STUDENT ACCOUNTANT
NOVEMBER/DECEMBER 2008

THE IMPORTANCE OF FINANCIAL REPORTING STANDARDS TO AUDITORS

RELEVANT TO ACCA QUALIFICATION PAPER P7

The *Study Guide* for Paper P7 contains (in Section D1 (iii) (j) *Evaluation and review*) a list of financial reporting matters which are examinable from the auditor's point of view. Candidates can expect to be faced with at least one requirement, and most likely several requirements each sitting dealing with such matters. This article provides extra guidance in this area.

The significance of financial reporting standards
In an audit of historical financial information, the significance of financial reporting standards cannot be over-emphasised. The opinion ultimately provided at the end of the engagement will state whether, in the auditor's opinion, the financial statements are fairly presented (or show a true and fair view). A fundamental issue which must be considered in order to reach this opinion is whether the financial statements have been prepared in compliance with the relevant financial reporting framework. In other words, have the relevant financial reporting standards been followed by the management of the entity when preparing the financial statements? The technical correctness of the financial statements is implicit in an unmodified audit opinion.

Clearly, the auditor must fully understand the relevant financial reporting standards to be able to reach an opinion as to whether they have been complied with. This is why the Paper P7 exam will test, on a regular basis, the matters which an auditor must consider with regard to a variety of financial reporting issues.

How much knowledge needs to be retained from previous papers?
There are a large number of financial reporting standards examinable for this paper. Because Paper P7 follows on from Paper P2, *Corporate Reporting*, all examinable financial reporting standards for Paper P2 are eligible for testing in Paper P7 questions. However, exposure drafts and discussion papers examinable in Paper P2 will not be tested in Paper P7. There is therefore a lot of assumed knowledge with regard to financial reporting standards. Candidates should be aware that in the context of Paper P7 questions they will be expected to retain a basic understanding of the key principles of financial reporting standards. This means that candidates should remember key definitions, recognition criteria, measurement rules and disclosure requirements, in sufficient detail to be able to discuss the financial reporting treatment of an item from the auditor's point of view.

Candidates will be aware of the large number of financial reporting standards, and it is fair to say that some of the standards are more examinable in Paper P7 than others. The first two Paper P7 exams have examined fairly straightforward financial reporting issues, as the transition from the old to the new syllabus meant that candidates attempting Paper P7 in the first two sittings would not necessarily have knowledge of the full range of standards examined in Paper P2. Financial reporting issues tested so far include: research and development, revenue recognition, provisions, inventory valuation, related party transactions, discontinued operations, impairment of assets, investment cost, and consolidation issues. All of these have associated financial reporting standards.

Now that the transitional phase is over, more challenging financial reporting matters are likely to be examined (as well as the type of matters already seen in the exam). The financial reporting issues which pose particular problems for the auditor are those that call for complex or subjective accounting treatments, and which create an inherent risk that the financial statements are prone to contain a material misstatement.

It is helpful to categorise financial reporting issues into those which require a more detailed level of knowledge, and those for which less detailed knowledge will be expected.

Likely to be examined in detail
- Recognition and valuation of tangible and intangible non-current assets including initial and subsequent measurement, revaluations, impairments, and investment properties.
- Leasing transactions including sale and leaseback arrangements.
- Financial instruments – particularly classification and subsequent measurement.
- Share-based payment arrangements, including equity-settled and cash-settled schemes.
- Deferred tax balances – recognition of deferred tax assets and liabilities, and their measurement.
- Employee benefits – defined contribution and defined benefit plans, including the basic principles of measurement, and the treatment of actuarial gains and losses.
- Discontinued operations and held for sale assets.
- Provisions (including decommissioning provisions and provisions associated with restructuring) and contingent liabilities and assets.
- Revenue recognition.
- Related party transactions.
- Events after the reporting date.
- Business combinations – particularly the cost of investment and calculation of goodwill, and determination of the status of an investment.

Likely to be examined in less detail
- Inventory and receivables valuations.
- Cash flow statements.
- Reporting operating (segmental) information.
- Earnings per share.
- Financial instruments – hedging and derivatives.
- Changes in accounting policy.
- Government grants and assistance
- Construction contracts.

Marks will be available on the marking scheme for reference to relevant financial reporting standards, though the amount of marks for simply referring to the name and number of relevant standard will be restricted. Most marks will be for demonstrating an understanding of a financial reporting issue, and its relevance to the audit.

What are the impacts of financial reporting issues for the auditor?
The auditor should consider financial reporting issues throughout an audit. Therefore, question scenarios involving these matters could be based in the planning phase, the evidence gathering period, or during the completion stage when the audit opinion is being evaluated. Each of these stages of the audit is discussed in turn below.

The planning phase
At this initial stage of the audit, the auditor will use risk assessment techniques to assess the client's business and financial statements for potential problem areas. One type of risk that the auditor will assess is financial statement risk. Financial statement risk is the risk that components of the financial statements could be misstated, through inaccurate or incomplete recording of transactions or disclosure. Financial statement risks, therefore, represent potential errors or deliberate misstatements in the published accounts of a business. Financial statement risks could lead to a balance being over or understated in value, or could result in an item being recognised when it should not be, or vice versa, the non-recognition of an item which should be recognised. In addition, financial statement risk could lead to an item being recognised at an inappropriate time, or in incorrect presentation or disclosure of a matter. Clearly, the auditor must understand financial reporting standard requirements in order to assess the risk of an item being recognised, measured, or disclosed incorrectly.

For an example of how this issue could be tested see Paper P7 June 2008 Q1 (bii) which requires an assessment of financial statement risks in relation to potential litigation and demolition of property, plant and equipment.

Gathering evidence
The second type of question that could feature financial reporting standards deals with the stage of the audit when the auditor is gathering evidence. Auditors need to gather sufficient, appropriate evidence regarding financial reporting issues. Of course, one of the matters for which the auditor needs to gather evidence is in relation to compliance with financial reporting standards. A common question requirement here will ask the candidate to 'comment on the matters to be considered' in relation to a financial reporting issue. Usually, a second, related requirement will ask the candidate to suggest relevant audit procedures. For an example of this type of question requirement, see Paper P7 June 2008 Q3 (b).

Some financial reporting matters are considered to be relatively hard to audit, and, in some cases, a particular International Standard on Auditing (ISA) has been issued to provide guidance to the auditor on such matters. An example is ISA 550 *Related Parties*, which provides guidance for the auditor on the subject of auditing related party transactions. These are the kind of matters which are likely to feature regularly in the exam, so candidates should pay particular attention to financial reporting matters which are the subject of specific ISAs (see ISAs 540–570). An example of a question featuring this type of financial reporting matter can be seen in Paper P7 June 2008 Q3 (a).

Candidates must pay close attention to the wording of question requirements. Questions which ask candidates to 'comment on the matters which should be considered' will feature regularly in the exam. Typical matters which should be considered by the auditor in the context of a financial reporting issue may include, for example:
- whether the financial reporting issue is relatively complex, or whether the financial reporting issue is subjective, necessitating the use of significant judgement. The existence of either increases the inherent risk that a balance or transaction will be materially misstated
- the specific requirements of any relevant financial reporting standard, in terms of the recognition, measurement, or presentation or disclosure of the item, and whether, in the context of the scenario, it appears that the requirements have been followed or not
- the materiality of the item in question, bearing in mind that materiality should be assessed from a quantitative and a qualitative viewpoint
- the wider impact of an issue on the financial statements, for example, consider the implication of a matter to all of the primary financial statements, and disclosure needed in the notes to the financial statements.

Candidates may also be required to consider only one aspect of a financial reporting matter, so care must be taken to restrict the answer to the specific requirement. For example, Paper P7 December 2007 Q2 (bii) required candidates to 'describe the evidence you would seek to support the assertion that development costs are technically feasible'. It is important to follow the instructions being given, in other words, to only discuss matters relevant to technical feasibility, and not to deviate into discussions of other, irrelevant matters. (Many candidates in answering this question discussed, for example, the commercial viability of the product in question, and whether the entity intended to use or sell the product, neither comment answered the question as set.) Similarly, candidates should make an effort to discuss only the specific balance or transaction required. As an example, Paper P7 June 2008 Q2 (bi) required the explanation of audit procedures appropriate for the carrying value of an investment. Many answers, however, incorrectly focused on the audit of the goodwill arising on consolidation, which was irrelevant to the question requirement.

Reaching an audit opinion
The ultimate impact of financial reporting issues is in arriving at the audit opinion. The auditor must decide whether the financial statements prepared by management comply with relevant standards, and if they do not, the auditor needs to consider the impact on the audit opinion. A non-compliance with standards leading to a material misstatement in the financial statements will result in an opinion modified due to disagreement, which could be an 'except for' qualification, or an adverse opinion. For an example of a question in this area, see Paper P7 December 2007 Q5 (a).

On discovering a material breach of financial reporting standards, the auditor should bring the matter to the attention of those charged with governance. This is to highlight the seriousness of the issue, and to ensure that those charged with governance have full awareness of the technical issues involved, and can therefore make an informed decision with regard to amending the financial statements.

CONCLUSION
There is a wide range of financial reporting standards which are potentially examinable, and candidates should be aware that a lack of knowledge of these standards, which is assumed from previous exams, will put their performance in Paper P7 at a disadvantage. Candidates should be conversant with the key aspects of all examinable financial reporting standards, but should focus their attention on the key financial reporting matters outlined above. Ultimately, an auditor of historical financial information cannot hope to perform a quality audit in the absence of a detailed knowledge and understanding of financial reporting standards, which is why such matters will regularly feature in the exam. Well-prepared candidates can score very highly in such questions by demonstrating their knowledge of a financial reporting matter, but more importantly, applying that knowledge to the issue faced by the auditor in the question scenario provided. ■

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