# Examiner’s report

## P7 Advanced Audit and Assurance
## December 2012

**General Comments**

Candidates’ overall performance in respect of the December 2012 P7 paper was similar to previous sittings. The paper included requirements relating to the planning and completion of audit engagements, as well as requirements involving ethical issues, audit evidence and audit reports.

The examination consisted of two sections. There were two compulsory questions in Section A - question one for 40 marks and question two for 28 marks. Section B comprised three further questions of 16 marks each.

The vast majority of candidates attempted the required number of questions, and there was little evidence of time pressure. In Section B question four was marginally less popular than the other two optional questions.

Similar factors as detailed in previous examiner’s reports continue to contribute to the unsatisfactory pass rate:

- Failing to answer the actual question requirements
- Lack of knowledge on certain syllabus areas, including core topics which are regularly examined
- Discussing too few points and generally writing too little for the marks available
- Identifying a number of relevant points but failing to expand on them
- Lack of analytical skills
- Illegible handwriting and inadequate presentation

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 40 marks, and was split into four question requirements. As is typical for question one, the scenario and requirements involved the planning of the audit, and information was given on the business background and recent developments of the client company, as well as some financial information. There were also ethical issues embedded in the scenario.

It was clear that the majority of candidates were familiar with audit planning questions and seemed comfortable with the style of the question and with the amount of information that had been given in the scenario. There was little evidence of time pressure despite the length of the question.

Requirement (ai) was for 12 marks, and asked candidates to evaluate the business risks faced by the company. This was by far the best answered requirement of the exam, with most candidates identifying and explaining a range of relevant business risks, which on the whole were developed in enough detail. Most candidates tended to be able to discuss at least six different business risks, with foreign exchange issues, the loss of several executives, reliance on a single supplier and too few customers, and the problems of operating in a high technology industry being the most commonly risks discussed.

For candidates who achieved lower marks on this requirement, the problem was that they did not develop their discussion enough to achieve the maximum marks per point. Some of the answers just repeated the business issue as stated in the question without discussing any of the impact on the business at all. Most candidates discussed going concern, which was relevant, but instead of relating going concern to specific matters such as liquidity problems and the large loan, it was simply mentioned as a conclusion in relation to every business risk discussed, and therefore was not specific enough to earn credit.

Many answers could have been improved in relation to business risk evaluation by including some simple analysis of the financial information made available, for example through the calculation of profit margins and trends. This would have been an easy way to develop the point that financial performance was suffering, as well as liquidity being poor.

Requirement (aii) was for 8 marks, and was less well answered. Candidates were asked to identify and explain four risks of material misstatement to be considered in planning the audit. (Note the UK and IRL adapted papers had a slightly different requirement with no specific number of risks of material misstatement required and a mark allocation for (ai) and (aii) combined at 20 marks). Answers were very mixed for this requirement. Some candidates clearly understood the meaning of a risk of material misstatement, and could apply their knowledge to the question requirement, resulting in sound explanations. However, despite this being a regularly examined topic and the cornerstone of audit planning under the Clarified ISAs, the majority of answers were unsatisfactory.

First, many candidates included a discussion about this being a first year audit which would result in a risk of material misstatement, but this was both incorrect and showed that the question had not been read carefully enough. Then, when attempting to explain a risk of material misstatement, many candidates could do little more than state a financial reporting rule, and then say the risk was that "this would be incorrectly accounted for". It was not clear if this type of vague statement was down to candidates being reluctant to come to a decision about whether a balance would be over or understated, or if they thought that their answer was specific enough. Very few answers were specific enough on the actual risk of misstatement to earn credit.

The matters that tended to be better explained were the risks of misstatement to do with inventory obsolescence, impairment of property plant and equipment, and the finance costs associated with the new loan.

On a general note, many candidates seemed confused between a business risk and a risk of material misstatement, and some answers mixed up the two. Candidates are reminded that it is an essential skill of an auditor to be able to identify both types of risk, and that they are related to each other, but they are not the same thing.

Requirement (aiii) was for 8 marks, and focussed on ethical issues. The requirement was to discuss the ethical issues raised in the scenario and to recommend actions to be taken by the audit firm. There were two ethical issues of relevance to planning the audit – the contingent fee that had been requested by the audit client, and the matter of the previous audit manager potentially gaining employment at the client. Answers here were mixed, and generally the answers in relation to the contingent fee were better than those in relation to employment at a client company. On the contingent fee most candidates seemed confident in their knowledge, and correctly identified that a contingent fee is not allowed for an audit engagement, and recommended sensible actions such as

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ensuring a discussion of the matter with those charged with governance. The majority of candidates had the correct knowledge here, and could apply appropriately to the question. As usual, candidates appear reasonably comfortable with the ethics part of the syllabus, but are reminded that to score well on ethical requirements in P7, they must do more than just identify a threat.

On the matter of the previous audit manager going to work at the audit client answers were unsatisfactory. Most could identify that it was an ethical threat, and could suggest which threat(s) arose, but were less competent at explaining why the threat arose in the first place. Most answers suggested at least one safeguard, usually involving reviews of work performed and ensuring that the manager has no further involvement with the audit, which were fine, but many also made inappropriate suggestions along the lines of “forbidding” the manager to work at the client, “prohibiting” the audit client from taking on the manager, and “disciplining” the manager himself. Very few answers considered the key ethical issue of considering whether the audit manager retained any connection with the audit firm. Some answers had incorrectly assumed that the manager was being loaned to the client on a temporary basis, rather than taking up a permanent position, and some thought that he would be involved in both the audit and the preparation of financial statements. It is important to read the scenario carefully and to take time to think through the information that has been given before starting to write an answer.

The requirements discussed so far attracted a maximum of four professional marks. Generally candidates presented their answer in a logical and appropriate manner, and a significant number of answers included both an introduction and an appropriate conclusion. Most answers used headings to separate their answer points and generally the presentation was improved from previous sittings.

Requirement (b) was for 8 marks and asked candidates to recommend the audit procedures that should be carried out in respect of an insurance claim that had been submitted by the client just before the year end. The wording of the requirement should have been familiar to candidates as it has been used in many previous exam questions. The scenario contained a brief description which should have made candidates sceptical of the claim being eligible to be recognised as a receivable – particularly the fact that the claim was highly material, and if recognised would have turned the company’s loss into a profit, and also the fact that the amount being claimed seemed very unrealistic when compared to the annual revenue. Unfortunately very few candidates picked up on these matters, and did not question the amount of the claim or the timing of it, and very few answers specified the impact that it would have on the financial statements. Most answers included one materiality calculation but not the impact the adjustment would have on the reported loss for the year.

While some answers correctly discussed the accounting and disclosure requirements for a contingent asset, a number of answers incorrectly thought that the claim should result in some kind of provision or liability.

The audit procedures that were recommended were mixed in quality. Most candidates suggested a review of the terms and conditions of the insurance policy to see if the situation was covered, and most also recommended reviewing the actual claim and contacting the insurance provider. All of these are valid and appropriate procedures and generally were well described. Some answers tended to state that the matter should be “discussed with management” with no further explanation, or that “an expert should be consulted” but with no description of what evidence the expert should be asked to provide, or even who the expert should be. Too many candidates seemed to want to rely on representations and discussions about the possible outcome of the insurance claim when there were other stronger sources of audit evidence available.

## Question Two

This question was for 28 marks, and was split into three requirements. The scenario was based on the completion of a group audit, and candidates were given draft consolidated financial statements and a selection of key audit findings, based on the audit work that had already been performed.

Requirement (ai) was for four marks and asked for an explanation of why auditors need to reassess materiality as the audit progresses. This was linked to a part of the scenario where it was explained that the materiality level applied to the audit of the Group has been reduced. Answers were usually limited here to a definition of materiality and a suggestion of how an appropriate materiality figure is determined, and few answers actually answered the question requirement. Those that did tended to focus on risk assessment and the auditor uncovering new information about the client as the audit progresses. These points are both valid, but very few answers discussed them, or any other relevant points, in sufficient detail.

Requirement (aii) was for 18 marks, and asked candidates to assess the implications of the key audit findings provided on the completion of the audit. Guidance was given on this requirement, instructing candidates that they needed to consider risk of material misstatement and the adequacy of the audit evidence obtained. Candidates were also specifically instructed not to recommend further audit procedures. The scenario provided nine key audit findings to be assessed.

This is a good example of a question requirement where candidates were expected to think on their feet and not rely on rote learnt facts. The candidates that did as the question instructed and took time to think about the information in the scenario scored well, and there were some sound answers. However the majority of candidates could not apply their knowledge to this scenario, leading to unfocussed answers that did not actually answer the question requirement. Answers were on the whole unsatisfactory. Candidates tended to approach the key audit findings in a logical way, working though them in the order presented in the question. However, for each key audit finding most answers simply stated that audit evidence was not adequate without explaining why, and then gave a list of audit procedures, which was specifically not asked for. As in Q1(aii), answers were inadequate at explaining risks of material misstatement, and in fact were worse in this question, maybe because audit completion is less frequently examined than audit planning. Candidates made mistakes in calculating materiality, using the wrong basis for most calculations, and generally did not understand the part of the information provided that dealt with other comprehensive income and its components.

Some key audit findings were better answered, mainly because marks could be awarded for financial reporting issues which candidates seemed comfortable discussing, namely the property disposal that could have been a financing arrangement, and the potential impairment of goodwill. However, all other key audit findings were inadequately dealt with, with some in some cases not even warranting an attempt at an answer, even though the issues, when thought through, were not difficult. For example, the key issue in relation to the actuarial loss that has been suffered was that a written representation is not sufficient evidence for such a material figure, and that no work had been done to consider the competence of the service organisation which had provided the figures. In relation to the associate, candidates did not seem sceptical of the fact that there was no movement on the statement of financial position, which in itself indicates a potential misstatement. A significant number of answers thought that the auditor need not obtain audit evidence for a material balance if it had not moved during the year.

Requirement (b) was for six marks, and asked for a discussion of the advantages and disadvantages of a joint audit being performed on a newly acquired subsidiary. Most candidates could identify at least two advantages and two disadvantages, though often they were not discussed at all and the answer amounted to little more than a list of bullet points, which would not have attracted many marks. Some answers seemed to confuse a joint audit with an audit involving component auditors, and some used the fact that the foreign audit firm was a small firm to argue that it could not possibly be competent enough to perform an audit or have a good ethical standing. Most answers identified the cost implications for the client, and the advantage of involving a local firm who would have knowledge of the local law and regulations.

Question Three

This question was marginally the most popular of the optional questions. Requirement (a) focussed on tendering, and provided information in relation to a potential new audit client – a multinational, newly listed group requiring a cost effective audit to a tight deadline. The requirement, for eight marks, was to identify and explain the matters to be included in the tender document.

This was generally well attempted, with a significant minority of answers achieving close to full marks. The best answers went through each of the typical contents of a tender document and related them specifically to the Group in the question, resulting in focussed and well explained answer points. Interestingly these answers were often relatively brief, but still managed to attract a high mark through application of knowledge to the question scenario. The more common areas discussed were the international network, audit specialism, fees and deadline, and the introduction of key members of the potential audit team.

Some answers tended to either be much too brief - sometimes little more than a list of bullet points, or did not answer the question requirement, and instead of explaining matters to be included in a tender document, discussed the matters that may impact client acceptance, such as whether the audit firm has sufficient resources, and whether a fee dependency would be created. Candidates are advised to read question requirements carefully and not to make assumptions about what is being asked for.

Requirement (b) was also for eight marks, and focussed on ethics. Two suggestions had been made to help an audit firm increase its revenue – one was to give managers and partners a financial reward for selling non-audit services to clients, and the other to provide an external audit service to clients. The requirement was to comment on the ethical and professional issues raised by the two suggestions. Answers tended to discuss one of the suggestions reasonably well, but then repeat almost identical points in relation to the second suggestion. There was some overlap given that both involved the provision of a non-audit service to an audit client, but there were enough separate points that could be made to avoid repetition. In relation to the financial incentives for partners and manager selling services to audit clients, hardly any candidates discussed the issue of the significance of the ethical threat depending on seniority and that partners couldn't have the arrangement. Many also discussed the self-interest threat in relation to the audit firm rather than its personnel.

In relation to the extended audit, most answers explained the self -review threat and suggested appropriate safeguards, usually that of separate teams. Fewer discussed the need for extended review procedures or for separate engagement letters and billing arrangements were the internal audit service provided to an audit client.

Fewer still knew the position of the ethical codes in relation to this matter, and there was very little in the way of discussion of the topic as a current issue.

The UK and IRL adapted papers were slightly different in this requirement, as they focussed solely on the extended audit situation and asked for discussion of the how the Auditing Practices Board (APB) has responded to ethical issues raised. Answers on the whole were satisfactory, with candidates appreciating the revision made to APB Ethical Standards in relation to the provision of non-audit services generally, and that robust safeguards are needed in the situations where a non-audit service is provided to an audited entity. Candidates seemed aware that this is a very topical issue and were largely ready to discuss the issue in some detail.

## Question Four

This question looked at revenue recognition from the auditor's point of view, beginning with a short discussion requirement, and moving onto two requirements based on short scenarios. This was marginally the least popular of the optional questions in Section B.

Requirement (a) was for six marks, and asked candidates to discuss the statement "Revenue recognition should always be approached as a high risk area of the audit". Answers here were mixed. There were some sound answers, which often used simple examples to illustrate the type of situation where revenue recognition is complex or subjective, with construction contracts, hotel deposits and the provision of services being common and pertinent examples. Many answers also referred to the problems of manipulation of revenue, and again sound answers illustrated the point with a simple example, the most common being pressure on management to maximise revenue or profit. It was however unsatisfactory that so few answers referred to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, specifically the fact that ISA 240 requires the auditor to use a presumption that there are risks of fraud in revenue recognition.

Most answers focussed exclusively on the risk factors. Only a minority of answers tried to provide a counter argument that some companies with good controls and simple revenue generating streams as being low risk. It is important in a discussion question to consider both sides of an argument.

Requirement (b) was for six marks and asked candidates to comment on the matters that should be considered and the evidence they should expect to find when reviewing the audit file in respect of a consignment stock arrangement, which was described in the scenario. This was generally well attempted, with most candidates discussing that the accounting treatment adopted for the consignment stock arrangement was not compliant with IAS 18 *Revenue,* and correctly determining the impact on profit, and the overall materiality of the transactions to the financial statements. It is perhaps odd that while this requirement did not ask for risks of material misstatement, most answers were competent at explaining exactly what the risk of misstatement was and also quantifying its impact, in contrast with Q1(aii) and Q2(aii), when risks of material misstatement was asked for, but not answered well. Candidates were less competent at explaining the audit evidence they would expect to find, and the answers here were usually limited to a review of the terms of the consignment stock arrangement, and evidence of an inventory count.

Requirement (c) took a different slant on revenue, this time providing a brief scenario in which a fraud had been discovered whereby a sales representative had been submitting false claims for commission earned on sales generated. The requirement, which was for four marks, asked for procedures that should be used to determine the amount of the fraud. Only a minority of candidates realised that procedures should focus on testing the validity of the sales that the sales representative had claimed to have generated – and these candidates then usually recommended some specific, valid procedures. Other answers were inadequate, and relied on evidence from "discussing with management" or "interviewing the suspect" – but without actually recommending the questions they would ask. Some answers simply did not answer the question, and instead of providing procedures gave an explanation of the steps involved in a forensic investigation or focussed on how they would "catch" the culprit and punish them.

## Question Five

This question, as is typical for question five in paper P7, focussed on reporting. The scenario for requirement (a) described the loss of accounting records that had occurred one month before the year end of a listed audit client. The records had been held by a service organisation, which had provided reconstructed records in respect of those that had been lost. Requirement (ai) was for seven marks, and asked candidates to comment on the actions that should be taken by the auditor, and the implication for the auditor's report. Most candidates correctly discussed that fact that the auditor was unable to obtain sufficient, appropriate audit evidence based on the reconstructed records, leading them to explain that the audit opinion should be disclaimed. Fewer candidates suggested that alternative procedures could be used to obtain evidence, and fewer still recognised that as the accounting records were available for eleven months of the year, the audit report may not necessarily be subject to a disclaimer of opinion, or even qualified at all if alternative procedures could take place. A small minority of answers discussed the fact that due to the client being a listed entity, it would most likely have back up records of its own and not be totally reliant on the service organisation in any case.

Some answers demonstrated a lack of knowledge on audit reports, stating incorrectly that an adverse opinion would be most appropriate, and few answers described the need for discussing the potential modification with those charged with governance, instead opting for resignation in the face of such "incompetent" management.

Requirement (aii) for three marks asked for a discussion of quality control procedures that should be carried out by the audit firm prior to the audit report being issued. Sound answers appreciated that because the client in the scenario was listed, an Engagement Quality Control review would be required, and the answers that described what such a review would entail achieved the maximum marks. Most answers were too general however, simply describing the quality control procedures that would be relevant to any audit. Many answers were extremely brief, with little more than a sentence or two provided.

Requirement (b) was for six marks, and was based on a scenario which described a review engagement that was taking place on the interim financial statements of another listed company. An accounting policy in relation to warranty provisions had been changed in the interim financial statements, and based on the information provided, candidates should have appreciated that the accounting treatment was incorrect. Figures were provided to enable materiality to be calculated. The requirement was to assess the matters that should be considered in forming an opinion on the interim financial statements, and the implications for the review report. Most answers were good at discussing the accounting treatment for the warranty provision, that the non-recognition was not appropriate, and the majority correctly assessed the materiality of the issue. Answers were inadequate in discussing the impact of this on the review report, being mostly unable to say much more than the auditor would need to mention it in the review report. There seemed to be a lack of knowledge on anything other than the standard wording for a review report, with many answers stating that the wording should be "nothing has come to our attention" followed by a discussion that there actually was something to bring to shareholders' attention but with no recommendation as to how this should be done.

## Conclusion

This exam sitting showed that candidates must take time to think through not just the information they are given in a scenario, but also what they have been asked to do with that information. Many candidates failed to achieve a satisfactory mark at this sitting because they rushed to answer a question requirement without really understanding what the requirement actually instructed them to do. In some cases there is a definite lack of knowledge, which is compounded by inadequate analytical skills. As stated in previous examiner's reports, analytical skills do not just relate to numerical analysis – it also refers to the ability to understand and evaluate the narrative information provided in question scenarios to detect the key issues contained. As usual, candidates are encouraged to work through past questions and answers as an important part of preparation for this challenging exam.