Examiner's report

P7 Advanced Audit and Assurance
March 2017

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.

The overall marks for this diet improved slightly but it remains evident that many candidates simply did not prepare in sufficient depth and were unable to think laterally and apply the knowledge that they have learned. There was a clear lack of both auditing and financial reporting knowledge. 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. Candidates who were able to critically evaluate the scenarios described and apply their knowledge and address the key issues performed well.

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

- Re-writing the question in the answer paper,
- Not answering the question as set,,
- Quoting accounting standards without applying them,
- Using vague phrases like "perform analytical procedures", "check the relevant documentation", "in accordance with the relevant standard" cannot earn marks in an exam at this level unless the point is developed further,
- Poor presentation and layout,
- Obvious lack of accounting knowledge; an error cannot simultaneously overstate assets and understate profits for example.

Specific Comments

Question One (35 marks)

This question presented the scenario of a large cosmetics group and candidates were presented with three requirements.

Question 1(a) required risks of material misstatement in the audit to be considered, including using analytical procedures, and a full statement of financial position and statement of profit or loss were provided. This was generally well-answered as there were lots of potential risks to discuss. Candidates that did not score well often concentrated on explaining audit procedures rather than evaluating risks. Disappointingly many candidates only calculated one or two ratios or trends even though the question asked for analytical procedures and contained a full page of numerical data to analyse. Candidates' inability to utilise all the information provided when evaluating risks continues to be an area of concern and continues to demonstrate that candidates must improve their exam technique in this regard.

Part (b) required candidates to highlight additional information to enable more detailed analytical review to be performed. Answers to this part were collectively disappointing with most candidates giving generic lists of additional items that may be required, such as board minutes or impairment reviews. These would be required as part of a wider audit plan but that was not what the question asked for. Very few candidates actually answered the question and highlighted what information was required for analytical review purposes, such as a breakdown of sales by product or market.

Part (c) was split into two sections, firstly the audit procedures related to the impairment of a brand. This was reasonably answered with some good procedures highlighted but many candidates erroneously digressed into seeking the original cost of the brand and discussing whether any claims were being made against the company which would have been better-included in part (a).

In part (c) (ii) the audit procedures related to a planned acquisition and were generally well-answered with sensible procedures such as reviewing the due diligence report, board minutes and discussions with management about the likelihood of success. Theorizing about whether the acquisition would be a subsidiary or associate or suggesting audit procedures for the enlarged group did not answer the requirement.

There were four professional marks available for presentation, logic and clarity. Candidates who presented their answers in a logical and reasoned manner with sub-headings and references scored well. Again candidates are advised to consider their exam technique in this area, for example only one concise paragraph is necessary as an introduction, not a whole page. Candidates are advised to space out their work and start a new page for each sub-section. .

Question Two (25 marks)

This question focused on a group audit with component auditors and audit issues in each of the subsidiaries. This question was not well-answered overall with many candidates appearing not to understand the concept of the level of control required by the group auditor and the amount of instruction and interaction required with component auditors.

Part (a) considered a poorly-planned audit where the audit manager had concluded at the interim audit that intercompany balances which were not being properly accounted for did not matter "as they were eliminated on consolidation" yet he repeated the same tests and reliance on controls at the final audit. Candidates seemed unable to grasp that, because of the control failures, substantive work (such as reconciliations) was required and that this control failure should be highlighted to management at the interim stage so they could take steps to resolve these issues in advance of the final audit.

Additionally, the manager tested capital expenditure controls in only one subsidiary and concluded that those results could be applied to the rest of the group without further testing. Many candidates discussed generically how to audit capital expenditure and did not consider the relevant issues raised in the scenario and that it would be necessary to evaluate the work of the component auditors and identify what additional procedures might be required.

Part (b) concerned a subsidiary acquired during the year which had a different auditor. Candidates generally failed to recognise that the role of the component auditor is firstly to audit the subsidiary for its whole financial year, regardless of the change of ownership. Most did not appreciate that the group auditor needs to issue instructions to the component auditor, assess their competence and independence and review and document their work as part of the group audit. Incorrectly blaming the component auditor for a poorly-planned group audit showed a lack of knowledge of the fundamentals of how a group audit works.

Requirement (c) presented another subsidiary which had a potential going concern issue but the component auditors had concluded that there was not a significant risk. Strong answers proposed a more detailed review of the component auditor's work and conclusions along with an assessment of their competence and then considered the impact on the group as a whole. It is evident that there is poor understanding that goodwill arising in the consolidated accounts is held in the consolidated statement of financial position and not in the financial statements of the subsidiary and that assessing any potential impairment is the role of the group auditor, not the component auditor. Candidates are advised to make sure that they are knowledgeable of the requirements of the ISAs in this area.

Question Three

The scenario was a forensic investigation into a non-client retailer who was fraudulently recognising revenue in the form of supplier rebates and placement fees before they were earned.

Part (a) concerned the professional matters to be considered before accepting the assignment and was generally well-answered with most candidates setting out the usual client acceptance and due diligence steps that would be undertaken such as capability, resources, risk, fees, timescale, audience and scope. Professional clearance with the auditors was not required but may have been a courtesy.

In part (b) candidates were asked to explain the procedures to quantify the revenue overstatement. Answers to this were particularly disappointing. Candidates did not understand the concept that transactions of this nature were being fraudulently made and approved at a senior level in the head office so proposals to "interview the sales staff" and "review all sales invoices" were unrealistic and ineffective.

Asking to review the auditor's working papers was an interesting angle which a few candidates explored; however, in such cases the audit firm and their insurers would likely prohibit the release of any information of this nature in the circumstances presented.

Part (c) asked whether the auditors should have identified the fraud. Strong answers set out the respective duties of management and auditors in respect of fraud but very few highlighted that ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires auditors to presume that there is a risk of fraud in revenue recognition and that audit work should be planned accordingly. This was especially important in the given context of falling profitability over a number of years.

Question Four

There were three scenarios for different clients, all of which related to ethical and professional issues arising from their audits. This question was the most popular of the optional questions and generally had the best answers.

Part (a) concerned the provision of multiple services to a listed group. Good answers identified that there was plenty of scope for self-review with the non-audit services (review of inventory controls and a cash flow and profit forecast), advocacy threats relating to a bank loan application and the prohibited contingent audit fee. Safeguards and limitations were well- discussed.

In part (b) the engagement quality control reviewer (ECQR) provided the listed client with some specialist advice which created a self-review issue and he should have recused himself from the role of ECQR. A number of candidates seemed to be uncertain of the role of the EQCR and it is recommended that candidates need to properly understand the respective roles of the personnel involved with an audit. In addition some candidates wanted to involve the client's audit committee without realising that this is purely an internal matter for the audit firm who need to improve their quality procedures.

Part (c) related to a non-listed client seeking advice on a new accounting system. Most candidates emphasised the obvious risks of the threat of management responsibility along with self-review threats to future audits. Mitigating controls, such as clear engagement letters and the use of separate teams were well explained. Some candidates concluded that this posed too many risks regardless of the safeguard and the assignment should be politely declined; such well-argued answers were rewarded.

Question Five

The question focused on the going concern review of a retail stationery chain facing online competition.

Part (a) (i) discussed if adequate audit evidence had been obtained on whether the going concern concept was applicable. Most candidates made reasonable points, such as highlighting that a 6-month period was inadequate, as was internally-generated evidence from the CEO. However, few applied sufficient scepticism to question why the cash forecast showed a large net inflow of cash when the business was declining which was out of line with previous cash flow patterns.

Section (a) (ii) sought details of additional procedures to carry out on going concern. Two particular issues were highlighted in the question – (1) lease costs were scheduled to rise and (2) minimum wages were rising. Very few candidates identified that the cash flow forecast should contain the new value with the increased costs rather than the current costs which is what the client had included. Digressions into whether this was a finance or operating lease was not relevant.

Part (b) concluded that the business was a going concern, but with material uncertainty and the requirement was to assess the implications for the auditor's report.

Understanding the concept and structure of the auditor's report is fundamental for this subject and a worryingly large proportion of candidates suggested an Emphasis of Matter paragraph which is no longer the appropriate way to report a material uncertainty, that has been adequately disclosed, in relation to going concern,. Most did identify that a "material uncertainty in respect of going concern" paragraph was required and that it would cross-reference the disclosure in the accounts and were correct that this statement should be placed directly after the opinion paragraph.

It should be noted that during this exam session it was appropriate for candidates studying under the United Kingdom or Ireland syllabus to continue to refer to the use of an Emphasis of Matter paragraph.

Some candidates stated that the audit partner was incorrect and that a qualified, disclaimer or adverse opinion should be given. These students did not read the question properly and again are reminded to consider appropriate exam technique

Conclusion

It is clear again that many candidates did not prepare properly for the exam and learn the topics in sufficient depth. A large number have a narrow focus on the topic that they are studying and are not reading around the subjects; answers to fraud in revenue recognition in a major retailer was a prime example of not linking theory to the current wider world.

It continues to appear that candidates take a “linear” approach to their exams and are not linking auditing to the other topics and exams 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.