Examiner's report

P7 Advanced Audit and Assurance
June 2012

ACCA

General Comments
Candidates' overall performance in respect of the June 2012 P7 paper was similar to previous sittings. The paper was, as usual, quite practical, including the planning of audit and non-audit engagements, as well as typical requirements involving ethical issues, audit evidence and audit reports.

The examination comprised two compulsory questions in Section A, and three questions in Section B of which two should be attempted. Both Section A questions were based on detailed scenarios, and contained several requirements covering different syllabus areas.

Each optional 15 mark question in Section B included several requirements based on short scenarios. Of the Section B questions, Question Four based on ethical dilemmas was the most popular, and roughly the same proportion of candidates chose to attempt Question Three and Question Five. The vast majority of candidates attempted all five 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
- Discussing too few points
- Identifying points but failing to expand on them
- Lack of knowledge on certain syllabus areas
- 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 37-mark question was based on the planning of a group audit when there had been a change in the group structure during the year. A wholly-owned subsidiary had been acquired, and candidates were given descriptions of some significant transactions and events, as well as limited financial information.

It was obvious that the majority of candidates were familiar with this part of the syllabus. Candidates also seem comfortable with the style of the question and with the amount of information that had been given in the scenario.

Requirement (ai) for 8 marks asked candidates to identify and explain the implications of the acquisition of the new subsidiary for the audit planning of the individual and consolidated financial statements. Most answers to this requirement identified the main planning implications, such as the determination of component and group materiality levels, the audit firm's need to obtain business understanding and assess the control environment in relation to the new subsidiary, and practical aspects such as the timings and resources needed for the group audit. Weaker answers to this requirement tended to just list out financial reporting matters, for example, that in the group financial statements related party transactions would have to be disclosed, and inter-company balances eliminated, but failed to link these points sufficiently well to audit planning implications.

The next part of the question dealt with risk assessment, requiring in (aii) that candidates evaluate the risk of material misstatement to be considered in planning the individual and consolidated financial statements. This was for 18 marks. The majority of answers focussed on the correct type of risk (i.e. inherent and control risks), though some did discuss detection risks, which are irrelevant when evaluating the risk of material misstatement. Answers to (aii) tended to cover a wide range of points but very often did not discuss the points in much depth.

For example, almost all candidates identified that accounting for goodwill can be complex, leading to risk of misstatement, but few candidates explained the specific issues that give rise to risk. Similarly, most identified that the grant that had been received by one of the subsidiaries posed risk to the auditor, but most answers just suggested (often incorrectly) an accounting treatment and said little or nothing about the specific risk of misstatement. Many answers also went into a lot of detail about how particular balances and transactions should be audited, recommending procedures to be performed by the auditor, which was not asked for. Weaker answers simply stated an issue, for example, that a grant had been received, and said the risk was that it would not be accounted for properly. Clearly this is not really an evaluation, as required, and will lead to minimal marks being awarded.

It was pleasing to see many candidates determining the materiality of the transactions and balances to the individual company concerned and to the group. However, candidates are reminded that materiality should be calculated in an appropriate manner. For example, the materiality of an asset or liability should usually be based on total assets and not on revenue.

Candidates' understanding of the relevant financial reporting issues varied greatly. Most understood the basics of accounting for grants received, the revenue recognition issues caused by online sales, and that contingent consideration should be discounted to present value. However, knowledge on accounting for loan stock that had been issued by the parent company was inadequate , and very few properly discussed how the probability of paying the contingent consideration would affect its measurement at the reporting date.

Candidates attempting the UK and IRL adapted papers are reminded that the syllabus is based on International Financial Reporting Standards. References to, and discussions of, accounting treatments under UK GAAP are not correct and cannot be given credit. For example, a significant minority of answers discussed the amortisation of goodwill, which is not permitted under IFRS (though it is correct under UK GAAP) and so could not be given any marks for this discussion.

The issues that were dealt with well included:

- The due diligence on Canary Co that had been provided by an external valuer
- The measurement of contingent consideration at present value
- Online sales creating risks to do with revenue recognition
- The control risks arising as a result of a new IT system
- The non-coterminous year end of Canary Co.

The issues that generally were inadequately evaluated included:

- The recognition and measurement of loan stock issued by Crow Co
- The classification and measurement of the grant received by Starling Co
- The financial information provided in relation to the group –very few answers performed any analytical review on the performance of the group and its components

Requirement (aiii), for 5 marks, asked candidates to recommend the principal audit procedures to be performed in respect of goodwill initially recognised on the acquisition of Canary Co. Generally candidates did well on this requirement, with many providing well described, relevant procedures. This represented a definite improvement from previous sittings. Most answers considered the need to look at source documentation regarding the acquisition, the importance of assessing the fair values attributed to Canary Co at acquisition, and the need to assess the probability of the contingent consideration being paid.

The final part of Question One dealt with ethical issues. For 6 marks candidates were required to evaluate the ethical implications of the audit engagement partner attending the client's board meetings, the secondment of the audit manager to the client, and assistance in recruiting a new finance director for one of the subsidiaries. Most answers went through the issues in order and identified the ethical threats that arose. However, a lot of answers took a scattergun approach, and said that all of the issues would give rise to the same threats of familiarity, management, self-review and self-interest, but then did not go on to explain how, or why, the threats arose and whether it would be possible for safeguards to reduce the threats to an acceptable level. Candidates appear comfortable with this 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.

Question Two

This 33 mark question was in two sections. Part (a), for 19 marks, dealt with an engagement to report on prospective financial information. Part (b), for 14 marks covered the audit of a factory closure, and the difficulties in measuring environmental and social performance. Generally candidates performed better on part (a) than part (b).

The first part of the question related to an audit client, Hawk Co that had requested its auditor to provide a report on forecast financial statements included in a business plan, which would be used to help secure a loan. The scenario contained extracts from a forecast statement of comprehensive income and a forecast statement of financial position.

Requirement (ai), for 6 marks, asked candidates to identify and explain the matters that should be considered in agreeing the terms of engagement. Candidates were specifically told not to consider ethical threats to objectivity. Answers varied greatly in quality for this requirement. The best answers focussed on matters that should be discussed with the client, such as management's responsibilities, the nature of the assumptions used in the forecasts and the planned contents of the review report and explained why those matters should form part of the terms of the engagement. Most answers discussed that negative assurance should be given, and explained the importance of determining the intended user of the report including issues to do with the use of a liability disclaimer. A significant number of candidates achieved high marks on this requirement. Weaker answers discussed only matters such as fee arrangements and deadlines, which, while relevant, are not enough to score well. Some answers discussed ethical issues, which specifically were not required, and others explained matters that would be more relevant to the initial acceptance of the engagement rather than agreeing terms with the client, such as whether the firm had the competence to perform the work.

The second requirement, (aii) was for 13 marks, and asked candidates to recommend the procedures that should be used to examine and report on the forecast financial statements to be included in the business plan. The best answers made good use of the forecast financial statements that had been provided, and gave procedures that were both well described and relevant to the specific content of the financial statements. Many candidates also performed analytical procedures to determine unusual trends and relationships in the figures and information provided, which helped to generate very exact procedures. Sound answers had a range of procedures, some general, some focussed on income and expenses, some focussed on assets, liabilities and equity.

Weaker answers tended to state simple enquiries, for example "ask management who prepared the forecasts", or "ask why sales has increased" without any further development. Another problem arose in answers that seemed not to realise that the figures were forecasts, so source documentation would not be available in the same way that it is for an audit of historical information. For example, many answers suggested agreeing assets purchased to invoices from suppliers, or the forecast increase in share capital to share certificates, but these items would not yet exist as they relate to future transactions. The one area that was missing from almost all answers was the need to ensure internal consistency in all forecast figures, so for example cross-checking from the forecast financial statements to a capital expenditure budget and to cash flow forecasts.

Another problem with weaker answers was that they tended not to always provide procedures. For example, some answers contained a lengthy discussion as to whether a part of the business that was planned to be sold should be accounted for as a held-for-sale group of assets, which is not very relevant to the question requirement. These answers seemed to be drifting into an assessment of potential material misstatements, which was not asked for.

The second part of Question Two was generally not well answered. This part of the question dealt with a client which had suffered an environmental accident resulting in the closure of a factory. The audit engagement partner had asked for briefing notes to be prepared in which the principal audit procedures to be performed in respect of the cost of closure of the factory were recommended. This first part of the briefing notes, requirement (bi), was for 6 marks.

Answers were often lacking in focus. Sound d answers recommended a range of procedures specific to the types of cost that would normally be included in a cost of closure provision, such as redundancy costs. Very few candidates recognised that the date at which an obligation arose in relation to the closure of the factory was crucial, and many could recommend little more than asking for management representations. There was often discussion of the recognition criteria for provisions contained in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* but little on the specific accounting requirements in relation to a restructuring, which could have prompted some specific procedures.

Requirement (bii), for 4 marks, was a discussion on the difficulties in measuring and reporting on environmental and social performance. Candidates often struggled to write more than a few bullet points here, and sometimes wrote from the point of view of the auditor trying to obtain evidence on key performance indicators. However, most answers did identify difficulties in defining performance measures on what can be quite intangible matters, and many also discussed the problems in quantifying socio-environmental issues.

Requirement (b) also contained 4 professional marks in relation to the briefing notes requested by the audit partner. Most candidates attempted a correct format and structure for the briefing notes, and the use of paragraphs, headings and an introduction meant that many candidates scored well here. Candidates are reminded that from this sitting onwards, professional marks are awarded in only one of the Section A questions.

The UK and IRL adapted papers contained a different part (b), which attracted 17 marks, (and part (aii) was worth 10 marks). Part (b) covered the auditing aspects of insolvency part of the syllabus, and many candidates had prepared well for this type of question. Candidates were provided with information about an audit client which operates two business segments – one of which had suffered from problems with its product, resulting in a poor performance and position of the company as a whole. Requirement (bi) asked candidates to examine the financial position of the company and determine whether it is insolvent. This was for 4 marks. Although some candidates knew the meaning of insolvency and used the figures provided to demonstrate that the company is indeed insolvent, a sizeable proportion of answers did not display this knowledge and could only provide vague discussions about the company's "dire position" and that it would be unlikely to continue as a going concern. Some candidates who attempted to calculate the net liability position of the company were unable to do so correctly. Weaker answers simply stated facts from the question, for example, the negative cash position, the loss that had been made, and then concluded that the company is in a poor state. This is clearly not enough to score credit.

Requirement (bii) was for 9 marks, and asked candidates to evaluate the options available to the directors in terms of the future of the company. There were many sound answers here, with candidates discussing the options in respect of administration and insolvency, usually leading to a comparison of the implications of them and leading to a recommendation. Weaker answers tended to suggest selling the underperforming part of the business, despite the fact that the significant problem with its product would make a sale extremely unlikely, and others suggested just raising more finance, without realising that it would be very difficult for the company to raise any form of finance given its financial position and damaged brand name.
If candidates attempt the UK or IRL adapted papers they should carefully study the insolvency part of the syllabus. It was clear that a minority of candidates had no real knowledge of this part of the syllabus.

Question Three
This 15 mark question focussed on money laundering and fraud. Two short scenarios relating to two audit clients were presented.

Part (a)'s scenario described a cash-based business whose owner manager was acting suspiciously in relation to the accounting for cash sales. A large sum of cash had been transferred to an overseas bank account and the transaction had no supporting evidence. The first requirement, (ai) for 6 marks, was to discuss the implications of these circumstances. This open requirement allowed for discussion of many different implications for the audit firm, included suspected fraud and / or money laundering, a poor control environment, the ethical implications of the owners intimidating behaviour, and problems for the audit firm in obtaining evidence. Most candidates covered a range of points and the majority correctly discussed fraud and / or money laundering.

Weaker answers tended to focus on the materiality of the cash transferred to overseas, and seemed not to notice the client's suspicious behaviour. Candidates are reminded that they will often be expected to identify a key issue in a question scenario and that in a question of this type it is important to stop and think about what is happening in the scenario before rushing to start to write an answer. This question is a good example of one where a relatively short answer could generate a lot of marks – if the scenario has been properly thought through before writing the answer.

Requirement (aii) was for 3 marks and asked for an explanation of any reporting that should take place by the audit senior. Candidates who had identified money laundering as an issue in (ai) usually scored well here, describing the need to report to the audit firm's Money Laundering Reporting Officer, and what should be reported to them. Weaker answers discussed the audit report or that the fraud / money laundering should be reported to the client's management - this is not good advice given that the owner- manager was the person acting suspiciously and would have resulted in him being tipped off.

Part (b) was for 6 marks, and described a client where unauthorised additions had been made to payroll, and contradictory audit evidence had been obtained. Candidates were asked to explain the term "professional skepticism" and to recommend further actions to be taken by the auditor. Answers here were reasonably good, with most candidates able to attempt an explanation of the term, and most identifying poor controls leading to a possible fraud involving the payroll supervisor. Some very specific further procedures were often recommended, and candidates often scored better on part (b) than part (a) for this question.

Question Four
This question provided two short scenarios both of which described an ethical dilemma that had arisen at an audit firm. Candidates were required to identify and discuss the ethical, commercial and other professional issues raised, and to recommend any actions that should take place. This was the most popular of the optional questions.

Part (a) was for 8 marks. The scenario described a situation in which an audit client has approached the audit firm with a business opportunity involving the development and sale of accounting and tax software, with the audit firm's client base being a potential customer base. The audit firm had been invited to jointly develop the business with the audit client. Sound answers here used a logical approach, being prompted by the question requirement to discuss in turn the ethical issues, then commercial issues, then professional issues and leading to a set of recommended actions. There were some sound answers in which the ethical threats to objectivity had been fully evaluated, especially the self-interest and self-review threats. Commercial issues were explored in the better answers, where typically the audit firm's level of skill to develop software was questioned, as well as the issue as to whether the audit firm would want to diversify into this type of business as it may detract from the quality of audit and accounting services they offer to clients.

Weaker answers tended to just list in bullet point format all of the possible threats to objectivity without any real discussion or development of the threats specific to the scenario. Candidates are reminded that the IESBA's Code of Ethics for Professional Accountants provides a framework for the evaluation of threats to objectivity, including the identification of threats, the evaluation of the significance of threats identified, and the use of professional judgement in deciding whether the application of safeguards can reduce threats identified to an acceptable level. The use of this framework is recommended in answering questions of this type.

Part (b) was for 7 marks, and described a situation that had arisen at an audit client whose business involved medical procedures at a private hospital. The audit senior had overheard a comment made by an employee of the hospital which insinuated that the employee was not qualified to perform medical procedures. Most candidates identified that the main issues for the audit firm to consider related to a potential breach of law and regulations by the hospital, and that the audit firm should consider disclosure in the public interest. Most answers identified that confidentiality was in issue, and that the matter should be firstly discussed with those charged with governance.

Some candidates focussed on disciplinary action to be taken against the employee of the hospital, and on the possibility that the hospital's management were somehow colluding with the employee to deliberately breach law and regulations and commit some type of fraud, which missed the point. Weaker answers also failed to consider the financial statement and therefore audit implications of a letter claiming negligence, which could lead to the recognition of a provision or disclosure of a contingent liability, and could potentially have going concern implications. These matters were relevant as the audit was ongoing.

Question Five

This question was in two parts. Part (a) was for 8 marks and described the self-construction of new property, plant and equipment at a client. A loan had been taken out to help finance the construction, and financial information was provided in relation to the asset and the loan. Candidates were asked to comment on the matters that should be considered, and the evidence that should be found when conducting a file review of non-current assets.

Candidates should have been familiar with this type of question requirement, as it commonly features in P7. Sound answers contained a calculation and explanation of the materiality of the asset and of the borrowing costs that had been capitalised, followed by a discussion of the appropriate accounting treatment, including whether the borrowing cost should be capitalised, and when depreciation in relation to the asset should commence. There were some sound answers here, with candidates demonstrating sound knowledge of the relevant financial reporting standard requirements, and going on to provide some very well described and relevant audit procedures.

Weaker answers said that it was not possible to capitalise borrowing costs, or incorrectly thought that the construction should be accounted for as some kind of long-term construction contract. Procedures in the weaker answers tended to rely on management representations and recalculations of every figure provided in the question.

Part (b) was for 7 marks and involved the critique of an extract from an audit report. The report contained an adverse opinion, which most candidates spotted, in relation to the non-recognition of a defined benefit pension deficit on the company's statement of financial position. There were some sound answers here, and candidates' performance in questions of this type has shown a definite improvement. Some answers not only identified but also provided an explanation of the problems with the audit report. The majority of answers suggested that an "except for" qualification may be more suitable than an adverse opinion, and correctly calculated the materiality of the pension plan deficit to support their discussion. A significant proportion of answers picked up on the incorrect order of the paragraphs in the report and on the incorrect wording used in the headings, and on the lack of explanation that had been provided in the report regarding the material misstatement. Fewer answers discussed the inappropriate use of the phrase “deliberate omission”.

The weaker answers tended to just list out bullet points with no explanation, limiting the amount of marks that could be awarded. Other weaker answers attempted to discuss the appropriate accounting treatment for the pension, often incorrectly.

Conclusion
Candidates must practice their analytical skills to perform well in paper P7. 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. This means that candidates must take time to carefully read the question scenarios and to consider the importance and implication of the information provided. As in the previous sittings, many candidates who failed to achieve a pass mark did so through not answering the question requirement as set. So it is imperative that candidates read the requirements carefully and only answer according to the instructions given.