Examiner's report
P7 Advanced Audit and Assurance
June 2017

ACCA

General comments

The examination consisted of two sections. Section A contained two compulsory questions for 35 and 25 marks respectively and Section B contained three questions of 20 marks each, from which candidates had to answer two questions.

Performance in this session was disappointing and it remains evident that many candidates did not prepare in sufficient depth and were unable to think laterally and apply the knowledge that they have learned. Too many candidates focused on the minutiae of a point and produced a list of everything they knew about a topic whether relevant or not while missing the wider implications of the issue in hand, and which by its nature only attracted only one or two marks. There was a clear lack of both auditing and financial reporting knowledge and candidates are reminded that their knowledge of the requirements of the International Standards on Auditing (ISAs) and financial reporting knowledge must be at an appropriate stage to tackle an exam at this level.

Specific areas where many candidates demonstrated poor examination technique were as follows:

- Re-writing the question in the answer paper which in the main achieves no marks,
- Not answering the question asked which also achieves no marks,
- Quoting accounting standards without applying them,
- Using vague phrases like "perform analytical procedures", "check the relevant documentation", "in accordance with the relevant standard" does not earn marks in exam at this level unless the point is developed further,
- Poor presentation and layout, and
- Obvious lack of accounting knowledge; an error cannot simultaneously overstate assets and understate profits for example.

Specific Comments

Question One

This question presented candidates with the scenario detailing a group making three acquisitions during the year.

Part (a) required candidates to identify audit risks relating to the three new subsidiaries acquired and which should be considered when developing the group audit strategy. The question was generally well-answered; it was largely non-numerical, apart from materiality calculations, and there were a lot of issues to be tackled so strong candidates were able to maximise marks in this area. Some candidates diverted into discussing audit procedures and business risks, which were not required. Repeating the same comments for each of the three acquisitions showed a lack of planning and structure in answers.

Two particular areas where candidates experienced difficulties were as follows:

(i) whether one of the acquisitions was a subsidiary or associate and many candidates were unable to consider whether control had been acquired. Thus missing the issue that this would have a significant impact on how the acquisition should be accounted for,
(ii) the parent company capitalized an internally-generated brand name as part of an acquisition. It is important to understand that this is a group consolidation adjustment in the parent company's books and does not affect the individual company accounts as internally-generated goodwill cannot be capitalised and many candidates demonstrated a lack of knowledge in this area.

Part (b) required candidates to recommend how to audit the brand name and was well-answered by a large majority of candidates who provided comprehensive and eminently sensible audit procedures such as verifying and discussing assumptions with management, reviewing sales forecasts for reasonableness, market comparisons and considering the risk of management bias.

In part (c) candidates had to examine the ethical and professional issues arising from one of the acquisitions. This readily split into two sections. The first was whether the auditor could advise a subsidiary which was audited by another firm on corporate finance activity and this was generally well-answered with the main threats of assuming management responsibilities, advocacy and self-review being well-explained. The second issue focused on granting the component auditor access to the group working papers. Few candidates picked up on either the confidentiality issue or the reason why access to the working papers was sought.

There were four professional marks available for presentation, logic and clarity. Candidates who presented their answers in a well-structured and reasoned manner with sub-headings and references scored well. A concise paragraph is all that is required as an introduction, not a whole page. Candidates are advised to space out their work and start a new page for each sub-section. If candidates have poor handwriting they are recommended to write on alternate lines so that their answers can be read more easily.

Question Two

This question focused on quality control and ethics. Answers to part (a) were much stronger than those of (b).

Part (a) considered a poorly-managed audit in several parts and was well-answered.

Firstly the audit team did not update control testing between the interim and final audit yet planned to rely on the controls testing and perform limited substantive procedures at the final audit. Most candidates answered this well by pointing out the obvious risks of changes to controls and their effectiveness between the two dates and that this approach showed a poor quality audit.

The second part related to an unusual situation where the issuance of an auditor's report was rushed due to the audit partner's impending vacation with insufficient quality control over the process; such as the Chairman's Report being issued after the accounts were signed. Again, most candidates picked up the main issues and were able to explain that this should not have been allowed to happen as the auditor has a duty to read through other information to ensure it is consistent with the information in the financial statements.

Finally, the question noted that an Emphasis of Matter paragraph was contained in the auditor's report concerning a legal case being brought against the company. Many candidates questioned the need for this and diverted into the application of IAS 37 Provisions, Contingent Liabilities and Contingent Assets but missed the main points of this issue. Firstly the lack of a final subsequent events review meant that the circumstances around the Emphasis of Matter had not been reviewed between the completion of the fieldwork and the auditor's report being issued with the very real risk that there could have been material developments in that period. Moreover if the circumstances behind the legal case had been reviewed and the auditor's report had been correctly reported then there was the need to have discussed the wording of the report with the Audit Committee and this ISA requirement had not been adhered to. The majority of candidates were unable to identify these issues.

Part (b) gave three ethical scenarios within the audit and this section was not as well answered as candidates did not develop and explain the points which they made, especially the implications for the audit of each of the failings described in the scenario. In particular candidates need to ensure that they explain the relevant ethical threat clearly and also explain why it would negatively affect the audit. At this level marks will not be awarded for simply identifying a category of threat to independence without an explanation or informed discussion of the impact of the issue.

Firstly an assistant had been incentivised to sell additional services to the client. Most candidates picked up that this was a self-interest threat and that the role of the audit junior was to carry out an audit and not sell additional services which might prevent her focusing on the audit work. But again candidates are reminded here that they will score few marks for simply stating that this is a self-interest threat. To score the marks candidates must identify what gives rise to the self-interest threat (cross-selling) and why this threat may exist (the audit team may be motivated to focus on selling other services rather than perform high quality audit work).

Secondly, an audit assistant had helped the Finance Director to design inventory-count procedures. The majority of candidates recognised that this was a self-review threat and that the assistant may not have the experience to do this, but very few highlighted that the assistant was in fact assuming a management responsibility. Equally, few questioned the competence of the Finance Director who needed help to write the procedures.

A third assistant on the audit had previously been seconded to the client. The self-review threat was well-identified here but the familiarity threat was not widely recognised.

Only a minority of candidates who concluded that the overall audit had clearly been poorly planned overall and the cumulative impact of these systemic and multiple failings could have a material impact on the overall audit.

Question Three

This was the least popular of the optional questions and focused on the audit of a hospital and was generally not well-answered.

Part (a) focused on a potential breach of laws and regulations through the potential use of out-of-date medicines and an intimidating client. Most candidates discussed the implication for inventory valuation reasonably and some suggested highlighting the issues and lack of co-operation from the Finance Director to those changed with governance and the potential for a limitation on the scope of the audit.

Disappointingly only a minority of candidates identified that there was a wider issue that using out-of-date medication could have severe or fatal health consequences and were able to discuss the balance between the auditor’s duty of confidentiality to the client compared with their wider ethical duty to notify the appropriate regulators and after seeking legal advice.

Part (b) asked candidates to distinguish between a performance audit and audit of performance information and answers were universally poor.

The UK and Irish exam paper had an alternative question about the benefits of independent assurance provided on key performance indicators for both management and external users. Candidates mostly correctly commented that this would provide greater credibility to the information and so would be relied on more by external users. Fewer candidates identified that this would also provide management with assurance that the systems and controls in place to produce the information was sufficient and operating satisfactorily.

In part (c) candidates were required to explain how to audit some performance KPI’s and although some good points were made a number of candidates stretched their imagination as to how these could be verified and were simply impractical in the nature of their procedures.

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Question Four

There were three scenarios where candidates were asked to describe the key matters and audit evidence that would be expected in each. Overall there appeared to be a poor understanding of the accounting issues raised by the scenarios.

Part (a) concerned the audit of manufactured inventory and the appropriate inclusion of overhead and labour costs. Most identified the need to check the components back to source documentation and review the reasonableness of the process but many candidates concentrated on discussing auditing and accounting standards rather than detailing the evidence that should have been gathered. However this was the best-answered of the three sections.

Part (b) related to a topical subject – an impairment review of a retailer's property portfolio caused by diminishing shop sales countered by growing internet sales. Many candidates simply discussed whether or not an impairment review should be carried out as there were indicators of impairment (falling retail sales) but this was a given from the question as the review had already been undertaken. Few questioned whether it was reasonable to base the value in use on the assumption that sales would grow by 1% a year when in reality they were falling. Candidates appeared unwilling to challenge this underlying assumption which actually lacked commercial justification.

Part (c) related to the audit of a warranty provision. Candidates spent a lot of time discussing IAS 37 with only a minority correctly questioning why the warranty provision was decreasing when the revenues were actually increasing, thus the majority of candidates demonstrated a lack of professional scepticism. Evidence and therefore the procedures to audit the provision were generally sound, such as looking at sales volume and historic claims rates by product group and basing the provision on these. Very few candidates questioned if there was the potential for management bias as there was a substantial release of the provision without explanation when the company's profits were falling despite increasing revenues. Candidates are reminded here that the application of professional skepticism is a key component of the auditor's skillset.

Question Five

There were two discrete scenarios presented:

Part (a) concerned revenue recognition. Many candidates gave a good summary of the IFRS 15 Revenue from Contracts with Customers, conditions that revenue cannot be recognized until the goods have been delivered, control transferred and all performance obligations have been met. However some candidates demonstrated out-of-date financial reporting knowledge by referencing the superseded IAS 18 Revenue. For the most part candidates usually correctly identified that the sale had not actually occurred before year end and should be adjusted for. However, many candidates digressed into visiting and inspecting the goods in a third-party warehouse when it was clear that the performance obligations had not yet been met. Most highlighted that they should ask management to amend the accounts and that the matter should be referred to those charged with governance.

The impact on the auditor's report if no adjustment was made was mostly well-answered with candidates explaining that the accounting treatment was factually incorrect and would result in an "except for" qualification. Candidates were good at highlighting the sequencing of matters in the auditor's report and it is refreshing to see that this area was clearly understood.

Stronger candidates additionally examined whether the matter was pervasive (which would result in a disclaimer of opinion) based on the fact that the issue focused on the timing of revenue recognition.

Part (b) involved reviewing a non-audit assurance report which had been prepared in conjunction with seeking a bank loan. Good answers highlighted that the report had been poorly written (in that it was not correctly addressed, provided positive assurance, was not time-bound and was self-contradictory) and explained how each of these should be remedied. Poorer answers only concentrated on omissions, such as the lack of a date on the report.

Conclusion

It is clear again that many candidates did not prepare properly for the exam and failed to learn the topics in sufficient depth. A large number have a narrow focus on the topic that they are studying and are not keeping up to date with changes to accounting standards, such as revenue recognition.

It continues to appear that candidates take a "linear" approach to their exams and are not linking auditing to the other topics and subjects that that they are studying when there are many interactions and common areas.

Again, candidates are urged to re-learn the basics of auditing – independence, ethics, robust third party evidence, audit risks and understanding the proper use of audit opinions – and are encouraged to use past questions to help them study and revise for the exam.