Exam technique for Advanced Audit and Assurance

Part 4 – Audit procedures

The Advanced Audit and Assurance (AAA) exam would not be complete without testing the ability to design relevant procedures by which assertions can be assessed. This core skill, started at the applied skills level in Audit and Assurance (AA), is further developed and tested in AAA. In this exam the issues being audited will be extended to more complex areas of financial reporting and the more judgemental areas of a set of financial statements such as KPIs, forecasts and documents used for other services. It is important that candidates can move beyond learnt lists of procedures or generic tests to specific focused procedures which will examine specific assertions. Candidates must ensure they can describe the appropriate action, source and purpose for a procedure.

This article examines the key syllabus requirements in relation to procedures and considers the level of detail needed in order to obtain credit at this level. It will also look at some examples of past questions on this syllabus area and explain the difference between a strong answer and a weak answer to illustrate the detail and specificity that candidates should produce in their answers to attain marks in the exam.

Syllabus requirements

Audit procedures are covered in several areas of the AAA syllabus and the relevant learning outcomes require candidates to 'identify and describe audit procedures to obtain sufficient appropriate evidence from identified sources' or to 'design appropriate audit procedures' with respect to the audit of historical financial statements, or for other assignments to 'describe and recommend appropriate substantive, exam or investigative procedures which can be used to gather sufficient appropriate evidence in the circumstances'.

Note that these learning outcomes require candidates to design or describe audit procedures not simply provide a list of sources of evidence or a verb with no purpose such as review. When audit procedures are required as part of the exam it is expected that for credit to be awarded, candidates will describe the procedure in sufficient detail to demonstrate that they understand what it is trying to corroborate and what underlying piece of evidence will assist with that process. A good rule of thumb is to ask, if you gave your list of procedures to a new trainee auditor, would they know what to do, how to do it and why they are doing it? If there is a specific source of information and an action that is aimed at a specific purpose, then the answer is more likely to be complete and understandable.
Structuring procedures

In the AAA exam, procedures are often examined in planning questions where you may be required to plan audit procedures over a specific area of risk, or later in the audit, when reviewing the evidence you would expect to find on the audit file when it is reviewed by the manager or partner. For both requirements, the basic principle is the same. The marking guides in published questions state 'up to 1 mark for each well described audit procedure' hence a poorly described procedure will not obtain 1 mark, it will obtain at most ½ mark.

Simple example (note this is for illustration and is not indicative of an AAA scenario)

The client has purchased a new machine for use in production of widgets. Design the principle audit procedures to be performed in respect of the new machine.

A good start to answering the question would be to consider what assertions need to be covered. Here the auditor will want to know whether the machine is owned by the company, its existence, and its valuation.

We can address valuation and ownership at the same time for an outright purchase using the invoice in most cases. This should be an easy mark in the exam and everyone should be aiming for a full mark for this procedure. Consider the answers below

Strong answer

Obtain the purchase invoice for the machine and confirm the purchase value to the non-current asset register and ownership of the machine - 1 mark

Weak answers

Review purchase invoice - this would score ½ mark - this does not state what the invoice is being reviewed for or what assertion is being targeted.

Purchase invoice - this would score no marks - this is a source of evidence but without an action is not a procedure.

Review the relevant document - this would score no marks - there is no detailed action or purpose and no identifiable source.

For the existence of the machine, we could physically examine it

Strong answer

Physically examine (or inspect) the asset to confirm it exists - 1 mark

Weak answers

Physically examine machine - this would score ½ mark - not tied to an assertion so does not explain why the asset is being examined.

Observe assets - this would score no marks - there is no detailed action or purpose and no identifiable source.

Adapting the basic technique to the AAA exam

The basic process illustrated above applies to the more complex situations that you will come across in the AAA exam questions however you will be facing more challenging areas than those seen in the AA exam. Rather than the existence of PPE, candidates may be required to consider the existence and valuation of intangible assets such as a brand (March/June 2017 Q1), the classification of an investment (March/June 2018 Q4) or the appropriateness of a forecast for assessing going concern or applying for finance (March/June 2018 Q2). Here candidates will be working with procedures that that can’t be rote learned and which need to be tailored to the scenario. There will often be judgements involved in areas examined where candidates will need to decide to what extent management can be relied upon and where candidates may be expected to demonstrate professional scepticism.

Practising past questions is important to extend your range of sources of evidences and develop an understanding of the sort of approaches which can be taken relating to specific judgements. However, it is also important to be able to think of original procedures to adapt to the differences in the scenario each time. What was appropriate in one exam may not be appropriate in another. The syllabus requirement to design procedures is the underlying skill being tested not the ability to learn a list of procedures for every occasion.
Example AAA procedures questions

The following is an extract from Question 2 in the September/December 2017 sample questions:

A provision of $430 million (2016 – $488 million) is recognised as a long-term liability. The provision is in respect of decommissioning a number of gas production and storage facilities when they are at the end of their useful lives. The estimate of the decommissioning costs has been based on price levels and technology at the reporting date, and discounted to present value using an interest rate of 8% (2016 – 6%). The timing of decommissioning payments is dependent on the estimated useful lives of the facilities but is expected to occur by 2046, with the majority of the provision being utilised between 2025 and 2040.

The accounting policy note discusses the methodology used by management for determining the value of the decommissioning provision and states that this is an area of critical accounting judgements including key areas of estimation uncertainty. The estimate has been made by management. In previous years, a management expert was engaged to provide the estimate but as this was expensive, management decided to produce the estimate for the year ended 30 June 2017.

This example relates to a decommissioning provision for an event which is occurring the future. This means that the exact amounts will be unknown and that a level of estimation and judgement is inherently part of the amount. This illustration will focus on only the amount (completeness and accuracy) of the provision (ignoring for this illustration the need to establish that the obligation exists to decommission the facilities). The provision should be measured at the best estimate of future costs discounted to present value. When the provision is created the debit is to PPE but changes in estimates thereafter affect the profit for the year. In order to assess that the amount is appropriate certain issues must be evaluated:

- The estimate of useful life and timing of the predicted decommissioning costs (most will be used between 2025 and 2040 but some as far ahead of 2046)
- The discount factor used to calculate the provision (it’s gone up which will decrease the present values of the cash flows)
- The estimates of the cost of decommissioning (based on information available today)
- The process of the calculation of the provision amount (management has previously used an external expert but have calculated the figures themselves this year and the provision has reduced so management might be using the release of the provision to increase profits)

From a testing point of view each of these elements should be considered and the appropriateness of them assessed. Before that can happen, we need to obtain the calculation we are performing work on. The table below shows a range of procedures to answer this question which would score full marks and examples of weaker answers with how many marks they would obtain shown against each.

<table>
<thead>
<tr>
<th>Strong answers - 1 mark each</th>
<th>Weak answers – 0 to ½ marks</th>
</tr>
</thead>
</table>
| Obtain a copy of management’s calculation of the provision and source documents to support the underlying figures to understand how the provision had been derived | Review management’s calculation (½)
| The term review without a specific purpose is vague and there is no purpose provided for the procedure |
| Assess management’s key assumptions and consider the validity of these assumptions in light of the auditor’s understanding | Review management’s assumptions (½)
| This does not state why the assumptions are being reviewed or make an attempt to confirm they are valid |
| Review any decommissioning agreements to confirm estimate of useful life of the assets and date of decommissioning | Check useful life (0)
<p>| There is no source given for identifying the useful life nor is there a purpose given for checking it |</p>
<table>
<thead>
<tr>
<th>Assessment</th>
<th>Action</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assess the reasonableness of the increase in discount rate by reference to movements in market interest rates</td>
<td>Ask management why interest rate has increased (½)</td>
<td>There is no purpose given for investigating the interest rates and the auditor is aiming to corroborate management's figure – interest rates are generally readily available from independent sources</td>
</tr>
<tr>
<td>Review a list of decommissioning costs and compare to quotes or prices of current decommissioning if available to corroborate management's estimates</td>
<td>Check costs to invoice (0)</td>
<td>These costs are in the future, so we have no invoice to corroborate costs. There is also no purpose given for the procedure</td>
</tr>
<tr>
<td>Compare methodology used this year to that used last year to confirm consistency or differences and assess whether changes are appropriate</td>
<td>Compare provision to last year's provision (½)</td>
<td>This lacks purpose for the procedure</td>
</tr>
<tr>
<td>Cast the provision schedule for arithmetical accuracy and agree to figure in the financial statements</td>
<td>Cast provision (½)</td>
<td>The purpose of casting the provision is omitted</td>
</tr>
<tr>
<td>Use an auditor’s expert to provide an independent calculation of the decommissioning costs and compare to management’s figures to support the appropriateness of the figures</td>
<td>Use expert (0)</td>
<td>This does not specify that the expert is independent or what they would be used for</td>
</tr>
<tr>
<td>Obtain independent expert calculation (½)</td>
<td>This mentions independent but does not specify a purpose</td>
<td></td>
</tr>
<tr>
<td>Review the notes to the financial statements to ensure that the disclosure on the movement in the provision and the description of the nature and timing of the costs and the assumptions are appropriate</td>
<td>Check disclosures (0)</td>
<td>This does not specify what the disclosures should be or the source</td>
</tr>
<tr>
<td>Get written representation (0)</td>
<td>See below</td>
<td></td>
</tr>
<tr>
<td>Review board minutes (0)</td>
<td>See below</td>
<td></td>
</tr>
<tr>
<td>Agree to the financial statements (0)</td>
<td>See below</td>
<td></td>
</tr>
</tbody>
</table>

There are a few things to note about this table. Firstly, the testing has been tailored to the information which was available in the question – the change in interest rates, the change in how the estimate is prepared (management vs external expert). Secondly the procedures must be specific to obtain credit – try to use an action, (it can be useful to refer
to the testing techniques in ISA 500, Audit Evidence – for example, inspect, recalculate etc), a source and a purpose. Without these you are not describing enough detail at this level of exam. And thirdly, the final three answers in the weak answer section are not obtaining credit here. This third point is a common area where candidates use rote learnt points without considering their appropriateness and relevance to the scenario and each is considered further below.

**Written representations from management**

Written representations from management are used to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements. They are often requested where management’s intentions can affect the validity of a judgement. They should not be used as the only audit evidence to support an assertion, and should not be used if it is possible to obtain the evidence without the need of a written representation. In the previous example, obtaining a written representation that management’s judgement of the discount factor is correct is not wholly appropriate. The auditor can assess the discount factor with respect to external factors and actual rates incurred by the company, so there are other more relevant and reliable sources of evidence.

If the scenario focuses on management’s intentions, written representations could be appropriate, for example the intent to sell a building, or to close down a division. There would still be a requirement however to obtain corroborative evidence. If candidates use a written representation from management as a procedure in the exam then it must be appropriate and the specific content and purpose of the representation should be described. An example of the appropriate use of a written representation and the contents is illustrated below:

**March/June 2018 Q2b procedures to be performed on a profit forecast to be used to obtain bank funding**

- Obtain written representation from management regarding the completeness of significant assumptions **AND** accepting their responsibility for the forecast (this is required by ISA 3400, The Exam of Prospective Financial Information and therefore is appropriate), or
- Obtain written representation from management the bank overdraft will be repaid by 1 September 2019 (note this is management’s intention and can be part of the evidence for justifying that it is appropriate that there is no overdraft interest in the forecast after that date)

A final point on written representations from management, is that where management are not believed to be reliable, for example they have been showing signs of earnings management and inappropriate judgements, then written representations are not likely to be a reliable form of evidence.

**Review board minutes**

Often candidates include this as part of every answer to every requirement without considering whether it is likely to be discussed at board level or in what detail. This procedure might be relevant when supporting management’s intentions regarding strategy or approval regarding major decisions such as acquisitions, but it is not likely to be the case that the board of directors approve every individual asset purchase (rather than the capex budget as a whole) or every allowance for slow paying customers. If it isn’t something the board discuss then candidates won’t be credited for this as a procedure. In addition, the purpose of reviewing the board minutes will need to be stated in order for any credit to be awarded.

**Strong answer**

Confirm that the acquisition of the new subsidiary was approved by the board through review of board minutes - 1 mark

**Weak answers**

- Review board minutes for approval (½ mark – not stated approval of what)
- Review board minutes for acquisition (½ mark - does not state what information regarding the acquisition is being obtained from the board minutes)
- Review board minutes (would score no marks – this will not receive credit as it is not specific to the scenario at all)

**Agree to the financial statements**

This is another area where candidates appear to make a general statement that is often not appropriate. For example, in the March/June 2018 Q4 candidates testing the elimination of the intercompany balances often stated to check the elimination of a single transaction between two of the group companies to the financial statements. By their nature financial statements are aggregate figures and do not show every transaction. The elimination would be something that could be agreed to a consolidation schedules but
will not be visible in the financial statements issued by a company. The distinction between detailed management accounts, breakdowns of the figures in the financial statements, consolidation schedules and the financial statements themselves should be something that candidates at this level appreciate. To obtain marks for agreeing something to the financial statements it will be necessary that the item can be seen in the financial statements or the notes and that the specific detail of what is being agreed is stated.

**Strong answer** – for example, for an acquisition in the year

Confirm disclosures in the financial statements include the date of acquisition, the fair value of consideration and the fair value of the net assets acquired (1 mark – note this isn’t everything that IFRS® 3 Business Combinations requires to be disclosed but it does give some specific details that shows understanding of the sorts of disclosures required)

**Weak answers**

Agree to financial statements – this would score no marks – no detail of what is being agreed

Agree the amounts for the acquisition have been disclosed in the financial statements – this would score ½ marks – no specific detail of the items to be disclosed

**Conclusion**

As can be seen from the discussion above, a good structure for presenting procedures (action-source-purpose) is key to obtaining strong marks on this section of the exam. For a candidate to score well they will need to be able to adapt the procedures to the details given in a scenario and question whether the source is appropriate. Past question practice is a good start for expanding the range of procedures in a candidate’s toolkit and the ability to tailor answers to the specific circumstances in the exam they are sitting.

Written by a member of the Advanced Audit and Assurance examining team

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