

# Specimen Exam 1

**Exam Name:** Audit and Assurance Professional (SAA INT)

**Time Allowed:** 3 hours 15 minutes

**Pass Mark:** 50%

This exam contains 2 sections:

Section A:

**1** question, worth 50 marks

Section B:

**2** questions, each worth 25 marks

**Total 100 marks**

## Section A

### Question 1

The following **exhibits** provide information relevant to the question:

1. Partner's email – an email which you have received from Ruby Swift, the audit engagement partner
2. Company information – background information about Python Co's current management structure and business activities
3. Revenue – revenue generation information and details about the service organisation used by Python Co to collect revenue from completed projects
4. Financial performance – information about the financial performance of Python Co
5. Request from management – email from Justin Ava, the financial controller, about additional work requested by Python Co

#### 1 Partner's email

It is 1 July 20X5. You are a manager in the audit department of Kotlin Associates, a firm of Chartered Certified Accountants. You are planning the audit of Python Co which is a new client of the firm.

**To: Audit manager**

**From: Ruby Swift, audit engagement partner**

**Subject: Audit planning for Python Co**

**Date: 1 July 20X5**

Hello

I have provided you with some information which you should use to start planning the audit of Python Co for the financial year ending 30 September 20X5.

Python Co is an unlisted client which operates an internet-based crowdfunding platform.

In line with Kotlin Associates' internal quality procedures, revenue will be used as the basis for determining materiality. You will need to determine and apply an appropriate materiality threshold in your briefing notes.

Using the information provided, I require you to prepare briefing notes for my own use, in which you:

**(a) Using Exhibits 2, 3 and 4 only, evaluate the significant audit risks, including those related to this being an initial audit engagement, to be considered when planning the audit of Python Co.**

**Your answer should provide justification as to how the risks should be prioritised.**

Note: You should NOT evaluate the risks associated with using the service organisation, E S Crow Co, as this will be addressed in requirement (b).

(21 marks)

**(b) Using Exhibit 3, assess the impact of Python Co using the service organisation E S Crow Co on the audit strategy and the overall level of risk in relation to revenue.**

Note: Your answer should address any actions which should be taken by the audit team to mitigate the identified risks in auditing revenue.

(6 marks)

**(c) Using Exhibit 4, evaluate the audit work proposed by the audit assistant in response to the purchase of the new head office building, recommending additional actions where appropriate.**

(6 marks)

**(d) Using Exhibit 5, assess any ethical and professional issues arising from the requests by Python Co’s management and recommend appropriate actions to be taken by Kotlin Associates.**

(7 marks)

**Thank you**

## **2 Company information**

### **Crowdfunding platform**

Python Co operates an internet-based crowdfunding platform which enables creative individuals (“project owners”) to raise money by listing projects explaining their business ideas. Python Co has a database of subscribers who review the available projects, and pledge money towards their chosen projects. Those who pledge money are called ‘backers’ by Python Co.

A successful project is one which obtains sufficient pledges from backers to meet its financial target by a set deadline. In return for their support, backers receive a non-financial reward. Backers are not committed to make any further investment in the business.

Projects which do not meet the predetermined financial target do not continue, and no money is taken from the backers.

### **Management of Python Co**

The three directors of the company have extensive experience in website design and video games, however, none of them had financial or business experience prior to starting the company four years ago. There are no other business advisers or non-executive directors on the board of the company.

The company has expanded rapidly, with a small finance department consisting of two staff members plus a newly qualified accountant as the company’s financial controller. Recruitment for a finance director is in progress.

Python Co received a financial penalty of \$85,000 due to failure to perform money laundering checks on project owners.

## Sustainability claims

The company intends to publish a sustainability report together with the financial statements. This will be the first time that the report has been published. Management of Python Co has stated that legislation does not require the sustainability report to be separately audited, therefore the audit team will not need to perform any audit work on it.

## 3 Revenue

### Revenue

Revenue is collected through a third-party service company, E S Crow Co. Once projects reach target, the money is collected from the backers by E S Crow Co and 10% is paid to Python Co.

Of the proceeds received from the backers, 90% is transferred directly to the project, and 10% is transferred to Python Co. This 10% is recognised as revenue in the financial statements of Python Co. Revenue is forecast to be \$52.70 million (20X4: \$44.60 million) for the year ending 30 September 20X5.

E S Crow Co sends daily statements to Python Co providing financial information on an individual project level. The statements detail which projects are in progress and those which are now fully funded. The finance team reviews these only to ensure that they agree to the amount of revenue paid to Python Co by E S Crow Co. E S Crow Co's auditor has provided a Type 2 report for the service company's financial year ended 31 May 20X5 to Kotlin Associates. The costs of using E S Crow Co are expensed by Python Co within cost of sales.

Python Co does not have any further involvement with the projects once the target has been reached.

### Accrued revenue

Total revenue includes accrued revenue for projects which have reached the financial target and those which are expected to reach the financial target as detailed below:

	<b>Note</b>	<b>30 September 20X5</b>	<b>30 September 20X4</b>
		<b>\$million</b>	<b>\$million</b>
Projects which have reached their target	1	4.55	3.20
Projects expected to reach their target	2	1.20	-
<b>Total accrued revenue</b>		<b>5.75</b>	<b>3.20</b>

**Note 1:** This is for the projects which have reached their target but for which Python Co has not yet received payment from E S Crow Co.

**Note 2:** This is for projects where the funding is close to, but has not yet achieved, the financial target. The accrual is based on the financial controller's best estimate. The year ending 30 September 20X5 is the first year this adjustment to total revenue has been made.

## 4 Financial performance

### Extracts from the management accounts of Python Co:

	Note	30 September 20X5	30 September 20X4
		\$million	\$million
Revenue		52.7	44.6
Other expenses	1	25.1	17.2
Profit before income taxes		4.3	3.1
Total assets which include:		27.4	18.3
Intangible assets	2	18.2	14.8
Property, plant and equipment	3	5.2	1.6

#### Note 1: Other expenses and data breach

Other expenses include \$23.04 million (20X4: \$14.4 million) of website hosting expenses. The website, and its data, are hosted by a cloud-based service provider. The expenses have increased significantly during the year due to an upgrade to a dedicated cloud server on 1 January 20X5. This upgrade allows more users to interact with the website. It also increases the security of user data which was required following a data breach in October 20X4 when personal data was leaked on the website. Management acted quickly and the breach was resolved. The data protection regulator has stated that there will be a fine, but the final amount will not be agreed until November 20X5. Data breach fines in this territory are usually 2% - 4% of revenue, depending on the severity of the breach and the measures the company has since taken to prevent another breach.

#### Note 2: Intangible assets

During the year, \$6.2 million was spent on the development and enhancement of internally developed software used in managing the crowdfunding website. This included upgrading the accounting software which integrates with the website.

Significant issues were encountered, and the data was not sufficiently validated once the new system was implemented, which resulted in the accounting records for November 20X4 being rebuilt using information from the old system, and a significant number of manual journals. The board believes that these issues have been resolved.

The \$6.2 million asset includes \$600,000 which relates to work investigating an aspect of the upgrade which was not used in the final software design.

Intangible assets are amortised over five years on a straight-line basis.

**Note 3: Purchase of head office**

On 1 January 20X5, Python Co purchased a property costing \$4 million, which is now the company's head office. This is the only property owned by the company, and it will be depreciated over 20 years, with a full year of depreciation in the year of acquisition.

The financial controller expensed legal and professional costs of \$500,000 associated with this purchase. In addition, costs incurred of \$645,000 were expensed in respect of relocating the staff and equipment from the previous rented location to the new building.

The audit assistant has proposed the following work is completed on the purchase of the head office property:

- Obtain the bank statements, agree the date of purchase and the cost to ensure the correct details have been recorded in the non-current assets register.
- Obtain the draft financial statements and agree the cost and accumulated depreciation of the addition to the non-current assets register.
- Agree the costs from the purchase of the property to supporting invoices to ensure accuracy of expenses incurred during the year.
- Visit the head office to ensure the existence of the asset.

**5 Request from management**

Hello,

As you are aware, Python Co intends to expand the company and is seeking to acquire controlling interests in other crowdfunding companies, preferably in the foreign country of Farland. To assist with these expansion plans, we would like Kotlin Associates to provide corporate finance assistance to develop a mergers and acquisitions strategy and identify potential target companies for acquisition. We would request your support during meetings with our bank regarding financing for this expansion.

In addition to this, as you know, we are still without a finance director, and the chief executive officer (CEO) of Python Co has requested that a member of Kotlin Associates works with the finance team and the board to design internal controls over the accounting system and also evaluate the operating effectiveness of the internal controls.

Please let me know whether this would be acceptable to your firm.

Kind regards

Justin Ava

Financial controller

**Requirement:**

**Respond to the instructions in the email from the audit engagement partner.**

Note: The split of the mark allocation is shown in Exhibit 1 - Partner's email.

(40 marks)

Professional marks will be awarded for the demonstration of skill in communication, analysis and evaluation, professional scepticism and judgement, and commercial acumen in your answer.

(10 marks)

**(50 marks)**

## Section B

### Question 2

The following **exhibits** provide information relevant to the question:

1. Babbage Co – extract from the audit file detailing the work performed on trade receivables
2. Ada Group – summary of fees charged for services provided

#### 1 Babbage Co

It is 1 July 20X5. You are an audit manager in Turing & Co and have been tasked with performing a post-issuance review of the audit of Babbage Co.

Babbage Co is an unlisted company with a financial year ended 31 March 20X5. The auditor's report was issued last week with an unmodified opinion. As this is the first year that Turing & Co have performed the audit, a post-issuance review is to be performed.

Materiality has been set by the audit engagement partner at \$17,000 in accordance with the firm's quality management procedures.

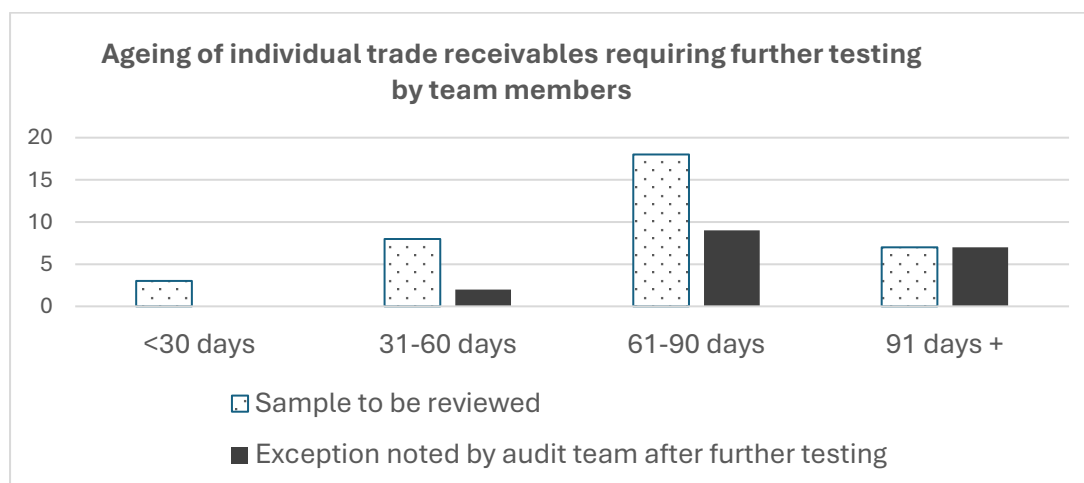
Turing & Co has a new data analytics software package. The firm's quality procedures require all staff to complete training on the software. This training reminds staff that:

- all sample sizes must be quantified and documented;
- all exceptions must be investigated and explained; and
- all exceptions must be discussed with the audit manager and the client. The outcome of these discussions should be documented to the extent that a member of another audit team can retest and confirm the conclusions.

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#### Extract from the audit file on trade receivables

The following samples have been flagged for further review by the audit team.



Test completed by	Tim Berners
Date completed	10 June 20X5
Test details	Items marked ‘sample to be reviewed’ require further testing for recoverability.  All items with exceptions must be discussed with management and the audit manager.
Sample size	100% of the trade receivables account have been analysed by the data analytics software which has identified 36 items for review.
Procedures performed	Individual balances were agreed to invoices.  Cash received after the year end was agreed to the balances in the sample outstanding at 31 March 20X5.
Result	Exceptions were noted in 18 of these reviewed items.  No cash was received after the year end in these cases.  However, as the individual exceptions did not exceed materiality, no further work was performed.  Appears reasonable.
Reviewer	

### Control environment

The systems and controls section of the file has a note stating that the data analytics software tested 100% of the trade receivables balance and therefore no further systems work was required.

### Use of data analytics software

The audit assistant tells you that neither they nor the audit supervisor really understand what the firm’s data analytics software does, but they followed the directions in the instruction manual for audit testing and put the results on file as evidence.

You have since worked with the data analytics implementation team to assure yourself that the financial statements do not contain any material misstatements.

## 2 Ada Group

You have also been asked to review information on the fees charged to Ada Group, another client of the firm. Ada Group (the Group) is an unlisted manufacturer which has undertaken a significant international expansion in recent years.

The Group is seeking a new auditor for the year ending 31 October 20X5, after its existing auditor identified that it did not have the required resources to continue auditing the expanding group, and Turing & Co has been asked to take on this engagement.

The Group has used Turing & Co to provide other services, including assurance and forensic engagements in the previous two years.

You have been provided with the following information from the billing department of your firm:

### Summary of fees: Ada Group

Note, all invoices to date have been settled in full.

<b>Department</b>	<b>Description</b>	<b>Amount</b> <b>\$'000</b>
Assurance	Corporate responsibility report	80
Consulting	Valuation for the purchase of a brand	140
<b>Total year to date 31 Dec 20X4</b>		<b>220</b>
Assurance	Corporate responsibility report	81
Forensic	Fraud investigation	157
<b>Forecasted year to date 31 Dec 20X5</b>		<b>238</b>

### Notes

The proposed audit fee is \$358,000. This has been calculated based on the hours required and the seniority of the team expected to perform the audit. A recurring 10% discount has already been applied to this proposed fee in recognition of the importance of the Group's audit to the firm.

Total fees for Turing & Co for the year to 31 December 20X5 are forecast to be \$1.21 million which excludes the proposed audit fee for the Group of \$358,000.

**Requirements:**

**(a) Evaluate the quality management issues arising in respect of the audit work performed on the trade receivables of Babbage Co and recommend any appropriate actions to be taken by Turing & Co to mitigate against future quality management issues.**

(12 marks)

**(b) Evaluate the professional and ethical matters relating to fees which should be considered by Turing & Co prior to accepting appointment as the auditor of Ada Group.**

(8 marks)

Professional marks will be awarded for the demonstration of skill in analysis and evaluation and professional scepticism and judgement in your answer.

(5 marks)

**(25 marks)**

### Question 3

The following **exhibits** provide information relevant to the question:

1. Extracts of the audit file – information about a fraud which was discovered during the audit and details of the new security system
2. Proposed auditor’s report – extract of the draft auditor’s report for the year ended 31 March 20X5

#### 1 Extracts of the audit file

It is 1 July 20X5. You work in the audit department of Commodore & Co. The Spectrum Group (the Group) is an audit client of your firm and the audit for the financial year ended 31 March 20X5 is in the completion stage. The Group, which is listed, develops security systems for businesses and residential customers.

Materiality for the audit of the Group financial statements has been determined to be \$140,000. You are reviewing the audit file and have gathered the following information:

#### Fraud

The Group finance director has informed the audit team that during the year, a fraud was carried out by a manager, Clive Apricot, in one of the Group’s procurement departments. Clive Apricot had raised fictitious supplier invoices and paid the invoiced amounts into his personal bank account. When questioned by the Group’s finance director, Clive Apricot confessed that he had stolen \$40,000 from the Group. The finance director asked the audit team not to perform any procedures in relation to the fraud, as the amount is immaterial. He also stated that the financial statements would not be adjusted for the fraud.

The only audit evidence on file is a written representation from management acknowledging the existence of the fraud, and a list of the fictitious invoices which had been raised by Clive Apricot. The conclusion documented on the audit file states that the fraud is immaterial and no further work is needed.

#### New security system

In August 20X4, the Group commenced development of a new security system which uses artificial intelligence (AI) to predict which security alerts require attention by the police. The Group incurred expenditure of \$1,200,000 during the financial year which has been recognised within intangible assets.

Costs of developing the new security system recognised within intangible assets:

	\$
Legal costs	150,000
Staff time working directly on the new system	450,000
Other costs	350,000
Internally generated brand	250,000
<b>Total costs of the new security system</b>	<b>1,200,000</b>

The audit file includes the following evidence in respect of this intangible asset:

- A sample of the costs included within the legal and other costs have been agreed to supporting invoices.
- The value of the internally generated brand of \$250,000 has been estimated by management.
- Cash flow projections, which indicate the project will generate a positive cash flow by 20X8 have been arithmetically checked.
- Written representation from management has been obtained stating management considers that the development of this new product will be successful.
- The Group's policy is to amortise intangible assets over five years.

You are aware that when the Group finance director was asked about the cash flow projections, he was reluctant to answer questions, simply saying that the assumptions underlying the projections have been agreed to assumptions contained in the Group's business plan. He provided a spreadsheet showing the projections, but the underlying information could not be accessed as the file was password protected and he would not provide the password to the audit team.

## **2 Proposed auditor's report**

Based on the above conclusions, the audit supervisor has drafted the auditor's report which includes the following extract:

### **Basis for opinion and opinion**

Audit procedures indicate that intangible assets are overstated. For this reason, we consider that the Group financial statements are likely to be materially misstated and do not fairly present the financial position and performance of the Group for the year ended 31 March 20X5.

**Emphasis of matter**

There are two matters to which we draw your attention:

1. A fraud was discovered which has resulted in \$40,000 being stolen from the Group. This does not impact the financial statements but we wish to highlight the illegal activity which took place during the year.
2. The Group finance director obstructed our audit by refusing to allow access to audit evidence. He has also refused to adjust the financial statements in relation to the material misstatement of intangible assets which led to the qualified audit opinion being issued. For this reason, we wish to resign as auditor with immediate effect.

**Requirements:**

**(a) Assess the implication of the fraud for the completion of the audit and recommend the further actions to be taken by the auditor.**

(6 marks)

**(b) Evaluate sufficiency and appropriateness of the audit evidence obtained in respect of the new security system and recommend any additional actions which should be taken by the auditor.**

(7 marks)

**Completion update**

It is now 15 July 20X5, and the audit team has completed work on the costs, however, management has not made any amendments to the financial statements in respect of the brand valuation.

**(c) Evaluate the extract of the proposed auditor's report of the Spectrum Group for the year ended 31 March 20X5.**

Note: You are NOT required to re-draft the extracts from the auditor's report.

(7 marks)

Professional marks will be awarded for the demonstration of skill in analysis and evaluation and professional scepticism and judgement in your answer.

(5 marks)

**(25 marks)**