Examiner's report

P7 Advanced Audit and Assurance
June 2015

ACCA

General Comments

The performance of candidates in P7 continues to be extremely mixed. At this sitting there were some excellent scripts which clearly demonstrated a thorough understanding of the syllabus content, and displayed effective application and analytical skills. However, performance overall continues to be disappointing. Many of the weaker scripts indicated that candidates had limited knowledge of auditing principles and that candidates struggled to appropriately apply knowledge to the question scenarios.

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.

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 Q1(c), Q3 (b), and Q4(c).
- Providing answer points that were not relevant to the requirement – in particular for Q1 (a), Q3 (b) and Q3(c).
- Failing to discuss, explain or generally expand on points beyond simple identification of facts given in the question. Answers often lacked the detailed evaluation and assessment that is required at this level.
- Writing points that were much too vague and failing to display either technical knowledge or application skills.
- Illegible handwriting and poor presentation.
- Lack of knowledge on certain syllabus areas.
- Lack of basic accounting knowledge – for example not understanding debits and credits or whether accounting errors would lead to the overstatement or understatement of balances and transactions.

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 set in the planning phase of the audit of a new audit client, Ted Co. The company was a computer games designer and publisher which had experienced significant growth in recent years, and had become listed in its home jurisdiction during the financial year. Information was provided on the company's financial background, its operations and corporate governance structure. Extracts from the financial statements were provided along with the Earnings per Share (EPS) figure calculated by the company's finance director.

The first requirement was for six marks, and asked candidates to discuss the matters specific to an initial audit engagement which should be considered in developing the audit strategy. Given that Ted Co was a new audit client this was a very relevant requirement. The answers were very mixed in quality, with the best answers concentrating on practical matters such as reviewing the previous audit firm's working papers, planning procedures to obtain evidence on opening balances, and ensuring that the audit team developed a thorough understanding of the business.

Unfortunately the majority of candidates provided generic answers discussing whether or not the firm could take on the audit, engagement letters, fees, customer due diligence and checking to see if the previous auditors had been correctly removed from office. It was not relevant to discuss whether the audit firm should take on the client and associated acceptance issues as it was clearly expressed in the scenario that this decision had already been taken and consequently answers of this nature scored limited credit.

Other weaker answers discussed general audit planning matters such as the need to determine a materiality level. This was not tailored to the specifics of this scenario as this would be relevant for any audit. Candidates are reminded to answer the specific question that has been set, which in this case should have meant answers focussing on matters relevant to planning an **initial** audit engagement after the engagement has been accepted.

Some candidates wrote a lot for what was only a six mark requirement. Candidates are reminded that the marks for each requirement are a guide as to how long should be spent on answering the question. In some cases the answers to Q1 (a) ran to several pages, leading to time pressure on subsequent answers.

Requirement (b) for 17 marks asked candidates to evaluate the audit risks to be considered in planning the audit. There were some excellent answers to this requirement, with many responses covering a range of audit risks, all well explained, and all relevant to the scenario. The best answers demonstrated that a methodical approach had been applied to the information in the scenario, and the better candidates had clearly worked through the information logically, identifying the risk factors, then going on to explain them fully and specifically. The audit risks that were generally dealt with well included those relating to the foreign currency transactions and to the portfolio of short term investments. The risk relating to whether research and development costs could be capitalised was also identified by the majority of candidates, but the issue of amortisation was not often discussed.

To achieve a good mark for this type of requirement, candidates should look for a range of audit risks, some of which are risks of material misstatement and some are detection risks. Candidates however do not need to categorise the risks they are discussing or to spend time explaining the components of the audit risk model.

When discussing audit risks relating to a specific accounting treatment, well explained answers will include an evaluation of the potential impact of the risk factor on the financial statements, for example, in this scenario there was a risk that the short term investments were overstated in value and that profit also was overstated. Materiality should be calculated when possible, as this allows prioritisation of the risks identified. Strong candidates, as well as providing detailed analysis and explanation of the risks, also attempted to prioritise the various risks identified thus demonstrating appropriate judgment and an understanding that the audit partner would want to know about the most significant risks first. Candidates are reminded that it is those risks that could result in a material misstatement in the financial statements, which need to be identified and addressed.

Weak answers included answer points that were too vague to be awarded credit. Comments such as “there is a risk this has not been accounted for properly”, “there is risk that this is not properly disclosed” and “there is a risk that the accounting standard has not been followed” are unfortunately too common and will not earn marks due to the lack of specificity. It would be beneficial for candidates to review their answers and to consider whether what they have written would provide the audit engagement partner with the necessary knowledge to understand the risk profile of the client in question.

Other common weaknesses in answers include the following points:

- Discussing business risks instead of audit risks – in particular business risks relating to theft of inventory, security issues in relation to e-commerce and exposure to foreign currency fluctuations were often discussed, sometimes in a lot of detail, but usually the related audit risk was not developed.

- Incorrect comments on accounting treatments – for example discussing that the licenses granted by Ted Co should be treated as intangible assets.

- Lack of knowledge on some accounting issues – in particular many candidates clearly did not know how EPS should be calculated and therefore did not realise that the finance director's calculation was incorrect or how short term investments should be measured.

- Evaluation of the company's corporate governance structure, but not linking this to audit risk.

- Incorrect materiality calculations.

Requirement (c) was for eight marks, asking candidates to recommend audit procedures to be performed on the portfolio of short term investments and on the EPS figure. Some candidates proved able to provide a good list of recommendations, but this was the minority. Answers tended to be better in relation to the investment portfolio, with many candidates appreciating that determining the short-term nature of the investments was an important issue and that the fair value of the shares at the year end could be agreed to stock market listings. However, most candidates could only provide vague suggestions such as "discuss with the board" or "agree to supporting documentation", and in relation to the fair value of the share many candidates could only suggest to "rely on an expert" which was not necessary given that the investment relates to the shares of listed companies. Some candidates tried to make the recommended procedures much too complicated, not fully appreciating that traded equity shares can be easily valued and documented.

The procedures in relation to EPS were often very vague, with many candidates only able to suggest a recalculation of components of the calculation provided, or check the board had approved the calculation, neither of which were relevant given that the calculation was incorrect. Very few candidates picked up on the fact that the weighted average number of shares would need to be verified given that the company had a share issue during the year.

There were four professional marks available, and most candidates secured most of these marks by providing an introduction and using headings to create an appropriate structure for their answer. However, presentation was not always good and candidates are reminded to pay attention to determining an appropriate layout for their answer.

The adapted papers for the UK and Ireland (IRL) candidates contained an adapted version of Question One in which the requirements were not separated out and given specific mark allocations and some extra background information had been included in the question. The candidates attempting these adapted papers dealt well with the style of question requirements, and mostly devoted an appropriate amount of time to the discussion of each of the requirements.

Question Two

This question was for 25 marks, and was split into two requirements. The first, requirement (a), asked candidates to comment on the matters to be considered and explain the audit evidence they would expect to find in a review of the working papers relating to the audit of the Adder Group. Candidates who have practised past exam papers will be familiar with requirements of this type, and with scenarios set in the completion stage of the audit. This requirement was for 16 marks, with eight marks available for discussion of each of the two issues described in the question.

The first issue related to a sale and leaseback arrangement. The Adder Group had derecognised the asset and recognised a profit on disposal. Information was provided in the scenario to allow candidates to discuss whether the leaseback was a finance lease or an operating lease, and then to comment on whether the accounting treatment appeared appropriate. Answers on the whole were good. Most candidates proved able to confidently discuss whether the lease had been appropriately classified and accounted for. In addition almost all candidates correctly determined the materiality of the balances and could provide some specific and well explained points on audit evidence.

The second issue related to the acquisition of a 52% shareholding in Baldrick Co, which had been accounted for as an associate in the consolidated financial statements. Again, candidates were able to identify that the accounting treatment seemed incorrect, and could explain their reasoning. Fewer candidates appreciated that the loss-making status of Baldrick Co was the possible explanation for the Group's reluctance to consolidate it as a subsidiary and therefore that the Group's profits were overstated. Most candidates could provide some evidence points, with the most commonly cited being the board approval of the acquisition and agreeing the cash paid to bank statements. Fewer candidates could suggest how the audit firm should obtain evidence on the exercise of control by the parent company or on the mechanics of the consolidation that should have taken place.

Requirement (b) was for nine marks and focused on laws and regulations, continuing to use the Adder Group as the scenario. Information was provided about suspicious activity in the Group's storage facility warehouses, where it was implied that internal controls were deficient and that hazardous materials were being kept, possibly against relevant laws and regulations. An employee had threatened the audit senior when questioned about the situation. Candidates were asked to discuss the implications of this situation for the completion of the Group audit.

Most candidates identified the obvious issues, namely that this was likely to be a breach of laws and regulations, internal controls were poor, and that an intimidation threat existed. Beyond this, the quality of answers varied dramatically. The best answers used a methodical approach to explain the auditor's responsibilities in relation to a suspected breach of laws and regulations; including the need to obtain more evidence, the auditor's reporting responsibilities, and the need to consider client confidentiality as well as possibly reporting the matter in the public interest. It was pleasing to see many candidates deal well with these issues, as well as the ethical threat raised by the employee's behaviour.

Weaker answers focussed solely on the potential money laundering implications, which while not irrelevant should not have been the only matter discussed. In addition, weaker answers simply stated facts without much attempt to apply the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, to the scenario. Some candidates suggested that the audit firm was responsible for ensuring that the Group was complying with relevant laws and regulations, saying that the audit firm should "ensure compliance", and there were occasionally suggestions that the audit senior should be "disciplined" for not taking further action when threatened by the employee of the Group. These comments, especially the latter, demonstrate a lack of judgment or real understanding of the role of the auditor in this regard.

Question Two was for many candidates the best attempted question on the exam. For requirement (a) it was encouraging that so many scripts discussed financial reporting matters with confidence, and crucially, were able to link those matters to relevant audit evidence points; for requirement (b) it was pleasing to see candidates indicate knowledge of the relevant ISA and demonstrate some application skills.

Question Three

This 20-mark question focussed on professional scepticism, the audit of goodwill impairment, and a forensic investigation into alleged bribery payments made by several of the audit client's employees.

Requirement (a) was a five mark discussion, asking candidates to explain the meaning of the term professional scepticism and to discuss its importance in planning and performing an audit. It was clear that many candidates had read and understood the contents of a recent article on the topic of professional scepticism. Most answers provided an appropriate definition of professional scepticism and went on to discuss how it links to audit quality. Stronger candidates also discussed how the auditor should apply professional scepticism when considering the risk of material misstatement associated with fraud and areas of the financial statements that rely on the application of judgment. Few candidates however, discussed the recent activities of the regulatory bodies in respect of professional scepticism.

The second part of the question, requirement (b), involved a scenario which described how the finance director of the Tony Group was insisting that the audit firm should rely on a file prepared by him in their audit of goodwill impairment. The file contained workings and assumptions and had been checked by the Group's head of internal audit. The requirement asked candidates to discuss how professional scepticism should be applied to the scenario, for six marks and to explain the principal audit procedures to be performed on the impairment of goodwill, for five marks.

Many candidates were able to explain that the Group finance director was intimidating the audit firm, that his workings were not sufficient as a source of evidence, and that he may have something to hide. It was disappointing that few candidates appreciated that the Group's profit before tax had fallen significantly, and therefore the small impairment to goodwill suggested by the finance director was unlikely to be sufficient in the circumstances, and probably influenced by management bias. Most candidates did however realise that the audit firm should perform their own workings and not place complete reliance on the procedures that had been performed by the head of internal audit.

The requirement relating to procedures on goodwill impairment was poorly attempted. The evidence points provided by candidates for this requirement tended to revolve around recalculation or a discussion with management. Very few suggested specific procedures that would allow the auditor to develop their own expectation in terms of the impairment necessary, which could then be compared with the finance director's workings. This was disappointing, as impairment has featured in several P7 exams as an audit issue and is a topic that candidates should be better prepared to tackle. Many candidates did not answer the question, and simply described the accounting treatment for goodwill, or suggested procedures that were relevant to the calculation of goodwill at acquisition but not relevant to a review of its impairment.

Requirement (c) was for four marks and asked candidates to recommend the procedures to be used in performing a forensic investigation. This was in relation to alleged bribery, whereby members of the Group's sales team were suspected of making payments to customers in order to secure contracts. Answers to this requirement were weak. Many candidates gave no procedures at all, therefore not answering the question set, and instead described agreeing the scope of the work or whether the investigation could be performed for ethical reasons. Other candidates gave broad statements instead of procedures, such as "quantify the loss" without explaining how this could be done, or "interview the suspects" without saying what the purpose of this interview would be.

To comment generally on the performance on Question Three, it was quite clear that many candidates had chosen to attempt this option question because they had read the relevant article on professional scepticism, but that they had very limited knowledge on either impairment audit issues or on forensic investigation procedures. To improve exam technique, candidates should ensure that they can have a good attempt at all requirements of a question before selecting that question in the exam.

The UK and Irish adapted papers had a slightly different format, but this did not seem to have any impact on candidates' performance in any part of the question.

Question Four

This question was broadly themed around audit quality and ethical issues and featured the audit of Wire Co, for which the audit report on the most recent financial statements had just been issued. The question was split into three short scenarios, with the requirement to comment on the quality control, ethical and professional issues contained in each with respect to the audit of Wire Co and the firm-wide policies of the audit firm. Candidates were also required to recommend any actions to be taken by the audit firm.

Part (a) described how the audit committee of Wire Co had refused to agree to an increase in audit fees despite an increase in the company's operations. Consequently the audit firm increased the materiality level used during the audit, reduced sample sizes used when obtaining audit evidence and cut out some review procedures. Many candidates attempted this part of the question well. Effective answers explained the intimidation threat to objectivity caused by fee pressure and went on to discuss the impact of each of the issues raised in the scenario on the quality of the audit that had been performed. It was pleasing to see many candidates discuss matters such as sampling risk and the need for review procedures to assure the quality of audit work and to reduce the audit firm's detection risk. Weaker answers tended to be repetitive, and for each of the issues simply say that "not enough evidence could be obtained" resulting in material misstatements and an inappropriate audit opinion.

Part (b) focussed on the issue of off-shoring audit work, which had been discussed in an article. This requirement was for five marks and the scenario described how some of the audit work in relation to Wire Co had been performed by an overseas office. The work performed by the overseas office included numerical checks on calculations and reading the board minutes of Wire Co. Answers ranged in quality, with some good attempts which identified that while off-shoring can bring efficiencies to an audit, care must be taken in deciding the type of work that is performed by the overseas office. From this scenario it should have been identified that off-shoring procedures such as the reading of board minutes to identify audit issues was not appropriate, but relatively few answers mentioned this point. Weaker answers tended to suggest that overseas offices would be incompetent and unable to perform even the simplest of audit procedures. Some candidates misinterpreted the information provided and assumed that the scenario was about using component auditors in a group situation, which was not the case.

Part (c) centred on the fact that the former finance director of Wire Co had joined the audit firm as an audit partner, and while he was not involved with the audit, he had discussed Wire Co with the audit engagement partner. Most candidates realised that the former finance director could have influenced the partner and had motivation to do so given that he held shares in Wire Co for a period of time after joining the audit firm. Stronger candidates were able to clearly explain the specific ethical threats that arose from the scenario, provided sensible recommendations, and also commented on the audit firm needing stronger firm-wide policies in the event of recruiting new audit partners from audit clients. The scenario also stated that audit team members were being encouraged to cross-sell non-audit services to audit clients and that they would be appraised on this. The answers here tended not to focus on the problems caused by appraising staff on their success in selling services to audit clients but instead discussed generally the ethical problems of providing non-audit services to audit clients. While not irrelevant, these discussions tended to be very general and not applied to the information in the scenario, resulting in answers that lacked focus.

Generally, when candidates are discussing ethical threats they must take care to explain why a threat has arisen. Many answers simply stated that a threat existed, for example by saying "holding shares in a client is a self-interest threat" but did not develop the point further. This limits the amount of marks which can be awarded.

It was also clear that many candidates were not guided by the mark allocation for the various parts of the question, and a significant number of answers to part (c) were the same length as the answer to part (a). As mentioned earlier, candidates should bear the mark allocation in mind, and use it to determine how long to spend in answering each part of the question.

Question Five

This question was based on the audit of Darren Co, a company operating in the construction industry and a new client of Nidge & Co. Information was provided in respect of three issues at the completion stage of the audit, and for each issue candidates were required to discuss the implication for the completion of the audit and for the auditor's report, and to recommend further actions to be taken. Generally the question was well attempted by many candidates who seemed well prepared for a question of this type.

Part (a) was for eight marks and described how Darren Co's financial statements recognised all of the profit relating to a long-term construction contract even though it was only part completed at the year end. Candidates performed well on this requirement, providing answers which confidently discussed both the inappropriate accounting treatment and the implications for the audit opinion if the material misstatements identified were not corrected by management. Some candidates missed out on marks by not recommending any further actions or by only discussing the impact for the audit opinion itself and not the overall impact on the audit report, failing to mention the need for a Basis of Opinion paragraph within the audit report. Only the strongest candidates realised that this incorrect accounting treatment may have been applied to other contracts and that opening balances may be incorrect given that this was a new audit client.

Part (b) was for six marks and provided information on a completed contract in respect of which Darren Co was facing legal action due to problems that had arisen following completion. The scenario stated that disclosure on the matter had been made in the notes to the financial statements and that the audit evidence on file concluded there to be a possibility of Darren Co having to pay the damages claimed. Candidates again seemed confident of the accounting rules, yet many suggested that a provision should be made for the damages; this may be because candidates assumed that there "should" be some implication for the auditor's opinion given the facts of the scenario, but this was not the case. The other significant issue was that Darren Co could not afford to pay the damages given its small cash balance, and this could raise a threat to the going concern status of the company. Only the strongest candidates made this connection and were able to explain clearly the implications for the audit report. In this scenario the issue was that a disclosure would be sufficient, as long as there was only a possibility that the claim would need to be paid, but the crucial aspect was that audit firm would need to audit the disclosure carefully to obtain evidence as to its sufficiency especially given the potential impact on going concern. As in part (a), the further actions were generally not given, other than a generic suggestion to "discuss with management".

Part (c) was for six marks and briefly outlined that Darren Co had included as a key performance indicator in its integrated report the percentage increase in profit before tax. Candidates were provided with the information to calculate that the indicator was incorrect. It was unfortunate that a significant minority of candidates were unable to work out a simple percentage increase despite the information being clearly presented in the question scenario. Despite this, almost all answers identified that the stated key performance indicator was incorrect. The best answers explained that management should be asked to amend the figure in the integrated report, and that if it remained uncorrected it would not impact on the audit opinion, but should lead to the inclusion of an Other Matter paragraph within the audit report. Weaker answers suggested that the opinion should be modified due to material misstatement which is incorrect. Again, there were few suggestions of further action to be taken other than "discuss with management".

The main weakness in answers to this question was a lack of specificity in the actions that had been recommended, and in many answers no actions were provided at all, severely limiting the marks that could be awarded.

Conclusion

As stated in the conclusion to the previous examiner's report, almost all candidates are able to identify at least some relevant issues to a particular requirement from the scenario, but not all can adequately explain, discuss or describe their points in sufficient depth or detail. Candidates must ensure that they answer the specific requirement which has been set, and focus their answer points on the scenario. Candidates are also reminded that while it is important to have good knowledge of financial reporting, they must be able to link this to the appropriate audit issues that arise in the question scenarios.

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.