Examiner's report
P7 Advanced Audit and Assurance
June 2014

ACCA

General Comments

Candidates performed better at this sitting in comparison with recent sittings, and a small improvement in the pass rate was noted. There were some excellent scripts which displayed a thorough understanding of the syllabus content and very good application skills. However, the majority of scripts failed to demonstrate that candidates had the necessary knowledge, understanding and application skills to succeed in this challenging examination. Overall the pass rate continues to be disappointing.

The examination consisted of two sections, and candidates were required to answer four questions. Section A contained Question One for 35 marks and Question Two for 25 marks, both of which were compulsory. Section B comprised three further questions of 20 marks each, two of which should have been attempted.

In Section B, Question Four was the most popular, and was often well attempted. Of the remaining Section B questions, Question Five was less popular than Question Three.

In terms of exam technique, a significant minority of candidates attempted Question One last. This almost invariably was a flawed exam strategy, as not enough time had been left to attempt the longest and most detailed question in the exam. Candidates are advised to attempt Section A first, to ensure that sufficient time is devoted to these longer scenario-based questions.

A number of common issues arose in candidates' answers that contributed to the disappointing pass rate:

- Writing too little for the marks available – this was especially the case for Q2 (aii), Q3 (b) and Q5 (ai).
- Identifying issues but not explaining, evaluating or assessing the issues as required in sufficient detail.
- Illegible handwriting and poor presentation.
- Lack of knowledge of certain fundamental syllabus areas such as audit risk and audit reports.
- Lack of basic accounting knowledge – for example suggesting that provisions should be made for future losses.

The rest of this report looks at each question in turn, discussing candidates' performance on each requirement, highlighting those areas that were answered well, and those where there is room for improvement. Where there are comments worth making in respect of the adapted papers, these have been included at the end of the general commentary on the performance of the majority of candidates who attempt the INT paper.

Specific Comments

Question One

This 35 mark question was based on planning the audit of a new client – the Adams Group. The Group comprised a parent company, three subsidiaries, one of which was located overseas, and an associate which had been acquired during the year. Information relevant to each of the components of the Group was detailed in the form of narrative notes and draft consolidated financial statements were also provided. The notes contained information on the Group's activities, details of inter-company transactions, a portfolio of investment properties held by one of the subsidiaries, a new system introduced in relation to inventory, and a bonus for management based on revenue. Details were also provided in respect of the auditors of the overseas subsidiary, which had retained the services of a small local firm.

The first requirement, for 18 marks, asked candidates to evaluate the audit risks to be considered in planning the audit of the Group. This is a very typical requirement for Question one in the P7 paper, and while it was encouraging to see that many candidates had clearly revised this part of the syllabus, there were many whose answers were extremely disappointing. The best answers worked through the information provided in the question to identify the various audit risks, and evaluated them by, including an assessment of materiality and a discussion of the significance of the risks identified. Most candidates proved able to include a discussion of the most obvious of the risks in their briefing notes, including the management bonus, the classification of the associate, the valuation of investment properties and the potential control risk caused by implementing a new system during the year.

Only the better candidates identified the risks arising from the opening balances and comparative information (due to this being a new audit client for the firm), the lack of presentation of income from the associate in the Group statement of profit or loss, the incorrect treatment of the investment property revaluation gains (which should be recognised as part of profit for the year) and the change in the effective tax rate.

The best answers included in their evaluation of each audit risk an identification of the risk factor from the scenario (e.g. the measurement of the investment properties), a determination of materiality where possible given the information in the question, a clear comment on the appropriateness of the accounting treatment where relevant, and the impact on the financial statements (e.g. not cancelling inter-company transactions would lead to overstated revenue, cost of sales, receivables and payables).

The key weakness present in many answers was the poor quality of explanations. Most candidates could identify a reasonable range of risks but could not develop their answer to demonstrate a clear evaluation of that risk, in a suitable structure, like the one discussed above. For example, having identified that the portfolio of investment properties would give rise to some kind of audit risk, many candidates would then attempt to expand their answer with vague comments such as "there is risk this is not accounted for properly", "there is risk in the accounting treatment" or "there is risk that IAS 40 will not be followed". This type of comment does not represent a detailed evaluation of audit risk and does not earn credit.

Other weaknesses seen in many answers included:

- Incorrect materiality calculations or stating that a balance is material without justification;
- Incorrect analysis of the financial statements provided or incorrect trend calculations, the most common of which was stating that inventory had increased by 50% when it had doubled;
- Too much emphasis on business risk with no development or discussion of the audit implications;
- Not using the draft financial statements at all to identify audit risks;
- Not identifying from the scenario that all Group members use IFRS as their financial reporting framework and report in the same currency, leading to sometimes lengthy discussion of irrelevant matters;
- Long introductions including definitions of audit risk, showing a lack of appreciation of the fact that the notes are for an audit partner, and general discussions about audit planning;
- Lack of understanding of certain accounting treatments such as equity accounting for associates and the correct treatment of investment properties;
- Focussing on goodwill - despite the fact that no goodwill was recognised in the Group financial statements many answers discussed at length that it must be tested for impairment annually;
- Suggesting that the bonus scheme would lead to manipulation of expenses, when the bonus was based on revenue.

Requirement (aii) was for five marks, and asked candidates to identify and explain any additional information which would be relevant to the evaluation of audit risk. There were some relatively straightforward marks available here, and strong answers suggested that the individual financial statements of the components of the Group would be essential to successfully plan the audit, along with information pertaining to the management bonus scheme, any due diligence report relevant to the acquisition of shares in the associate, and background information such as relevant laws and regulations to which the Group members are subjected. Weaker answers suggested audit procedures which are not relevant to the planning stage of the audit, or just asked for management representations on matters that were included in the question scenario. A similar requirement was included in Question One of the December 2013 examination, so it was surprising that candidates seemed somewhat unprepared for this requirement.

Requirement (b), for eight marks, asked candidates to explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of the component auditor. This requirement was relatively well attempted, with the majority of answers covering a range of relevant matters and associated procedures. It was clear that many candidates had studied this part of the syllabus, and could apply their knowledge to the question scenario. Most candidates identified that the component audit firm was a small firm, so resourcing the audit could be an issue, and that due to its overseas location there may be differences in the ethical code and auditing standards used by the firm. Weaker answers incorrectly discussed the problem of the overseas subsidiary not reporting under IFRS (the question clearly stated that it did) and tended to focus on accounting issues rather than answering the question requirement. Some answers were also very brief for the marks available, amounting to little more than a few sentences or a short list of bullet points.

The UK and Ireland (IRL) adapted papers had a slightly different style in that the question requirements were not separated out and some extra information had been included in the question. The candidates attempting these adapted papers dealt well with the style of question requirements, and on the whole devoted an appropriate amount of time to the discussion of each of the requirements.

There were four professional marks available, and most candidates secured at least two of these marks by providing an introduction and using headings to create an appropriate structure for their answer. Too few answers contained a conclusion, and a significant minority of answers included a heading for a conclusion, but with nothing written underneath that heading, so the conclusion mark could not be awarded.

Candidates are reminded that practising past exam questions with a careful review of model answers is essential in order to build up a good technique for audit planning requirements such as seen in this question.

Question Two

This question focussed on two issues – prospective financial information and money laundering. It was well attempted by many candidates, indicating that these syllabus areas had been studied and understood. There was however, a lack of application to the scenario, especially in relation to the first requirement.

The scenario centred on Waters Co, an audit client, that had approached your firm to provide a report on prospective financial information which would be used by the company's bank in making a significant lending decision. The amount advanced would be used to upgrade the cinemas operated by Waters Co and a forecast statement of profit or loss was provided in the scenario, along with some of the assumptions used in its preparation by management.

Requirement (ai) was for six marks, and asked candidates to explain the matters to be considered by the audit firm before accepting the engagement to review and report on the prospective financial information. The quality of answers here was quite good, with almost all candidates making a reasonable attempt to discuss relevant matters including ethical issues, resource availability, the scope of the engagement and the nature of the assumptions used in the forecast. Where candidates scored less well on this requirement it was often due to lack of application to the scenario. A minority of answers amounted to little more than a bullet point list, often posed as questions (e.g. "are there any ethical matters to consider", "who is the report for", "why is the report needed"), and while these are matters to consider the lack of any application to the scenario limits the amount of credit that can be awarded.

Requirement (aii) for eight marks asked for examination procedures to be used in respect of the forecast statement of profit or loss, assuming the engagement is accepted. This was also quite well attempted by many candidates, who used the information provided to generate specific and relevant enquiries and other procedures.

Weaker answers tended to write very vague comments which were not tailored to the scenario or explained, or were just incorrect, such as. “obtain representations”, “agree forecast to audited financial statements”, “check whether assumptions are realistic”, “perform analytical procedures”.

The second part of the question focussed on money laundering, and in contrast to previous sittings where this subject has been examined, the answers were generally of a reasonable standard. Requirement (bi) for five marks asked candidates to explain the stages used in money laundering and to comment on why Waters Co had been identified as high risk; and requirement (bii) for six marks asked for four recommendations in respect of an anti-money laundering programme that audit firms should have in place. Most answers were reasonably well attempted, and most candidates demonstrated knowledge of both the stages of money laundering, and the elements of an anti-money laundering programme. The weaker answers tended to simply be too short, limiting the marks that could be awarded. Some answers failed to comment on why Waters Co had been assessed as having a high risk of money laundering, even though the reasons were fairly obvious from the information provided.

The UK and IRL adapted paper had a different requirement (b) which asked candidates to provide advice to Coxon Ltd, an existing non-audit services client of the firm that had been placed into compulsory liquidation after several years of making losses and a worsening cash position. The company’s directors had continued to trade in the knowledge that the company was insolvent and that loan covenants had been breached. Candidates were asked to discuss whether the directors would be liable for the company’s debt, and also to explain the impact of the liquidation for the company’s employees and creditors. This requirement was for 13 marks.

Answers to this requirement were mixed. Many candidates provided good answers, showing that they understood this syllabus area and could apply their knowledge to the scenario. The best answers discussed fraudulent and wrongful trading, and commented on whether the directors could be found guilty of either, including the implications for the directors in each case. Weaker answers were too vague, and some clearly did know this syllabus area well enough to provide any reasonable advice. On the issue of implications for employees and creditors answers were generally better, and most could discuss in some detail the order of payment of creditors on the winding up of a company.

Question Three

This question scenario was set at the completion stage of the audit of Cooper Co and candidates were well prepared for this type of question, as it was well attempted by many of the candidates that chose to answer it. The first requirement for this question, worth 15 marks in total, presented information on two separate issues uncovered during the audit that have been brought to your attention by the audit senior – factories that are producing a chemical that would be phased out in three years’ time (eight marks), and a vehicle that was sold to the company’s finance director (seven marks). The wording of this requirement would have been familiar to candidates who had practised past exam papers, and specifically candidates were required to comment on the matters to be considered in relation to each of the issues, and the audit evidence that should be found during a review of the audit working papers.

There were some excellent answers here, with many candidates achieving close to the maximum marks. Most candidates correctly identified that possible impairment was the main matter to consider in relation to the factories, and discussed the issue well. However, there were two common problems visible in answers. Firstly, there was an over emphasis on going concern issues, even though the scenario explicitly stated that sales of output from the factories was still buoyant. While it was correct to identify that without a replacement for the product there would be an impact on the company’s revenue in the future, this was not a pressing issue for this year’s audit. Secondly, in relation to the feasibility study into a replacement chemical, many candidates spent time detailing the capitalisation criteria for development costs, even when they had already stated in their answer that the amounts would have to be expensed as a research cost. This wasted valuable time as the capitalisation criteria were not relevant to their answer. Worryingly, a significant minority of answers commented on the need for a provision to be made for the loss of revenue that would happen in future years, which displays a lack of understanding over some fairly basic accounting principles.

The second issue was often well dealt with, with many answers correctly identifying the related party transaction and explaining the associated issues, including the necessary disclosure of the transaction in the financial statements. However there were often errors in the calculation of materiality, with candidates thinking that the vehicle had been sold for $50 million to the finance director, indicating that they had failed to read the question carefully. Weaker answers often stated that the sale was “illegal” or “unethical”, or that the accounting treatment was wrong, and that assets should always be revalued to fair value immediately prior to sale.

For both issues, while the comments on the matters to consider were often good, the evidence points were usually weaker. Candidates lost marks by not providing an explanation of why the evidence would be necessary, which was a specific requirement of the question. For example while most candidates suggested a review of management’s impairment calculations, this was rarely expanded upon. Similarly it was often recommended that a copy of the government regulation should be on file and reviewed, but the purpose of this review was seldom explained. In relation to the related party transaction, few procedures other than checking the invoice and obtaining management representations were usually given, and while these are relevant again the purpose of the evidence was not usually explained.

Requirement (b) was for five marks, and briefly described an issue that had arisen regarding the same audit client but in relation to a section of the previous year’s audit file that had not been completed. The section related to the development of an internally generated brand name which had been capitalised as an intangible asset and was still recognised in the financial statements. Candidates were asked to explain the implications for the completion of this year’s audit, explain any other professional issues arising and to make recommendations as to an appropriate course of action.

This requirement was not well answered. Many candidates did not know the correct accounting treatment for internally generated brand names, and discussed the capitalisation criteria which were not relevant, or impairment or amortisation of the brand name, which were also not relevant. Most could correctly determine the materiality of the brand, but far fewer identified the key issue, which was that a prior period adjustment would be necessary to correct the material misstatement that existed in the prior year’s financial statements. Few candidates discussed the quality control issues that this raised in any detail, with the most common comment being that the audit partner should be “disciplined”.

Question Four

This question contained four different issues with a common requirement to explain the ethical and professional matters relevant to each. This was the most popular of the Section B questions but performance varied tremendously.

Issue (a) focussed on business risk and risk of material misstatement, asking candidates to explain each and to explain how identifying business risk relates to risk of material misstatement. This was for four marks and most candidates could attempt the definitions, but some went into far too much detail for the marks available. The relationship between the two types of risk was usually explained by way of example, which was acceptable, and many of the examples were appropriate. The most common mistake seen in answers here was to explain audit risk rather than risk of material misstatement.

Issue (b) focussed on outsourcing, and asked candidates to consider, in the context of a manufacturing company that outsourced payroll, how the outsourcing would affect audit planning. This was also worth four marks and there were some good attempts, with most answers identifying issues in relation to access to information, assessment of the internal controls at the service organisation, and the competence of the service organisation. Disappointingly, few answers mentioned type 1 and type 2 reports that are typically obtained in this situation, and many tried to focus on ethical matters such as independence, and therefore didn't specifically address the requirement.

Issue (c) was about a potential conflict of interest between two audit clients and confidentiality of information. The audit firm had been asked to provide advice on a tender for an important contract that one audit client was preparing in relation to a different audit client. Many candidates did correctly determine that a conflict of interest would arise and could recommend appropriate safeguards. However, many answers failed to identify the potential issues surrounding the confidentiality of client information. Some candidates tried to include a comment on every one of the ethical principles – many of which were irrelevant. It is a better exam technique to focus on the most relevant of the ethical threats, and not to try to cover all of them, especially when there are only five marks available.

Issue (d) explained that the audit firm had been approached to invest in a business opportunity with an audit client, which proposed the audit firm invest some cash and supply personnel to work in a joint business venture, with profit being shared between the audit firm and the audit client. Seven marks were available for discussion of this issue. Most answers picked up on the potential for a close business relationship to be created with an audit client, and many could discuss that the severity of the ethical threats resulting from such an investment are unlikely to be acceptable. Some answers also considered the commercial angle, and many also reached an appropriate conclusion. Weaker answers listed out all of the possible threats to objectivity without any real application to the scenario.

In summary, the answers to Question Four showed that many candidates have a good understanding of ethical issues and can apply that knowledge to deal with specific scenarios. There has been some improvement in the way that candidates discuss ethical matters, with threats usually being explained, their significance evaluated, and relevant safeguards suggested. Where candidates performed less well on this question it tended to be due to them not appropriately assessing the mark allocation. It was common to see most written in the answer to (a) and less for issues (c) and (d), when the mark allocation would suggest otherwise.

Question Five

This was the least popular of the Section B questions. The question concentrated on audit reports, and also included a requirement in relation to a current issue.

Requirement (a), for eight marks, asked candidates to explain the suggestions made by the IAASB in respect of additional disclosures in the auditor's report regarding going concern status, and to discuss the benefits of such disclosures. This requirement was based on the IAASB's Invitation to Comment on Improving the Auditor's Report, an examinable document, and about which there had been a relevant article published for the benefit of candidates on ACCA's website.

It was clear that many candidates who attempted this question had read the article and understood the main proposals, and marks were awarded for this knowledge. However, very few candidates made any attempt to discuss the proposals, as requested, which limited the marks that could be awarded. Some candidates had little awareness of the IAASB's Invitation to Comment, and instead gave an answer that simply outlined the existing requirements in relation to the auditor's responsibility in respect of going concern.

The UK and IRL adapted papers contained a slightly different requirement (a), because the IAASB Invitation to Comment is not an examinable document for the UK and Irish candidates. The requirement was more general, asking for a discussion of whether including specific disclosures on going concern would improve the quality and usefulness of the auditor's report. Answers here tended to be good, with a real attempt made to properly discuss the issues and to reach an opinion and justified conclusion on the topic.

Requirement (b) was for 12 marks, and asked for a critical appraisal of a proposed auditor's report. The report contained many errors of fact and of judgment, and well prepared candidates scored highly here. There were some quite obvious matters that most candidates discussed, for example that the structure of the report was not correct, the wording was not professional, the basis for opinion paragraph lacked sufficient detail, and the nature of the modification was wrong in the circumstances described in the scenario. Most candidates also commented on the incorrect use of the Emphasis of Matter paragraph and correctly determined the materiality of the two issues described in the scenario. Overall however, answers to this requirement were often too short for the marks available, and while most issues had been identified, they were not always well explained.

Conclusion

The performance of candidates at this exam sitting showed a small improvement, and candidates seemed better prepared for some requirements. Similar to comments raised in previous examiner's reports, candidates are able to identify the relevant issues for a particular requirement from the scenario, but the ability to adequately explain, discuss or describe points in sufficient depth or detail continues to be lacking. This is often what makes the difference between a pass and a fail – with the candidates that are unsuccessful simply not providing enough appropriate explanation for the points that they identify. This is especially the case for audit planning questions, where the explanation of risk, in this case audit risk, is usually very weak. Many candidates who were not successful made reasonable attempts at Question 2 and at the Section B questions, but were let down by their answers to Question One.

Candidates are encouraged, as always, to practise past exam questions and to carefully review the model answers and the examiner's reports that accompany the past exam papers. This is important to gauge the style of question requirement that regularly appears in this paper, and to gain an appreciation of what it means to explain an answer point rather than just identify an answer point.