provided were too vague to gain credit, e.g. 'check for payment of license', 'ask who prepared the forecast'. Some recommended impossible procedures, not appreciating the very nature of a forecast is that the transactions have not yet occurred, e.g. 'agree dividend payment to bank statement' – this cannot be done as the payment is forecast to occur in the future.

Requirement (b) asked for an explanation of the main contents of the assurance report that would be provided. Most candidates could make an attempt at a list of contents, but very few answers provided sufficient explanation of the content identified, e.g. most could identify that a statement of negative assurance would be provided, but few explained what that meant. Some answers provided a contrast between an audit and an assurance report, which was not asked for. The main problem with answers to this requirement is that they were just too brief for the marks available.

Question Four

This was the most popular of the Section B questions. The question focussed on the IAASB's Clarity Project, and on ethical and professional issues. The topic should not have been a surprise to candidates given the importance of this current issue, and the examiner's recent article covering the subject.

Requirement (a) tested candidate's knowledge and understanding of prescriptive and principles- based approaches to auditing. Generally, this requirement was answered well. Most candidates could provide sound descriptions of the two approaches. Most candidates could also identify the arguments for and against the prescriptive approach, but sometimes the points were not well explained. Unfortunately a minority of candidates discussed prescriptive rules in relation to financial reporting rather than auditing, and some confused auditing regulations with corporate governance regulations.

Requirement (b) contained three sub-requirements, testing candidates understanding of the terms 'intimidation threat', 'lowballing', and also including a section on the advertising rules which auditors should abide by. Most candidates could demonstrate that they knew the basic facts about each, but generally did not explain their points in sufficient detail to score a high mark on requirement (b) as a whole. For example, with regards to lowballing, most candidates could state that this involves charging a low fee for the performance of an audit engagement, but not all candidates then developed the point into issues relating to the quality of the audit performed. It was pleasing that the requirement on advertising rules was well answered, given that this is a relatively peripheral area of the syllabus. Unusually for the ethics question, at this sitting it tended to be the optional question in which candidates scored the highest mark.

Question Five

Question 5 focussed on the auditor's responsibility in relation to subsequent events, and provided a brief scenario dealing with a potentially significant subsequent event. Unfortunately, despite the majority of candidates attempting this question, performance was on the whole unsatisfactory.

Requirement (a) was a fairly factual requirement, asking for an explanation of the auditor's responsibility in relation to subsequent events. It was obvious that some candidates had studied ISA 560 *Subsequent Events*, and those that had done so performed well on this requirement. However, the majority of candidates clearly knew very little about ISA 560 (making it therefore surprising that they would pick to attempt this question), leading to answers which almost exclusively focussed on the financial reporting requirements of IAS 10 *Events After the Reporting Period*, while other answers simply listed the various types of audit reports that could be issued in relation to a variety of subsequent events. While approximately half of candidates could provide the terms 'active duty' and 'passive duty', the terms were not well explained and often attached to the wrong time period. Very few candidates provided examples of the types of procedures that auditors should use in relation to subsequent events. Finally, a common misunderstanding was that it is the auditor's responsibility, rather than management's to make any necessary amendments to the financial statements.

Requirement (b) was based on the scenario provided. (bi) required candidates to comment on the financial reporting implications and advise further audit procedures in relation to a significant restructuring, which was announced three days before the planned issue of the audit report. Although some candidates wrote at length, few performed well on this requirement. The main problems were:

- Incorrect or absent materiality calculations;
- Identifying the event as both adjusting and non-adjusting according to IAS 10, e.g. stating that the event is non-adjusting but that a provision should be recognised in the statement of financial position;
- Failing to provide any audit procedures at all, other than 'discuss with management'; and
- Writing at length about going concern issues – though this may be a consideration, the question clearly states that the factory in question is being closed and relocated, so there is no hint that the company is insolvent or that operations are likely to cease.

(bii) asked candidates to recommend the actions to be taken by the auditor if the financial statements were not amended. The approach taken by many candidates here was to list every possible type of modification or qualification to the audit report, in the hope that one of them would be a correct answer. This displays a complete lack of understanding of the impact of non-amended financial statements, which is a crucial area of knowledge for this syllabus. It also indicates a lack of professional judgment skills. Marks are not awarded to candidates who attempt to 'hedge their bets' in this manner.

Some candidates correctly identified that a qualification on the grounds of disagreement would be the most appropriate course of action, and that the matter should be discussed with those charged with governance, and raised with shareholders at the company general meeting.

Conclusion
This sitting showed that candidates who are well prepared for this examination can perform extremely well. However, many candidates still fail to demonstrate not only a lack of application skills, but a lack of basic understanding of crucial elements of the syllabus.

A significant proportion of candidates continue to produce answers that lack focus, do not actually answer the question requirements, display inadequate technical knowledge and very little commercial and practical awareness, and in some cases are technically incorrect. These candidates are encouraged to improve their examination technique as well as knowledge of the syllabus 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.