Examiner’s report

P7 Advanced Audit and Assurance
March 2018

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 for this diet was disappointing and it is clear that many candidates simply did not prepare in sufficient depth and were unable to apply their knowledge to the question scenarios and the specific requirements of the questions. Too many candidates focused on the minutiae of a point and produced a list of everything they knew about a topic (which attracted only one or two marks) 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.

An area that was often surprisingly badly dealt with this session was materiality. Many candidates calculated materiality on revenue, profit and assets for each balance within the financial statements without considering the relevance of each. The carrying amount of an asset in the statement of financial position has no practical relationship to profit whereas it is relevant to total assets. There are normally only limited marks available for the materiality calculation on each metric so including all three calculations does not achieve any further marks and candidates need to ensure that their materiality calculation is relevant to the scenario otherwise they can draw incorrect conclusions. Candidates also need to ensure they take care when calculating materiality as a significant number of candidates made basic arithmetical errors and hence drew an incorrect conclusion about whether or not an item was material.

Specific areas where many candidates applied inappropriate exam technique included:
1. Copying out the question which achieves no marks.
2. Not answering the question requirements which had been set.
3. Quoting accounting standards without applying them and discussing the requirements of the standard.
4. 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.
5. Poor presentation & layout with illegible handwriting; if an answer is clearly written and well presented then it is easier to mark. Space out your answer and start each section of a question on a new page.
6. Obvious lack of accounting and financial reporting knowledge; an error cannot simultaneously overstate assets and understate profits for example.
7. Lack of knowledge and/or inability to apply the requirements of International Standards on Auditing.

Specific Comments

Question One (35 marks)

This question presented the scenario of new, listed, publishing client who had some quite aggressive accounting policies.

Part (ai) required candidates to evaluate audit risks. Generally this was satisfactorily answered and it was evident that candidates had prepared well for this type of scenario. There were plenty of areas where marks could be accumulated quite quickly, such as internally-generated assets, accounting for publication rights, the need for impairment reviews and segmental reporting. An area less understood was the concept of making a royalty advance and amortising this over the expected period of sales; many candidates did not understand the underlying double entry. It was also noted that a number of candidates had gaps in their financial reporting knowledge in respect of accounting for intangible assets and did not realise that internally developed software could be capitalised if the criteria set out in IAS 38 were met.

Some candidates continue to refer to generic risks of consolidation such as arithmetical mistakes, or omission of a subsidiary, which are often too vague to attract marks. Others digressed into describing audit procedures rather than risks. Better candidates focused on the consolidation of the named foreign subsidiary and were awarded marks for identifying the appropriate accounting treatment of the subsidiary and the need to adjust for the specific transactions detailed in the scenario.

The second requirement referred to areas where professional skepticism should be used. Again, there were plenty of areas where it was indicated in the question scenario that management were deferring and smoothing costs through inappropriate amortisation policies or by capitalising expenditure, which might not meet the qualifying criteria to be recognised as a development cost. Better candidates highlighted that there were many impairment indicators with revenue overall being static but online revenue growing at 20% annually which had clear implications for the other areas of the business as their share of revenues were, by definition, declining. The sale of software at an inflated value to the foreign subsidiary experiencing currency volatility was another clear warning flag that management were looking to inflate assets to enhance the financial statements.

The final requirements started by requiring the candidates to determine whether the foreign subsidiary was a significant component. The subsidiary was significant by value as it represented more than 15% of the group’s assets although this could vary depending on the exchange rate which was applied and which was a point made by stronger candidates. In addition the nature of its specialist business and the fact the subsidiary operated in a volatile country were additional indicators that it was significant. A concerning number of candidates could not recall the 15% threshold and others confused significance with materiality. Other candidates mistakenly thought that a significant component was an associate.

The nature and extent of involvement that the group auditor should have with the risk assessment of the auditor of the foreign subsidiary was also mostly well-answered. Most candidates were able to discuss the need to consider the regulatory framework, competence and independence of the component auditor and the need for discussion and review of their documentation.

There were four professional marks available for presentation, logic and clarity. Candidates who presented their answers in a 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.

Question Two (25 marks)

Part (a) related to the ethical issues and other matters which should be considered in respect of the acceptance of a potential new client. The introduction was made through an existing client who sought to intimidate the auditor into taking on the new client of doubtful reputation.

A number of candidates had obviously studied a recent article on the ACCA website on how to answer ethics questions and were able to earn good marks. Candidates are reminded that they need to identify the indicator in the scenario, what the relevant ethical threat is, to describe why this is the case and further explain the implication to the auditor if relevant safeguards aren't then put in place.

Most candidates highlighted the key area of intimidation but there was a tendency to diverge into potential advocacy issues with the new client seeking a bank loan, which was beyond the scope of the question. The need for safeguards was usually well explained but candidates need to be able to explain, for example, what a self-review threat is (reviewing their own work which causes a loss of skepticism) rather than just stating that there is a self-review threat.

The potential new client had a questionable history and not enough candidates explored this in sufficient detail.

The importance of new customer due diligence was also a requirement of this question and this was poorly answered as many confused this with a due diligence review. Many candidates talked about initial acceptance procedures such as reviewing accounts and contacting the previous auditor rather than concentrating on the main Customer Due Diligence (CDD) procedures such as money laundering, sources of client funds, the identity of the beneficial owner, any shadow directors and other companies owned by the prospective client. Other candidates incorrectly discussed procedures, which would be undertaken when performing audit planning. Most, however, did pick up on needing photographic identification, Companies House searches and Certificates of Incorporation as proof of identification as well as wanting to understand the previous issues of alleged pension fund misappropriation & breach of employment laws.

Part (b) required candidates to recommend examination procedures to be used when reviewing a profit forecast and was generally well answered with all of the main areas covered. Candidates were able to include the need to identify who prepared the forecast and their competence, unusual trends in revenue, revenues growing quicker than costs and the risk of management bias while the objective of the forecast was to procure a bank loan. Marks were also available for calculating relevant trends and good candidates were able to earn extra credit here.

Question Three

This question related to issues identified during the engagement quality control review of the audit of a new, listed, client, which was nearing completion. The question was attempted by a large number of candidates who produced answers of variable quality.

(a) The first issue was the identification of control deficiencies in purchase order approval which the audit team had concluded was acceptable and no additional procedures were required. Most candidates explained that this was inadequate and that increased sample sizes were needed and that the audit manager or partner also needed to have considered if a more substantive approach to the audit was appropriate. The question also asked for matters to be communicated to management and Those Charged With Governance (TCWG) to be included and this was not answered well. Candidates need to ensure they can explain clearly what needs to be communicated, why it needs to be communicated and to whom. Better candidates were able to do this but many candidates merely wrote that the issue needed to be communicated to management/TCWG with no further comment and were awarded no marks.

(b) In the second scenario it had been identified that the cashier was misappropriating funds and that the audit assistant who was his brother had audited this area. The amount was clearly immaterial but should have been documented in the audit working papers as it was a fraudulent transaction and to be dealt with in accordance with ISA 240. The obvious familiarity threat was well-explained but only a minority proposed that the firm's own internal procedures may have been at fault for not identifying this relationship.

(c) The third issue concerned two exceptions identified when performing cut off testing on revenue. Sales-cut-off manipulation was well-explained; how this should change the audit approach to check for other similar transactions was less well-explained. Some candidates still refer to the outdated revenue recognition criteria and did not refer to performance obligations being met. Better candidates identified that there was a non-compliance with IFRS 15 that should be communicated to TCWG.

(d) The final issue concerned the request for tax advice made by the finance director to a recently qualified audit assistant. Again, this was well-answered with candidates explaining that the client should not be asking the audit assistant to prepare the tax computation and that this cast doubt on the competence of the finance director. Candidates were also able to identify that if the assistant were to complete the computation then it would cause a self-review threat and that the preparation of tax calculations for listed companies is specifically prohibited by IESBA for listed clients. Stronger candidates then identified that the lack of competence displayed by the finance director needed to be reported to TCWG as being significant to the oversight of the financial reporting process.

As mentioned above candidates were not good at differentiating between reporting matters to management and TCWG and often confused the different roles of these two groups. Management run the business day-to-day and are responsible for the design and operation of controls whereas TCWG are often independent of day-to-day activities and are responsible for setting the overall strategic framework of controls and management of the audit. Management potentially have a vested interest in not highlighting matters to TCWG hence the auditor needs to report certain matters directly to TCWG.

Question Four

This was a review of ethical issues arising with three clients.

(a) The first scenario concerned a financial institution director stealing company funds. It was concerning that only a minority of candidates recognized that this was a financial institution and as a result is a Public Interest Entity ("PIE"). Many candidates simply discussed whether the theft should be noted in the financial statements and the effect this would have on the audit opinion (although the question indicated the theft was not material) and totally missed the issue of client confidentiality and this being over-ridden by the professional duty to report this to the regulator. The IESBA guidance on NOCLAR (Non Compliance with Laws and Regulations) was barely mentioned and overall candidates scored very poorly on this requirement.

(b) The second scenario dealt with an established client who was about to purchase another company to whom the firm of Chartered Certified Accountants had just been appointed auditor. This led to a conflict of interest between the two clients. The ethical issues of confidentiality and the need for permission from both clients to act in these circumstances – and the options if consent were not given - were reasonably covered as were the safeguards required to ensure confidentiality. However, some candidates diverged into a discussion of due diligence on acquisition which was not required.

(c) Intimidation from a client on which there was a high fee dependency. Knowledge of fee dependency rules was deficient and many struggled to recall as to whether it is 10% or 15%, recurring fees or total fees and whether these differed if the client was listed. The IESBA rule is 15% of fees for a listed company for two years consecutively. Likewise the period of rotation for a key audit partner is 7 years for a listed company. In the UK/IRL adapted papers the local ethical standards as set by the FRC and the IAASA were applicable so 10% of fees and the period of rotation for a key audit partner is 5 years. Self-interest was usually reasonably discussed, as was the client's overt intimidation in introducing the audit team to a partner from another audit firm and the role of TWCG in such situations.

Question Five

This was the least popular question on the paper and the scenario dealt with a property company whose audit was being completed.

(a) Additional pension benefits were being offered to staff for retention purposes. The key point is that the element of the increased cost that relates to past service needed to be recognised immediately and not amortized over future periods. Most candidates recognised that if this was not adjusted for then the opinion would be qualified.

(b) Investment properties were devalued. The key here was that the client was recognising the correct quantum of impairment but was accounting for it though other comprehensive income rather than in profit or loss for the year on the grounds that it was temporary in nature. Weaker candidates did not identify this nuance and merely reiterated that the impairment needed to be recognised as a reduction in the asset value (it had already). Again, this was a material misstatement which would result in a qualified opinion if not amended.

Stronger candidates highlighted that the combined effect of (a) and (b) wiped out the profit for the year and turned it into a small loss so advocated that this could result in an adverse opinion due to the pervasive effect of these combined events.

(c) There was also a subsequent event, which was not reported in the Chairman’s Statement. Most candidates correctly identified that this was a non-adjusting event which needed to be disclosed in the notes and failure to do so would again result in a qualified opinion. Candidates were far less likely to consider the need for the event to be referred to in the Chairman’s Statement and additional marks were available for realising this and discussing the auditor’s responsibilities relating to other information. A very few strong candidates were able to discuss this in more detail and consider the different implications if the financial statements were adjusted but the Chairman’s statement was not.

Conclusion

It is clear 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 keeping up to date with changes to accounting standards, such as revenue recognition.

Candidates need to take time to carefully read the requirements of each question and to consider at what point of an audit the scenario is set. There is a considerable difference between suggesting activities to be undertaken during the planning stage of an audit and those procedures needed at the completion of an audit and it is not always evident that candidates have grasped this.

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.