Examiner’s report

P7 Advanced Audit and Assurance
March 2016

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.

Overall performance in this sitting was poor with it being obvious that many candidates had not properly prepared for this wide-ranging examination and were unable to adequately apply their knowledge to answer the questions set. 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. There was a clear lack of both auditing and financial reporting knowledge.

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

- Writing out or simply restating points from the question with little development
- 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” does not earn marks unless the point is developed further,
- Obvious lack of accounting knowledge; an error cannot simultaneously overstate assets and understate profits for example.

Specific Comments

Section A

Question One (35 marks)
This question followed the pattern of previous examinations and was set at the planning stage of the audit/assurance cycle and candidates were presented with four requirements which covered risks, using the work of a service organisation and audit procedures.

Candidates were required to provide an analysis of business risks for a large retail chain operating in a specialized industry. Some candidates answered this very well and were able to draw on the details in the scenario to confidently discuss risk over compliance, regulation and licensing, macroeconomic issues and the implications of a recent purchase of a portfolio of stores. However, disappointingly many candidates were unable to differentiate between business risks and audit risks.

Candidates were then required to identify and discuss four risks of material misstatement. A question of this nature should be straightforward for most candidates and provide the opportunity to showcase and apply their accumulated knowledge. Disappointingly many candidates were not able to provide sufficient detail and analysis in relation to the risks identified. Many candidates focused on issues that were not relevant or they had been specifically told in the question were not material, for example the valuation of certain inventory in the various stores was specifically referred to in the question that this inventory had been immaterial in previous years and was expected to be the same this year yet the number of candidates who identified this as their main risk was concerning. Candidates are reminded that the requirement is looking for risks of MATERIAL misstatement. If a balance is immaterial it is unlikely that it can result in a material misstatement in the financial statements.

Candidates who scored well in this area focused on revenue recognition, the risks in the valuation and disclosure of a recently-acquired store portfolio, errors in the calculation of holiday pay accruals and foreign exchange risks. Better candidates were also able to identify the risks of material misstatement connected to a planned refurbishment programme which had not yet happened. 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, assessing materiality before going on to explain them fully and specifically in terms of how the risk could impact the financial statements. Candidates are reminded that when discussing risks of material misstatement 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. 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 that it is necessary to assess the most significant risks first. Candidates are again reminded that it is those risks that could result in a material misstatement in the financial statements, which need to be identified and addressed.

Candidates were then further required to consider how outsourcing the credit control function to a service organization should be audited. Responses to this were disappointing with very few candidates demonstrating a sound understanding of the issue. There was confusion between outsourcing and using an audit expert. Many candidates focused on explaining the advantages and disadvantages of outsourcing which was not required and did not answer the question, and moreover inappropriately advised the client not to do it. It was evident that many candidates had little knowledge of outsourcing and ISA 402 ***Audit Considerations Relating to an Entity Using a Service Organization*** or the guidance provided within the ISA. Only the best candidates were able to discuss the Type 1 or Type 2 reports as detailed in ISA 402.

Finally candidates were required to identify the procedures for auditing a holiday pay accrual which had doubled from the prior year. Many candidates focused on errors in the payroll system which was not directly relevant to the question. Most candidates were able to identify some of the procedures that would be required but in many cases produced a generic list of audit procedures which had not been linked the question. Candidates are reminded that at this level answers but be specific and tailored to the scenario provided.

There were four professional marks available and most candidates were able to earn the presentation marks by providing a clear introduction and conclusion and using headings to create an appropriate structure for their answer. Many candidates did not articulate their points in a clear or logical order and therefore many missed out on the logical flow and clarity marks.

Question Two (25 marks)
This question followed a familiar format of addressing the matters arising and evidence expected to be found on three financial reporting issues in part (a) and to provide examination procedures in relation to prospective financial information in part (b).

In relation to the matters to consider, candidates were faced with deferred tax, a convertible bond and an operating lease. The first topic of deferred tax proved difficult for many candidates, and many found it hard to grasp the concept of a significant deferred tax asset arising from historic trading losses. Many candidates missed the crux of the question which was that the company's situation was changing which cast doubt on the ongoing validity of the asset. As such much of the evidence identified by candidates focused on irrelevant areas, such as the need to rework prior year accounts.

The second topic was a convertible bond issue. Only a minority of candidates identified that this should have both debt and equity elements and the number that actually attempted to split the value between these elements was disappointingly low. Many candidates confused the interest rate on the bond with the discount rate that should be used to value the bonds.

The third topic related to an operating lease with a rent-free period. The question stated that "this was an operating lease" yet the majority of candidates spent time trying to analyse whether it was an operating or a finance lease which was not relevant in the circumstances. Very few candidates were able to identify that a copy of the lease should have been obtained and reviewed in order for the total cost of the lease to be confirmed in order to allow for the appropriate expense to be calculated. Many candidates did not read the question properly and failed to recognize the key issue described in the scenario.

For each of these issues there were some relatively straightforward marks for calculating materiality and identifying sources of evidence which most candidates managed to reasonably achieve. Fewer candidates were able to comprehensively articulate what those sources of evidence would be used for.

Candidates were also asked about providing an assurance service for a client applying for a bank loan to finance a construction project. There were some straightforward marks available for the basic procedures of agreeing the prospective financial information to third party evidence but a number of candidates based their answer around simply checking what management had prepared without seeking external reference points such as quotations from potential contractors. One would obtain management representations in such a scenario but not at the expense of other, more compelling, evidence. A lot of candidates talked about how some of the costs should have been accounted for and disclosed which was not relevant to the question as the objective was not to produce a set of financial accounts. Good answers included having a project contingency and queried whether all potential costs had been considered.

Section B

Question Three

This was the least popular of the optional questions and was answered by a minority of candidates. The first part required candidates to discuss why auditors should presume that there is a risk of fraud in revenue recognition and this requirement was poorly answered with most candidates setting out lengthy explanations of the respective duties of the auditor and management for the identification and prevention of fraud and thereby not answering the question. Strong answers considered management bias and targets, judgments in complex business and cut-off errors.

The second part explored two unusual issues which had occurred in an entrepreneurial audit client. Many candidates were able to identify the potential money laundering transaction and identified the placement and layering stages which were involved. Most candidates answered this part of the question well and were able to identify; the need for proper evidence, the poor controls over payments, notification to the MLRO and avoiding tipping-off the client.

Candidates were also asked to consider the release of a provision relating to a legal claim for which evidential documentation was not available. Most candidates discussed the implications of the reversal quite well but failed to identify the creative accounting and profit smoothing which was the purpose behind the provision reversal.

In both parts numerous candidates demonstrated poor exam technique and diverted into highlighting what would be included in the audit report which was not required.

Question Four

This was the most popular optional question on the paper which was attempted by the majority of candidates. The question focused on ethics and practice management and was split into three scenarios with roughly equal marks for each and in general was well-answered.

Firstly candidates had to consider the effect of a longstanding listed client where the Finance Director was seeking to choose the audit team himself and by threatening to tender the audit if this did not happen. This was generally well-answered as most candidates identified and discussed the issue of rotating senior audit staff and the resultant risks of familiarity and a lack of professional skepticism. There were many views as to the frequency of rotation of audit partners with around half of candidates identifying seven years as the maximum duration. The intimidation was recognized by most candidates but some over-focused on the particular issue of whether the client could influence the choice of audit manager and their relationship.

Secondly candidates were asked to consider the provision of non-assurance services to a client and the majority of candidates correctly identified self-review and self-interest as the main ethical risks faced by the firm. Using separate teams and disclosing the referral fees were identified by most candidates as the best way of managing these potential threats.

Finally candidates were asked to consider an audit firm's over-dependency on a single (listed) client. Very few candidates read the question properly and erroneously stated that there was no fee dependency as they were below the threshold without actually calculating the percentage of current year fees arising from this client. Knowledge of the fee threshold was poor and very few candidates identified the rule that fees cannot exceed 15% for two consecutive years without additional safeguards and did not highlight that several of the engagements this year were one-off in nature. Most did identify the need for pre-issuance reviews before signing the audit report and that there were self-review, self-interest and advocacy risks present in the circumstances.

It is concerning the ease with which candidates would readily recommend resigning as auditors in the face of what are, in reality, relatively low to medium-level threats to independence. In normal circumstances such threats could reasonably be solved with an appropriate level of professional engagement with client senior management.

Question Five

The question set out four potential audit adjustments and candidates were required to discuss each, considering the individual and aggregate impact on the audit report. The values of each potential adjustment were given in the question so there were materiality marks available and many candidates scored these but performed less well in discussing the associated issues. Most of the adjustments were relatively straightforward such as the capitalisation of loan interest, allowance for a bad debt and revaluation of investments and the issues around these were reasonably answered. The issue of impairment was less well answered.

There was significant inconsistency in answers where candidates concluded that an issue was not material but concluded that the auditor's report required modification. Furthermore candidates need to ensure that they understand what Emphasis of Matter and Other Matters paragraphs are. They are not a substitute for a modified opinion and should only be used where there are significant issues that the auditor wants to bring to the attention of the users of the accounts

Conclusion

The overall impression is that the vast majorities of candidates were unprepared for this exam and had not put enough effort into learning many of the basics necessary to pass P7. 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 it is important to have good knowledge of financial reporting, and further 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 questions. 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