Exam technique for Advanced Audit and Assurance

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Part 3 – Accounting issues

In the Advanced Audit and Assurance exam you will be required to discuss accounting issues in many contexts. It could be that during planning you are asked identify areas of audit risk or risk of material misstatement arising from accounting issues. You may be expected to discuss accounting issues and their treatment in a completion question, where the appropriateness of a treatment is considered, or areas of risk exist. Accounting issues could arise in reporting questions where there may be an impact on the auditor’s report and the type of opinion which will be given. This list is not exhaustive but illustrates how important it is to have a good understanding of the accounting and financial reporting issues covered in all of the financial reporting areas of the qualification. In addition you will be required to recommend audit procedures or explain the evidence you would expect to see in the audit file in order to conclude on the appropriateness of these treatments and amounts.

As such, bringing forward a sound knowledge of financial reporting is crucial when preparing for the Advanced Audit and Assurance exam. Some of those areas may be relatively straightforward, for example the valuation of inventory at the lower of cost and net realisable value while others can be more involved or complex such as financial instruments, revenue recognition or pensions.

The purpose of this article is to utilise past questions from the Advanced Audit and Assurance exam to illustrate how accounting issues could be examined and to recap the accounting treatment on some of the areas candidates typically find difficult in this exam.

Example 1 – Impairment

It is rare to see an Advanced Audit and Assurance exam which does not cover impairment and the requirements of IAS 36 Impairment of Assets. This is a crucial standard which you need to understand as impairment considerations apply to so many assets within a set of financial statements.

A summary of the key financial reporting principles from IAS 36 is provided below:

- An asset is impaired if its carrying amount is higher than recoverable amount.
- The recoverable amount of an asset is the higher of its value in use (the present value of future cash flows deriving from the asset – or group of assets) and its fair value less disposal costs (the price which would be received in an orderly transaction between market participants – eg what you could sell it for).
IAS 36 paragraph 36.2 lists the assets which fall outside the scope of the standard including inventories, deferred tax assets, financial assets and non-current assets held for sale.

Recent example – sample March/June 17, Question 4

This is an example from a matters and evidence style question. These questions are typically set at the completion stage of an audit. Materiality, accounting treatment and risks are typical areas which would count as matters to be considered. In these questions the auditor’s report implication is only relevant if you are asked specifically to consider this area.

You are the manager responsible for the audit of Osier Co, a jewellery manufacturer and retailer. The final audit for the year ended 31 March 2017 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of $1,919 million (2016 – $1,889 million), revenue of $1,052 million (2016 – $997 million) and profit before tax of $107 million (2016 – $110 million).

At the year end management performed an impairment review on its retail outlets, which are a cash generating unit for the purpose of conducting an impairment review. While internet sales grew rapidly during the year, sales from retail outlets declined, prompting the review. At 31 March 2017 the carrying amount of the assets directly attributable to the retail outlets totalled $137 million, this includes both tangible assets and goodwill. During the year management received a number of offers from parties interested in purchasing the retail outlets for an average of $125 million. They also estimated the disposal costs to be $1·5 million, based upon their experience of corporate acquisitions and disposals. Management estimated the value in use to be $128 million. This was based upon the historic cash flows attributable to retail outlets inflated at a general rate of 1% per annum. This, they argued, reflects the poor performance of the retail outlets. Consequently the retail outlets were impaired by $9 million to restate them to their estimated recoverable amount of $128 million. The impairment was allocated against the tangible assets of the outlets on a pro rata basis, based upon the original carrying amount of each asset in the unit. (7 marks)

In this question you can open with the materiality of the impairment. The impairment loss of $9m represents 0.47% of total assets and 8.41% of profit before tax and is material to the statement of profit or loss (1 mark for an appropriate calculation and conclusion).

You should then state the underlying rule that an indicator of impairment triggers an impairment review and define impairment and recoverable amount. (1 mark)

Most of the credit will be available for determining and explaining the risks arising and applying the accounting treatment to the information you have available.

We’re told that

- Carrying value is $137m
- Net realisable value is $125m - $1.5m = $123.5m (you will generally receive ½ mark for calculating this figure)
- Value in use is estimated at $128m
- Recoverable amount is therefore $128m based on management’s calculations
- Impairment write off was based on value in use and has been pro-rated against assets based on the original carrying value of the assets in each unit.

As auditors we need to look for risks in the process and treatment. Based on the information you can conclude that the carrying value is relatively low risk – we audited last year’s figures and it’s not an inherently risky area in general so in the absence of other information to the contrary you need to focus on the more risky areas.

The net realisable value carries some risk – external offers though are a good source of evidence and while not set in stone there have been several parties interested so it’s likely...
that the company would be able to sell the retail outlets for that price.

So what are the key risk areas and the matters which should be considered?

Risk 1 – Management has estimated the costs of sale. An estimation is inherently risky as it is not certain. It’s also been estimated by management who could be biased.

Risk 2 – The value in use is the major source of risk. The calculation is complex and judgemental and so is inherently risky. It has been calculated by management who may be biased to keep the impairment loss as low as possible. The calculation was based on historic cash flows with 1% annual growth which appears unrealistic given that retail sales have fallen not grown at 1%.

If the forecast used is overly optimistic then the impairment write off is insufficient and therefore assets are overstated and profit is overstated (as expenses are understated).

Risk 3 – The treatment of the impairment write off may be incorrect as goodwill should be reduced before reducing the assets on a prorate basis and it should be ensured that no individual asset is reduced to below its own recoverable amount.

The matters part of this question as illustrated within the boxes above and answer points which focussed on these risk areas would attract maximum credit for that part of the question.

As this was a matters and evidence question remember that you also need to go on to explain evidence you would expect to find on the audit file. The requirement is for the evidence to be explained in these questions so listing sources of evidence is not sufficient. Your answer points must also explain what they are providing evidence of in order to attract high marks. If you write out evidence as a list of described procedures then this will be acceptable and well described, relevant procedures will generally receive a mark each.

Example 2 – Intangibles

Intangible assets are non-monetary assets without physical substance such as patents, trademarks, customer lists, quotas, brands, franchise agreements etc

A summary of the key financial reporting principles from IAS 38 Intangible Assets is provided below:

- Intangible assets must be identifiable (capable of being separated and sold/ transferred and arise from contractual or other legal rights) - controlled - provide future economic benefits
- In order to be recognised as an asset there must be a probable future economic benefit arising from the asset and the cost must be capable of reliable measurement. If this is not possible then expenditure on the asset must be recognised as an expense. This is why internally generated brands and customer lists are not allowed to be recognised but purchased ones can be (including those purchased as part of the acquisition of another company)
- Subsequent treatment of intangible assets will be either on a historical cost basis or under a fair value model if it is possible that fair value can be determined by reference to an active market (e.g. production quotas, taxi licences)

Exam focus

By definition brands are unique and therefore it would not be possible to compare to an active market hence the fair value model does not apply and they cannot be revalued upwards.

- Intangible assets will either have a finite life (a limited period of benefit to the company over which the asset will be amortised with the amortisation expense being charged to profit and loss) or an indefinite life (where no foreseeable limit to the period of economic benefits exist – hence no amortisation is charged)
- Where an asset is deemed to have an indefinite life it is not amortised but the useful life should be reviewed every reporting period to determine whether events continue to support an indefinite life and additionally, the asset should be assessed for impairment each reporting period.
- All intangible assets are subject to an impairment review where there is an indicator of impairment.
Recent example – Sample March/June, Question 1

This is an extract from a planning question which asked candidates to evaluate risks of material misstatement arising from a scenario where the Group holds several purchased brand names for products.

Acquired brand names are held at cost and not amortised on the grounds that the assets have an indefinite life. Annual impairment reviews are conducted on all brand names. In December 2016, the Chico brand name was determined to be impaired by $30 million due to allegations made in the press and by customers that some ingredients used in the Chico perfume range can cause skin irritations and more serious health problems. The Chico products have been withdrawn from sale.

When answering a requirement to evaluate risks from a scenario relating to specific accounting issues you should start by calculating the materiality of the issue – in this question, total assets were $358 million and PBT $28 million. The impairment of the Chico brand is 8.4% of total assets and more than 100% of PBT and is therefore material to both the statement of financial position and the profit and loss for the year. (1 mark for an appropriate calculation and conclusion).

You should then state the underlying accounting rule (1 mark).

Acquired brand names should be capitalised and amortised over their useful life. Where this is indefinite, no amortisation is required, however an annual review of the appropriateness of the assumption of indefinite life should be performed and an annual impairment test is also required.

How this should be written up in a risk question has been illustrated in the second article in this series.

Here, the company has decided to hold brands at cost as they deem them to have an indefinite life – this is an acceptable treatment under IAS 38 however the important part of the standard which we need to consider is that this should only be done if there is no foreseeable limit to the periods of benefit. There’s also a requirement that this assumption should be reviewed annually and additionally an impairment review performed. The scenario tells us that an impairment review has been performed but not that a review of the indefinite life has occurred hence there is a risk that this may not have been done.

That decision to hold the brands with an indefinite life is a judgement call on behalf of management – judgements are subjective and therefore are a source of inherent risk. Quite often the justification for such a decision would be linked back to expenditure on the brand and marketing efforts along with market research. These costs cannot be capitalised but do provide evidence to support an indefinite life.

Similarly, impairment reviews for a brand would be looking at value in use based on the discounted value of future expected cash flows which is complex and judgemental.

In the exam you need to communicate these risk areas arising above - an example of a description for each that would be sufficient in an exam is shown below:

Risk 1 – Management’s judgement that the brands have an indefinite life may be incorrect

Risk 2 – Management may not have reviewed the useful life of the brands in the reporting period to ensure that the assumption of indefinite life is still correct

Risk 3 – The impairment review may not be accurate as the assumptions used by management may not be appropriate as the calculation is complex and judgemental. (IAS 36)

The scenario goes on to describe the impairment of the Chico brand after allegations made about the products. The products have been withdrawn from sale. This brings in the impairment consideration in more detail. Here there has been a specific indicator of impairment for both the brand and inventory relating to Chico and therefore poses more risks.
Risk 4 – The impairment of the Chico Brand may not be sufficient (we can’t tell if it has been fully written down IAS 36)

Risk 5 – The inventory relating to Chico products may need to be written off if its net realisable value is below cost (IAS 2 Inventories)

Risk 6 – Other brands and inventory may be affected by the negative publicity regarding Chico and may also need to be written down (IAS 36)

Exam focus

No credit is awarded for the name or number of auditing and financial reporting standards.

You should avoid describing audit approach or evidence/procedures unless you have been asked to do this in the requirement.

Conclusion

The above examples aim to demonstrate how candidates can effectively apply their accounting knowledge in the Advanced Audit and Assurance exam in order to maximise their marks in a variety of questions including those which cover planning and matters and evidence considerations. As with most areas of the Advanced Audit and Assurance exam, it is the application of that accounting knowledge to a scenario rather than the knowledge itself which will attract marks. This means that when preparing for this exam, a good grasp of the accounting knowledge underpinning the syllabus is important but practising questions and developing the skills of applying that knowledge is the key to passing.

Written by a member of the P7 examining team

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