Examiner's report

P7 Advanced Audit and Assurance
December 2013

ACCA

General Comments

Candidates' performance this sitting was similar to that of previous sittings, though there was some improvement in the way that certain question requirements were attempted. There were some scripts which displayed not only a thorough understanding of the syllabus content, but also sound application skills and high quality explanations. However, the majority of scripts failed to demonstrate that candidates had the necessary knowledge, understanding and application skills to succeed in this challenging examination.

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.

The majority of candidates attempted the required number of questions, and there was little evidence of time pressure. Where question requirements were left unanswered by candidates, this appeared to be due to a lack of knowledge or inadequate exam technique, as opposed to time pressure.

In Section B, Question Four was the most popular, and was often well attempted. Questions three and five were attempted by a roughly equivalent proportion of candidates and none of the Section B questions seemed particularly unpopular.

This sitting there seemed to be an improvement in exam technique, as the vast majority of candidates answered Section A first, leaving the shorter Section B questions to the end. This is a sensible exam strategy given that Section A accounts for 60 of the marks available for the paper.

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

- Writing too little for the marks available – this was especially the case for Q1(c), Q2(a), Q3(b) and Q5(ai).
- Identifying issues but not explaining, evaluating or assessing the issues as required.
- Lack of any real analytical or discursive skills.
- Illegible handwriting and inadequate presentation.
- Lack of audit knowledge.
- Lack of basic accounting knowledge – there was a worrying display of inadequate understanding of double entry bookkeeping in many scripts, and this appears to be becoming more of an issue.

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.

Specific Comments

Question One

This 35 mark question involved the Stow Group, which had undergone some reorganisation during the year. A subsidiary had been disposed of, and a new foreign subsidiary had been acquired. Information was provided in the form of notes of a meeting that had been held with the Group's finance director. The notes described the acquisition of the foreign subsidiary Zennor Co and the goodwill arising on the acquisition, the disposal of Broadway Co, and gave information about some trading between group companies. In addition, some detail was provided on Zennor Co's internal audit team.

As is typical in Question One, the requirements were based on planning the audit. The first requirement, for 12 marks, asked candidates to explain the risks of material misstatement to be considered in planning the Group audit, and to comment on materiality. This type of requirement is standard for P7, many candidates made a reasonable attempt at this requirement. Almost all candidates could at least identify several risks of material misstatement and determine their materiality, however the quality of explanation varied dramatically between scripts.

The best dealt with issues included the acquisition of the new subsidiary, with the majority of candidates correctly retranslating its figures into the Group's currency and discussing the risks relating to the reatranslation process. Other matters generally well dealt with was the measurement of goodwill on acquisition and the risks associated with the elimination of balances arising on transactions between Group companies.

The main weakness seen in candidate's answers to this requirement was that of inadequately explained risks of material misstatements. While most candidates could identify a risk, only a small minority could adequately explain the risk. For example, having identified a risk, say in the recognition of goodwill, some candidates would simple suggest that "this should be accounted for properly" or that "the auditor must ensure that this is calculated properly", or simply "this needs to be accounted for in accordance with accounting standards". Unfortunately this type of comment does not adequately answer the question requirement and where candidates supplied this type of explanation in their answers they would be unlikely to generate sufficient marks to pass this question requirement. Candidates are reminded that practicing past questions and carefully reviewing the model answers are the best way to prepare for this type of requirement, in order to understand exactly what is being asked for in the question requirement and to develop skill in explaining the risks identified.

Very few candidates picked up on some of the less obvious risks of material misstatement such as the tax implication of the disposal of Broadway.

Other common errors and weaknesses in answering this requirement included:

- Discussing business risks and failing to develop these into risks of material misstatement.
- Discussing detection risks, which are not part of the risk of material misstatement.
- Incorrectly calculating the amount of profit that should be consolidated for the subsidiaries during the year.
- Stating that Zennor Co's assets and liabilities should be recognised on a time-apportioned basis due to the subsidiary being acquired part way through the year.
- Stating that goodwill on acquisition should be cancelled out and not recognised in the group accounts because it is an inter-company transaction.
- Discussing that Broadway Co's assets and liabilities should be classified as held for sale at the year. end, when in fact the subsidiary had been sold some months prior to the year end.
- Providing long discussions on the use of component auditors at the year end, which was not relevant to the scenario.
- Simply saying that a balance is material without demonstrating that this is the case.

Requirement (aii), for 4 marks, asked candidates, in the context of planning the Group audit, to identify further information that would be needed. Answers to this requirement were very mixed. Sound answers identified that information such as the due diligence report on the acquisition of Zennor Co and its previous years financial statements and audit reports would useful in planning the audit, as well as business background given that it is a first-year audit. Some answers gave audit procedures rather than information requirements, which was not asked for. Again candidates are encouraged to review similar past exam requirements and their model answers to gain an understanding of the type of information that would be useful in planning the audit.

The next requirement was for 8 marks, and required candidates to recommend the principal audit procedures to be performed in respect of the disposal of Broadway Co. While there does seem to have been an improvement in the way that some candidates describe audit procedures, with many candidates scoring enough marks to pass this requirement, many answers were too vague to score well on this requirement. It was common to see procedures suggested such as “agree to supporting documentation”, or simply “discuss with management” without any suggestion of what documentation should be looked at, and for what purpose, or the relevant matters that may be discussed with management. Procedures need to be specific to score well.

Requirement (c), for 7 marks, focussed on a suggestion by the Group’s finance director that the external audit firm should use Zennor Co’s internal audit team as much as possible in order to reduce the audit fee. Some information was provided about the internal audit team, the work they had performed, and the fact that it reports to the board of directors in the absence of an audit committee. The finance director had also requested that the audit fee should not be increased from the previous year. Candidates were asked to discuss how the finance director’s suggestions impact on audit planning and to comment on relevant ethical issues.

This requirement was generally quite well answered. Most candidates knew the main requirements of the relevant ISA and could to some extent apply them to the scenario. Many candidates picked up on the fact that Zennor Co not having an audit committee would impact on the control environment of the company, and that the work of the internal audit team would need to be evaluated before any reliance could be placed on it. Most candidates could describe the impact that using the work of internal audit could have on the overall audit strategy, though this was often only very briefly mentioned, and few candidates suggested the type of work that the internal audit team could perform with relevance to the audit. On the whole though, this issue was quite well dealt with. The issue in relation to the audit fee was also generally well answered. Almost all candidates could identify the ethical threats raised, and attempted to evaluate them in the context of the scenario. However a significant minority of candidates thought that the finance director’s suggestion was some kind of contingent fee arrangement, which was not correct, and there were the usual suggestions that the finance director should be “disciplined” or “sacked” due to her improper suggestions, which did not earn credit.

To summarise on this question, the answers on risk of material misstatement were unsatisfactory, especially given that this is a regularly examined area. Candidates need to improve on the quality of their explanations of the risks identified. Simply stating that a balance or transaction may be “risky” without explaining why, and calculating its materiality is not enough to score well in this type of question. There were also relatively easy marks lost in many scripts where candidates had failed to provide any additional information requests, or due to audit procedures being inadequately described. For many candidates the requirement where they demonstrated the best level of understanding was in relation to internal audit and ethical matters.

Comments specific to adapted papers:
For Question One there are some points worth making in relation to the performance of candidates attempting the adapted papers, as specific issues arose when marking these scripts.

SGP - this had the same question requirements as the INT paper, so the answers produced by the SGP candidates should not have been markedly different to those written by INT candidates. However, the answers to requirement (c) in relation to internal audit were generally inadequately answered by those candidates attempting the SGP adapted paper, displaying a lack of understanding of the role of internal audit and the relationship between the internal and external auditors.

UK and IRL – these adapted papers had a slightly different Question One, as is standard in P7. While the scenario was largely similar to the INT paper, the question requirements were not split into requirements (a), (b) and (c). In addition there was a little more background and additional information provided to candidates. These adaptations were made to Question One in light of recommendations made by the regulator of the UK and Irish papers, and are not meant to make the question more difficult, but to allow for a greater range of answer points and flexibility in how the requirements are approached. The inclusion of the extra information also allows greater assessment of whether candidates can select the relevant information to be used in planning the audit. As the marks are not allocated between the requirements, candidates will need to gauge how long to spend on each. This may seem daunting, but it can be seen as advantageous, as it means that marks are not capped for any one requirement. Generally the UK and IRL candidates performed quite well on this question and generally provided sound explanations of risk factors and well-described audit procedures.

Question Two

This question focussed on due diligence, a topic that has appeared in P7 examinations several times previous to this sitting. The scenario described a due diligence assignment to be performed on the target company Mizzen Co, at the request of Baltimore Co. The history and activities of the target company was described in some detail, and some financial information provided for the last four years. For Baltimore Co this would be their first acquisition, and was being considered as a means to diversify the company's operations.

Requirement (a) was for 6 marks, and asked candidates to discuss three benefits to Baltimore Co of a due diligence review being performed on Mizzen Co. While some reasonable answers were given, possibly by candidates who had practiced the past exam question containing a similar requirement, on the whole answers were unsatisfactory. The following factors contributed to inadequate performance in relation to this requirement:

- Writing answers that were much too brief for the marks available – it was common to see three sentences given as an answer to this requirement, which cannot be enough for a 6 mark requirement.

- At the other extreme, some very lengthy answers were given that usually failed to answer the question requirement and instead either simply wrote in detail on how a due diligence assignment should be performed, or suggested in some detail the operational benefits to Baltimore Co of acquiring Mizzen Co.

- Many answers failed to limit to three benefits and instead provided a bullet point list of benefits that were not discussed at all.

Requirement (b) was the main part of the question, and asked candidates, for 16 marks, to identify and explain the matters that the due diligence review would focus on, and to recommend the additional information needed. The answers provided to this requirement were extremely mixed in quality. There were some exceptionally sound answers, explaining relevant matters in sufficient depth, and using the financial information provided to come up with reasonable points. These answers also provided relevant requests for additional information.

However, the majority of answers were unsatisfactory. Most candidates picked up at least a few marks by identifying some of the matters that the review would focus on, but as in Question One, many candidates let themselves down by failing to explain the matters that they had identified in any real depth. It was common for answers to simply contain a list of bullet points with very little explanation at all, and only a limited amount of marks can be awarded to answers of this type.

Some points were better dealt with, including the following:

- Most answers picked up on the fact that Mizzen Co used premises owned by the venture capitalist company, and the fact that this arrangement would probably cease on the acquisition.
- Many candidates realised that the two founders of Mizzen Co were crucial to the company's success and that without them the acquisition would probably be pointless.

- Many candidates used the financial information to some extent, though sometimes only in a very limited way, but most picked up on the fact that Mizzen Co was paying finance charges, and so information would be needed to understand what those charges relate to.

- Many answers considered that revenue recognition would be a matter to focus on due to the relatively complex nature of the company's revenue streams.

- Some answers performed a little analytical review on the financial information to reveal that expenses were not increasing in line with revenue, and that this would need to be investigated.

The answers that were unsatisfactory, as well as containing inadequately explained points as mentioned above, also tended to focus too much on financial reporting matters, for example giving very lengthy discussions on the calculation of goodwill. While the accounting treatment of some items certainly was relevant to the answer, just focussing on these matters meant that candidates did not provide a broad enough range of comments to score well.

Another factor leading to poor marks for this requirement was that many candidates simply failed to recommend any additional information at all that would be needed in the review. Many candidates missed out on marks here, for example for recommending that a statement of financial position, management accounts and cash flow forecasts would be needed.

Some candidates supplied a lengthy discussion of matters relating to the acceptance of the due diligence assignment, such as agreeing fees and clarifying deadlines, which was not asked for.

Requirement (c) was for 3 marks, and required candidates to describe the type of conclusion that would be issued for a due diligence report and to compare this to an audit report. This was well answered by most candidates, who compared the type of assurance that could be offered for a due diligence assignment with that given in an audit report, and linked this to the type of work that is carried out. Credit was awarded for different types of answers, as some discussed due diligence as being performed as agreed upon procedures rather than a review engagement, either of which is appropriate.

Comments specific to adapted papers:
For Question Two there are some points worth making in relation to the performance of candidates attempting the adapted papers, as specific issues arose when marking these scripts.

SGP – it was apparent that very few candidates attempting the SGP paper really understood the nature of a due diligence engagement and answers were often consequentially very brief.

UK and IRL – these adapted papers were slightly different in that the marks for the separate requirements were not broken down, effectively removing the marks cap for each requirement, and allowing more flexibility in answering the question. Answers tended to be reasonable, and those attempting the IRL paper in particular demonstrated a sound understanding of how a due diligence engagement would be performed, and provided very strong answers to requirement (b).

Question Three

This question was in the style of a typical paper P7 question, set in the completion stage of an audit, and asking candidates to comment on the matters to be considered, and he audit evidence that should be expected to be found during the review of the audit files by the audit manager. Candidates were well prepared for this type of question, and it was quite well attempted by many of the candidates that chose to attempt it.

The scenario involved a coal mining company operating in a highly regulated environment. An accident had caused significant damage to one of the coal mines, and to residential properties located in its vicinity. Management had agreed to meet some expenses relating to the relocation of the residents of these properties, which may need to be demolished in the future. Management had not reported the accident to the relevant regulatory body.

Requirement (a) contained standard wording for a P7 requirement, asking candidates to comment on the matters to consider and the evidence that should be found in undertaking a review of the audit file and financial statements of the company. This was for 14 marks. There were some sound answers, and most candidates correctly identified impairment, provisions or contingent liabilities and going concern as the main financial reporting issues that would need to be considered, and in many cases a range of appropriate evidence was described. The impairment issue tended to be the best dealt with, and as usual in this type of question, many candidates demonstrated a sound understanding of the financial reporting matter and linked this to its audit implication.

Where candidates performed less well on this requirement, it tended to be due to focussing on just one issue, and dealing only very briefly with other matters. For example, in some scripts almost all of the answer discussed the impairment issue, and only touched on provisions in a couple of sentences at the end. In other scripts the answer focussed on going concern, almost to the exclusion of any other matters. Some answers displayed a lack of basic financial accounting knowledge, suggesting that lost revenue should be provided for. Audit evidence points were often not well described, sometimes too vague to be awarded any credit, for example "discuss with management" or "check properly disclosed" – these comments are pretty meaningless as they have no context.

Requirement (b) was for 6 marks and focussed on management's decision not to report the accident to the regulatory authority, asking candidates to discuss the auditor's responsibilities and recommend the actions to be taken by the auditor in respect of this. Most candidates had some basic knowledge of the auditor's responsibilities in relation to law and regulations, but not many could capitalise on this knowledge through proper application to the scenario. Many answers focussed on the lack of integrity of management, suggesting that the audit firm should "discipline" the company's directors. Other answers were too vague and brief, simply suggesting without any real explanation that the auditor should report to the regulatory authority, and failing to justify this as an appropriate course of action. The best answers applied the requirements of the relevant ISA to the scenario and recommended an appropriate course of action.

Question Four

This was the most popular of the Section B questions, and was generally well attempted. Three short scenarios were provided, describing a range of situations giving rise to ethical threats and other issues, with the requirement to identify and discuss the ethical and other professional issues raised, and to recommend any actions to be taken by the audit firm for each of the scenarios given. This is a fairly standard type of question for P7, and many candidates performed well, obviously having practiced some past exam questions.

Requirement (a) was for 8 marks, and described a potential new audit client, a small owner-managed company providing financial services. There were several issues that candidates should have spotted in the scenario including a potential lack of integrity of the company's managing director, potential self-interest and self-review threats arising from the provision of non-audit services, threats arising from non-compliance with the regulatory body, and a potential for audit pre-conditions not to be met. The majority of candidates picked up on most of these issues and explained the ethical threats well. There has been a definite improvement in the way that candidates tackle this type of question, and in many cases close to the maximum marks were awarded.

Requirement (b) was for 6 marks, and outlined the situation of an existing client facing going concern problems. The audit engagement partner had been asked to accompany the managing director to a meeting with the bank where additional finance would be sought, and there were intimidation threats in that the client had threatened to put the audit out for tender, and there were also outstanding fees. Again, candidates generally did well on this requirement, identifying and explaining the correct ethical threats, and on the whole recommending appropriate courses of action. The only problem in some scripts was a focus on the lack of integrity of the managing director, rather than discussing specific ethical threats raised.

Requirement (c) was for 6 marks, and described the situation in which a listed client company had asked the audit firm to perform an actuarial valuation of its pension plan. The audit firm had an appropriately qualified person to perform the work, and as with the other requirements of this question, on the whole this was well attempted. Some answers failed to correctly calculate the materiality of the pension plan to the financial statements, and in some answers the fact that the client was a listed entity was not considered. However most candidates suggested an appropriate course of action in response to the ethical matters identified.

Question Five

This question combined the topics of going concern and audit reports. The scenario gave some detailed information about an audit client, Burford Co, facing various financial and operating difficulties, due in part to the obsolescence of its main product. A new product was being developed as a replacement being due to launch in the next financial year. A cash flow forecast had been prepared by management, and the key assumptions used in the forecast were provided.

Requirment (ai) asked candidates to identify and explain the matters which cast doubt on the going concern status of Burford Co. This was for 6 marks. Some candidates provided sound explanations. However, as seen in other questions, many candidates did not provide explanations for the matters that they had identified. Candidates should be aware that by this stage in their professional studies simply repeating information from the given scenario is not enough to secure a pass mark for an individual requirement.

Requirement (aii) required candidates to explain the audit evidence they should expect to find when performing a file review in respect of the cash flow forecast. Again, answers were mixed in quality, with some answers providing well explained, specific evidence points, while other answers were too vague to score well. Typically weak evidence points would include “discuss cash flows with management” or “agree figures to supporting documentation” which are simply too vague. Some candidates also seemed to forget that they were commenting on a cash flow forecast, suggesting that all of the figures in the forecast should be agreed to the company’s bank statement even though some of the transactions included in the forecast were due to occur a few months in the future. Another problem in some scripts was that the evidence points provided did not focus on the cash flow forecast as requested, but instead were evidence points on going concern generally.

Requirement (c) focused on the audit report. The scenario described that the Burford Co’s audit committee would include a brief note on going concern in the company’s financial statements, but that a detailed note would not be provided. The requirement asked candidates to discuss the implications of this for the auditor’s report and to recommend further actions to be taken. This was for 6 marks. This was generally answered in a satisfactory way, with most answers correctly discussing the use of the Emphasis of Matter paragraph where the note provided by the client is deemed sufficiently detailed, and that the audit opinion would be modified if it were not sufficiently detailed. Many answers explained these issues well, and provided the appropriate actions to be taken by the auditor. Requirement (c), was often the best answered requirement of this question.

Conclusion

In this exam sitting performance varied greatly, with the difference between a pass and a fail often being down to how well explained the answer points were. Almost all candidates can identify relevant issues, but not all can adequately explain, discuss or describe their points in sufficient depth or detail. This does not mean that answers need to be very long to score well. In fact many of the best scripts are relatively brief, but in these scripts the answer points being made are appropriate to the scenario and sufficiently expanded upon to score well. Candidates are reminded that bullet point answers are rarely going to be appropriate in paper P7, and that only a limited amount of marks can be awarded for identification of points with no explanation.

Candidates are encouraged, as always, to practice 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.