Answers
1 SHIRE OIL CO

(a) Audit risks

Inherent – financial statements level

■ As Shire is a listed company there will be pressures on its management to meet the expectations of users, in particular shareholders and analysts, thereby increasing inherent risk.

■ The oil industry is exposed to a volatile market (e.g. in futures trading). This increases going concern (failure) risk.

■ Shire operates in different regions with exposure to economic instability, currency devaluation and high inflation. Increased disclosure risk arises as IAS 1 ‘Presentation of Financial Statements’ requires that key assumptions concerning the future of such sources of estimation uncertainty be disclosed.

■ Disclosure risk is increased as Shire is required to comply with the extensive disclosure requirements of IAS 14 ‘Segment Reporting’.

■ The fall in basic EPS (as compared with the first six months of the previous half year) may increase management bias to overstate performance in the second half year (to 31 December 2005).

Inherent – assertion level

■ The grant of a licence may be valued at either cost or fair value (IAS 20 ‘Accounting for Government Grants and Disclosure of Government Assistance’). However, valuation other than at cost ($nil) is inherently risky as fair value has been estimated by management. The licence may be unique (being for five years in a remote region) and in the absence of an active market in them – or recent transactions for which prices can be observed – it seems unlikely that any estimate of fair value made by management can be substantiated.

■ The licence is an intangible asset. If recognised other than at cost it should be amortised on a straight-line basis over five years (IAS 38 ‘Intangible Assets’).

■ Item replacements (e.g. of drilling equipment) should be recognised as items of property, plant and equipment (and the replaced items as disposals) in accordance with (IAS 16 ‘Property, Plant and Equipment’). Constituent items of each rig should be depreciated over their useful lives.

■ If management is properly re-assessing the useful life of each rig annually then this should be reflected in the change, from time to time, of the number of years over which each rig is depreciated.

Tutorial note: A change in estimate – not policy. It is NOT a risk that the useful life of a platform is not the same for all rigs.

■ Although the treatment of decommissioning provisions (Debit Asset/Credit Provision) appears to be correct (IAS 16 and IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’) abandoning the cyclone-damaged rig calls into question Shire’s recognition of such provisions. In the absence of a legal or constructive obligation there is no liability to be provided for.

■ The abandoned rig may be overstated. Depreciation should cease and the rig tested for impairment. In particular, the decommissioning provision should be reversed against the undepreciated balance included in cost (and any difference included in profit or loss).

Tutorial note: The difference is between depreciation charge and finance cost (on ‘unwinding of the discount’).

■ Actual and/or contingent liabilities may arise if Shire is exposed to fines/penalties as a result of abandoning the rig (IAS 37). As the rig was damaged before the year end, provisions should be made as at 31 December 2005 unless they cannot be reliably measured (unlikely). (This could include provision for redundancy of rig workers.)

■ The oil pipeline is a jointly controlled asset that should be accounted for to reflect its economic substance (IAS 31 ‘Interests in Joint Ventures’). Shire must recognise its share of the asset, liabilities and expenditure incurred and any income from the sale of its share of the oil output (as well as its own liabilities and expenses separately incurred).

■ The prior year modification would have been ‘qualified – except for’. If there is a similar lack of evidence in the current year the auditor’s report should be similarly qualified. Even if the correct position at 31 December 2005 is determinable, the audit opinion at that date should be modified in respect of the impact, if any, on the opening position and comparative information (unless the opening oil reserves position has since been ascertained and can be corrected with a prior period adjustment).

Tutorial note: Modification could not have been an emphasis of matter as there was a lack of scope. The matter was evidently material but not pervasive.
Tutorial note: Credit will be given for additional answer points relevant to the scenario and the industry. For example:

- Going concern (failure) risk is increased if significant operating licences\(^1\) are withdrawn from oil-producing areas (e.g. as a result of non-compliance with environmental legislation).

- Research and Development\(^2\) costs must be expensed unless/until Shire has a legal right to explore the area in which they are incurred. So, in the remote region, Shire can only capitalise costs incurred from April. (Risk is asset overstatement.)

- Exploration and evaluation assets should be classified as tangible (e.g. rigs) or intangible (e.g. drilling rights) according to their nature (IFRS 6 ’Exploration for and Evaluation of Mineral Resources’).

- When the technical feasibility and commercial viability of extracting oil from an area of interest can be demonstrated, exploration and evaluation assets must be tested for impairment before reclassification (as tangible/intangible assets).

(b) Principal audit work – useful life of rig platforms

Tutorial notes: The platforms are just one item of each rig. Candidates should not be awarded marks here for the matters to be considered in the assessment of useful lives (since this is illustrated in the scenario). No marks will be awarded for criticising management for estimating useful lives on a per platform basis or for audit work on depreciation charges/carrying amounts unrelated to the determination of useful lives.

- Review of management’s annual assessment of the useful life of each rig at 31 December 2005 and corroboration of any information that has led to a change in previous estimates. For example, for the abandoned rig, where useful life has been assessed to be at an end, obtain:
  - weather reports;
  - incident report supported by photographs;
  - insurance claim, etc.

- Consider management’s past experience and expertise in estimating useful lives. For example, if all lives initially assessed as short (c. 15 years) are subsequently lengthened (or long lives consistently shortened) this would suggest that management is being over (under) prudent in its initial estimates.

- Review of industry comparatives as published in the annual reports of other oil producers.

- Comparison of actual maintenance costs against budgeted to confirm that the investment needed in maintenance, to achieve expected life expectancy, is being made.

- Comparison of actual output (oil extracted) against budgeted. If actual output is less than budgeted the economic life of the platform may be:
  - shorter (e.g. because there is less oil to be extracted than originally surveyed); or
  - longer (e.g. because the rate of extraction is less than budgeted).

  Tutorial note: An increase in actual output can be explained conversely.

- A review of the results of management’s impairment testing of each rig (i.e. the cash-generating unit of which each platform is a part).

- Recalculation of cash flow projections (based on reasonable and supportable assumptions) discounted at a suitable pre-tax rate.

  Tutorial note: As the rigs will not have readily determinable net selling prices (each one being unique and not available for sale) any impairment will be assessed by a comparison of value in use against carrying amount.

- Review of working papers of geologist/quantity surveyor(s) employed by Shire supporting estimations of reserves used in the determination of useful lives of rigs.

(c) Social and environmental responsibilities

Performance indicators

- Absolute ($) and relative (%) level of investment in sports sponsorship, and funding to the Shire Ward.

- Increasing number of championship events and participating schools/students as compared with prior year.

- Number of medals/trophies sponsored at events and/or number awarded to Shire sponsored schools/students.

- Number of patients treated (successfully) a week/month. Average bed occupancy (daily/weekly/monthly and cumulative to date).

- Staffing levels (e.g. of volunteers for sports events, Shire Ward staff and the company):
  - ratio of starters to leavers/staff turnover;
  - absenteeism (average number of days per person per annum).

\(^{1}\) Withdrawal of the new licence would not create a going concern issue.

\(^{2}\) May also be described as ‘exploration and evaluation’ costs or ‘discovery and assessment’.
Number of:
- breaches of health and safety regulations and environmental regulations;
- oil spills;
- accidents and employee fatalities;
- insurance claims.

Evidence

Tutorial note: As there is a wide range of performance indicators that candidates could suggest, there is always a wide range of possible sources of audit evidence. As the same evidence may contribute to providing assurance on more than one measure they are not tabulated here, to avoid duplication. However, candidates may justifiably adopt a tabular layout. Also note, that where measures may be expressed as evidence (e.g. trophies awarded) marks should be awarded only once.

- Actual level of investment ($) compared with budget and budget compared with prior period.
  Tutorial note: Would expect actual to be at least greater than prior year if performance in these areas (health and safety) has improved.

- Physical evidence of favourable increases on prior year, for example:
  - medals/cups sponsored;
  - number of beds available.

- Increase in favourable press coverage/reports of sponsored events. (Decrease in adverse press about accidents/fatalities.)

- Independent surveys (e.g. by marine conservation organisations, welfare groups, etc) comparing Shire favourably with other oil producers.

- A reduction in fines paid compared with budget (and prior year).

- Reduction in legal fees and claims being settled as evidenced by fee notes and correspondence files.

- Amounts settled on insurance claims and level of insurance cover as compared with prior period.

2 INDIGO CO

(a) Opening balances – principal audit procedures

Tutorial note: ‘Opening balances’ means those account balances which exist at the beginning of the period. The question clearly states that the prior year auditor’s report was unmodified therefore any digression into the prior period opinion being other than unmodified or the prior period not having been audited will not earn marks.

- Review of the application of appropriate accounting policies in the financial statements for the year ended 31 December 2004 to ensure consistent with those applied in 2005.

- Where permitted (e.g. if there is a reciprocal arrangement with the predecessor auditor to share audit working papers on a change of appointment), a review of the prior period audit working papers.

Tutorial note: There is no legal, ethical or other professional duty that requires a predecessor auditor to make available its working papers.

- Current period audit procedures that provide evidence concerning the existence, measurement and completeness of rights and obligations. For example:
  - after-date receipts (in January 2005 and later) confirming the recoverable amount of trade receivables at 31 December 2004;
  - similarly, after-date payments confirming the completeness of trade and other payables (for services);
  - after-date sales of inventory held at 31 December 2004;

- Analytical procedures on ratios calculated month-on-month from 31 December 2004 to date and further investigation of any distortions identified at the beginning of the current reporting period. For example:
  - inventory turnover (by category of metal);
  - average collection payment;
  - average payment period;
  - gross profit percentage (by metal).

- Examination of historic accounting records for non-current assets and liabilities (if necessary). For example:
  - agreeing balances on asset registers to the client’s trial balance as at 31 December 2004;
  - agreeing statements of balances on loan accounts to the financial statements as at 31 December 2004.

- If the above procedures do not provide sufficient evidence, additional substantive procedures should be performed. For example, if additional evidence is required concerning inventory at 31 December 2004, cut-off tests may be reperformed.
(b) Financial statement risks

Assets

- There is a very high risk that inventory could be materially overstated in the balance sheet (thereby overstating profit) because:
  - there is a high volume of metals (hence material);
  - valuable metals are made more portable;
  - subsidy gives an incentive to overstate purchases (and hence inventory);
  - inventory may not exist due to lack of physical controls (e.g. aluminium can blow away);
  - scrap metal in the stockyard may have zero net realisable value (e.g. iron is rusty and slow-moving);
  - quantities per counts not attended by an auditor have increased by a third.

- Inventory could be otherwise misstated (over or under) due to:
  - the weighbridge being inaccurate;
  - metal qualities being estimated;
  - different metals being mixed up; and
  - the lack of an independent expert to identify/measure/value metals.

- Tangible non-current assets are understated as the parts of the furnaces that require replacement (the linings) are not capitalised (and depreciated) as separate items but treated as repairs/maintenance/renewals and expensed.

- Cash may be understated due to incomplete recording of sales.
- Recorded cash will be overstated if it does not exist (e.g. if it has been stolen).
- Trade receivables may be understated if cash receipts from credit customers have been misappropriated.

Liabilities

- The provision for the replacement of the furnace linings is overstated by the amount provided in the current and previous year (i.e. in its entirety).

Tutorial note: Last replacement was two years ago.

Income statement

- Revenue will be understated in respect of unrecorded cash sales of salvaged metals and ‘clinker’.
- Scrap metal purchases (for cash) are at risk of overstatement:
  - to inflate the 15% subsidy;
  - to conceal misappropriated cash.
- The income subsidy will be overstated if quantities purchased are overstated and/or overvalued (on the quarterly returns) to obtain the amount of the subsidy.
- Cash receipts/payments that were recorded only in the cash book in November are at risk of being unrecorded (in the absence of cash book postings for November), especially if they are of a ‘one-off’ nature.
  
  Tutorial note: Cash purchases of scrap and sales of salvaged metal should be recorded elsewhere (i.e. in the manual inventory records). However, a one-off expense (of a capital or revenue nature) could be omitted in the absence of another record.
- Expenditure is overstated in respect of the 25% provision for replacing the furnace linings. However, as depreciation will be similarly understated (as the furnace linings have not been capitalised) there is no risk of material misstatement to the income statement overall.

Disclosure risk

- A going concern (‘failure’) risk may arise through the loss of:
  - sales revenue (e.g. through misappropriation of salvaged metals and/or cash);
  - the subsidy (e.g. if returns are prepared fraudulently);
  - cash (e.g. if material amounts stolen).

  Any significant doubts about going concern must be suitably disclosed in the notes to the financial statements. Disclosure risk arises if the requirements of IAS 1 ‘Presentation of Financial Statements’ are not met.

- Disclosure risk arises if contingent liabilities in connection with the dumping of ‘clinker’ (e.g. for fines and penalties) are not adequately disclosed in accordance with IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’.
Appropriate audit approach

Tutorial note: In explaining why an audit approach is appropriate for Indigo it can be relevant to comment on the unsuitability of other approaches.

- A risk-based approach is suitable because:
  - inherent risk is high at the entity and financial assertion levels;
  - material errors are likely to arise in inventory where a high degree of subjectivity will be involved (regarding quality of metals, quantities, net realisable value, etc);
  - it directs the audit effort to inventory, purchases, income (sales and subsidy) and other risk areas (e.g. contingent liabilities).

- A systems-based/compliance approach is not suited to the risk areas identified because controls are lacking/ineffective (e.g. over inventory and cash). Also, as the audit appointment was not more than three months ago and no interim audit has been conducted (and the balance sheet date is only three weeks away) testing controls is likely to be less efficient than a substantive approach.

- A detailed substantive/balance sheet approach would be suitable to direct audit effort to the appropriate valuation of assets (and liabilities) existing at balance sheet date. Principal audit work would include:
  - attendance at a full physical inventory count at 31 December 2005;
  - verifying cash at bank (through bank confirmation and reconciliation) and in hand (through physical count);
  - confirming the accuracy of the quarterly returns to the local authority.

- A cyclical approach/directional testing is unlikely to be suitable as cycles are incomplete. For example the purchases cycle for metals is ‘purchase/cash’ rather than ‘purchase/payable/cash’ and there is no independent third party evidence to compensate for that which would be available if there were trade payables (i.e. suppliers’ statements). Also the cycles are inextricably inter-related to cash and inventory – amounts of which are subject to high inherent risk.

- Analytical procedures may be of limited use for substantive purposes. Factors restricting the use of substantive analytical procedures include:
  - fluctuating margins (e.g. as many factors will influence the price at which scrap is purchased and subsequently sold, when salvaged, sometime later);
  - a lack of reliable/historic information on which to make comparisons.

(c) Extent of alleged fraud – Matters to be considered

- Details reported to police: The managing director may have made some estimate of the possible extent of the fraud in reporting the chief accountant’s disappearance to the police.

- The minimum loss (assuming no insurance) would be sales for the three days before he left. If not known (e.g. because the only record of them was in the cash book) a simple estimate might be $0.6 \times \frac{3}{20} \times \text{total recorded revenue for a typical month}.$

- The pattern of cash bankings extracted from bank statements: A falling trend starting during the year might mark the time from which the chief accountant began to misappropriate cash.

- Whether other managers have voiced their suspicions, if any, on the chief accountant’s behaviour. For example, if there was any marked change in his lifestyle (what he appeared to spend his money on, the hours he worked, etc).

- The prior year auditor’s report was unmodified. If this was appropriate the chief accountant’s alleged fraudulent activities may have only started in the current year.

- The amount of fidelity insurance cover (i.e. against employees handling cash) that Indigo has taken out to meet any claim for fraud.

- The likelihood, if any, of recovering misappropriated amounts. For example, if the chief accountant has assets (e.g. a house) that can be used to settle Indigo’s claims against him in the event that he is caught/successfully prosecuted.

3 ALBREDA CO

(a) Cessation of ‘home delivery’ service

(i) Matters

- $0.6 million represents 1.4% of reported revenue (prior year 1.9%) and is therefore material.

  Tutorial note: However, it is clearly not of such significance that it should raise any doubts whatsoever regarding the going concern assumption. (On the contrary, as revenue from this service has declined since last year.)

- The home delivery service is not a component of Albreda and its cessation does not classify as a discontinued operation (IFRS 5 ‘Non-current Assets Held for Sale and Discontinued Operations’).

  - It is not a cash-generating unit because home delivery revenues are not independent of other revenues generated by the restaurant kitchens.
1.4% of revenue is not a ‘major line of business’.

Home delivery does not cover a separate geographical area (but many areas around the numerous restaurants).

The redundancy provision of $0.2 million represents 11.1% of profit before tax (10% before allowing for the provision) and is therefore material. However, it represents only 0.6% of total assets and is therefore immaterial to the balance sheet.

As the provision is a liability it should have been tested primarily for understatement (completeness).

The delivery vehicles should be classified as held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the following IFRS 5 criteria must be met:

- the vehicles must be available for immediate sale in their present condition; and
- their sale must be highly probable.

Tutorial note: Highly probable = management commitment to a plan + initiation of plan to locate buyer(s) + active marketing + completion expected in a year.

However, even if the classification as held for sale is appropriate the measurement basis is incorrect.

Non-current assets classified as held for sale should be carried at the lower of carrying amount and fair value less costs to sell.

It is incorrect that the vehicles are being measured at fair value less costs to sell which is $0.3 million in excess of the carrying amount. This amounts to a revaluation. Wherever the credit entry is (equity or income statement) it should be reversed. $0.3 million represents just less than 1% of assets (16.7% of profit if the credit is to the income statement).

Comparison of fair value less costs to sell against carrying amount should have been made on an item by item basis (and not on their totals).

(ii) Audit evidence

- Copy of board minute documenting management’s decision to cease home deliveries (and any press releases/internal memoranda to staff).
- An analysis of revenue (e.g. extracted from management accounts) showing the amount attributed to home delivery sales.
- Redundancy terms for drivers as set out in their contracts of employment.
- A ‘proof in total’ for the reasonableness/completeness of the redundancy provision (e.g. number of drivers × sum of years employed × payment per year of service).
- A schedule of depreciated cost of delivery vehicles extracted from the non-current asset register.
- Checking of fair values on a sample basis to second hand market prices (as published/advertised in used vehicle guides).
- After-date net sale proceeds from sale of vehicles and comparison of proceeds against estimated fair values.
- Physical inspection of condition of unsold vehicles.
- Separate disclosure of the held for sale assets on the face of the balance sheet or in the notes.
- Assets classified as held for sale (and other disposals) shown in the reconciliation of carrying amount at the beginning and end of the period.
- Additional descriptions in the notes of:
  - the non-current assets; and
  - the facts and circumstances leading to the sale/disposal (i.e. cessation of home delivery service).

(b) Revaluation of owned premises

(i) Matters

- The revaluations are clearly material as $1.7 million, $5.4 million and $7.1 million represent 5.5%, 17.6% and 23.1% of total assets, respectively.
- The change in accounting policy, from a cost model to a revaluation model, should be accounted for in accordance with IAS 16 ‘Property, Plant and Equipment’ (i.e. as a revaluation).

Tutorial note: IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’ does not apply to the initial application of a policy to revalue assets in accordance with IAS 16.

- The basis on which the valuations have been carried out, for example, market-based fair value (IAS 16).
- Independence, qualifications and expertise of valuer(s).
IAS 16 does not permit the selective revaluation of assets thus the whole class of premises should have been revalued.

The valuations of properties after the year end are adjusting events (i.e. providing additional evidence of conditions existing at the year end) per IAS 10 ‘Events After the Balance Sheet Date’.

Tutorial note: It is ‘now’ still less than three months after the year end so these valuations can reasonably be expected to reflect year-end values.

If $5·4 million is a net amount of surpluses and deficits it should be grossed up so that the credit to equity reflects the sum of the surpluses with any deficits being expensed through profit and loss (IAS 36 ‘Impairment of Assets’).

The revaluation exercise is incomplete. If the revaluations on the remaining three properties are expected to be material and cannot be reasonably estimated for inclusion in the financial statements for the year ended 30 September 2005 perhaps the change in policy should be deferred for a year.

Depreciation for the year should have been calculated on cost as usual to establish carrying amount before revaluation.

Any premises held under finance leases should be similarly revalued.

(ii) Audit evidence

- A schedule of depreciated cost of owned premises extracted from the non-current asset register.
- Calculation of difference between valuation and depreciated cost by property. Separate summation of surpluses and deficits.
- Copy of valuation certificate for each property.
- Physical inspection of properties with largest surpluses (including the two valued before the year end) to confirm condition.
- Extracts from local property guides/magazines indicating a range of values of similarly styled/sized properties.
- Separate presentation of the revaluation surpluses (gross) in:
  - the statement of changes in equity; and
  - reconciliation of carrying amount at the beginning and end of the period.
- IAS 16 disclosures in the notes to the financial statements including:
  - the effective date of revaluation;
  - whether an independent valuer was involved;
  - the methods and significant assumptions applied in estimating fair values; and
  - the carrying amount that would have been recognised under the cost model.

(c) Fines and penalties

(i) Matters

- $0·1 million represents 5·6% of profit before tax and is therefore material. However, profit has fallen, and compared with prior year profit it is less than 5%. So ‘borderline’ material in quantitative terms.
- Prior year amount was three times as much and represented 13·6% of profit before tax.
- Even though the payments may be regarded as material ‘by nature’ separate disclosure may not be necessary if, for example, there are no external shareholders.
- Treatment (inclusion in cost of sales) should be consistent with prior year (‘The Framework’/IAS 1 ‘Presentation of Financial Statements’).
- The reason for the fall in expense. For example, whether due to an improvement in meeting health and safety regulations and/or incomplete recording of liabilities (understatement).
- The reason(s) for the breaches. For example, Albreda may have had difficulty implementing new guidelines in response to stricter regulations.
- Whether expenditure has been adjusted for in the income tax computation (as disallowed for tax purposes).
- Management’s attitude to health and safety issues (e.g. if it regards breaches as an acceptable operational practice or cheaper than compliance).
- Any references to health and safety issues in other information in documents containing audited financial statements that might conflict with Albreda incurring these costs.
- Any cost savings resulting from breaches of health and safety regulations would result in Albreda possessing proceeds of its own crime which may be a money laundering offence.
(ii) Audit evidence

- A schedule of amounts paid totalling $0.1 million with larger amounts being agreed to the cash book/bank statements.
- Review/comparison of current year schedule against prior year for any apparent omissions.
- Review of after-date cash book payments and correspondence with relevant health and safety regulators (e.g. local authorities) for liabilities incurred before 30 September 2005.
- Notes in the prior year financial statements confirming consistency, or otherwise, of the lack of separate disclosure.
- A ‘signed off’ review of ‘other information’ (i.e. directors’ report, chairman’s statement, etc).
- Written management representation that there are no fines/penalties other than those which have been reflected in the financial statements.

4 JINACK CO

(a) Auditor’s responsibilities for subsequent events

- Auditors must consider the effect of subsequent events on:
  - the financial statements;
  - the auditor’s report.

- Subsequent events are all events occurring after a period end (i.e. reporting date) i.e.:
  - events after the balance sheet date (as defined in IAS 10); and
  - events after the financial statements have been authorised for issue.

Events occurring up to date of auditor’s report

- The auditor is responsible for carrying out procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor’s report that may require adjustment of, or disclosure in, the financial statements have been identified.

- These procedures are in addition to those applied to specific transactions occurring after the period end that provide audit evidence of period-end account balances (e.g. inventory cut-off and receipts from trade receivables). Such procedures should ordinarily include:
  - reviewing minutes of board/audit committee meetings;
  - scrutinising latest interim financial statements/budgets/cash flows, etc;
  - making/extending inquiries to legal advisors on litigation matters;
  - inquiring of management whether any subsequent events have occurred that might affect the financial statements (e.g. commitments entered into).

- When the auditor becomes aware of events that materially affect the financial statements, the auditor must consider whether they have been properly accounted for and adequately disclosed in the financial statements.

Facts discovered after the date of the auditor’s report but before financial statements are issued

Tutorial note: After the date of the auditor’s report it is management’s responsibility to inform the auditor of facts which may affect the financial statements.

- If the auditor becomes aware of such facts which may materially affect the financial statements, the auditor:
  - considers whether the financial statements need amendment;
  - discusses the matter with management; and
  - takes appropriate action (e.g. audit any amendments to the financial statements and issue a new auditor’s report).

- If management does not amend the financial statements (where the auditor believes they need to be amended) and the auditor’s report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion (as appropriate).

- If the auditor’s report has been released to the entity, the auditor must notify those charged with governance not to issue the financial statements (and the auditor’s report thereon) to third parties.

Tutorial note: The auditor would seek legal advice if the financial statements and auditor’s report were subsequently issued.

Facts discovered after the financial statements have been issued

- The auditor has no obligation to make any inquiry regarding financial statements that have been issued.

- However, if the auditor becomes aware of a fact which existed at the date of the auditor’s report and which, if known at that date, may have caused the auditor’s report to be modified, the auditor should:
  - consider whether the financial statements need revision;
  - discuss the matter with management; and
  - take appropriate action (e.g. issuing a new report on revised financial statements).
(b) Implications for the auditor’s report

(i) Corruption of perpetual inventory records

- The loss of data (of physical inventory quantities at the balance sheet date) gives rise to a limitation on scope.
  
  **Tutorial note:** It is the records of the asset that have been destroyed – not the physical asset.

- The systems failure in October 2005 is clearly a non-adjusting post balance sheet event (IAS 10). If it is material (such that non-disclosure could influence the economic decisions of users) Jinack should disclose:
  - the nature of the event (i.e. systems failure); and
  - an estimate of its financial effect (i.e. the cost of disruption and reconstruction of data to the extent that it is not covered by insurance).
  
  **Tutorial note:** The event has no financial effect on the realisability of inventory, only on its measurement for the purpose of reporting it in the financial statements.

- If material this disclosure could be made in the context of explaining how inventory has been estimated at 30 September 2005 (see later). If such disclosure, that the auditor considers to be necessary, is not made, the audit opinion should be qualified ‘except for’ disagreement (over lack of disclosure).
  
  **Tutorial note:** Such qualifications are extremely rare since management should be persuaded to make necessary disclosure in the notes to the financial statements rather than have users’ attention drawn to the matter through a qualification of the audit opinion.

- The limitation on scope of the auditor’s work has been imposed by circumstances. Jinack’s accounting records (for inventory) are inadequate (non-existent) for the auditor to perform tests on them.

- An alternative procedure to obtain sufficient appropriate audit evidence of inventory quantities at a year end is subsequent count and ‘rollback’. However, the extent of ‘roll back’ testing is limited as records are still under reconstruction.

- The auditor may be able to obtain sufficient evidence that there is no material misstatement through a combination of procedures:
  - testing management’s controls over counting inventory after the balance sheet date and recording inventory movements (e.g. sales and goods received);
  - reperforming the reconstruction for significant items on a sample basis;
  - analytical procedures such as a review of profit margins by inventory category.

- ‘An extensive range of inventory’ is clearly material. The matter (i.e. systems failure) is not however pervasive, as only inventory is affected.

- Unless the reconstruction is substantially completed (i.e. inventory items not accounted for are insignificant) the auditor cannot determine what adjustment, if any, might be determined to be necessary. The auditor’s report should then be modified, ‘except for’, limitation on scope.

- However, if sufficient evidence is obtained the auditor’s report should be unmodified.

- An ‘emphasis of matter’ paragraph would not be appropriate because this matter is not one of significant uncertainty.
  
  **Tutorial note:** An uncertainty in this context is a matter whose outcome depends on future actions or events not under the direct control of Jinack.

2006

- If the 2005 auditor’s report is qualified ‘except for’ on grounds of limitation on scope there are two possibilities for the inventory figure as at 30 September 2005 determined on completion of the reconstruction exercise:

  (1) it is not materially different from the inventory figure reported; or

  (2) it is materially different.

- In (1), with the limitation now removed, the need for qualification is removed and the 2006 auditor’s report would be unmodified (in respect of this matter).

- In (2) the opening position should be restated and the comparatives adjusted in accordance with IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’. The 2006 auditor’s report would again be unmodified.

  **Tutorial note:** If the error was not corrected in accordance with IAS 8 it would be a different matter and the auditor’s report would be modified (‘except for’ qualification) disagreement on accounting treatment.

(ii) Wholly-owned foreign subsidiary

- The cash transfer is a non-adjusting post balance sheet event. It indicates that Batik was trading after the balance sheet date. However, that does not preclude Batik having commenced trading before the year end.

- The finance director’s oral representation is wholly insufficient evidence with regard to the existence (or otherwise) of Batik at 30 September 2005. If it existed at the balance sheet date its financial statements should have been consolidated (unless immaterial).
The lack of evidence that might reasonably be expected to be available (e.g. legal papers, registration payments, etc) suggests a limitation on the scope of the audit.

If such evidence has been sought but not obtained then the limitation is imposed by the entity (rather than by circumstances).

Whilst the transaction itself may not be material, the information concerning the existence of Batik may be material to users and should therefore be disclosed (as a non-adjusting event). The absence of such disclosure, if the auditor considered necessary, would result in a qualified ‘except for’, opinion.

**Tutorial note:** Any matter that is considered sufficiently material to be worthy of disclosure as a non-adjusting event must result in such a qualified opinion if the disclosure is not made.

If Batik existed at the balance sheet date and had material assets and liabilities then its non-consolidation would have a pervasive effect. This would warrant an adverse opinion.

Also, the nature of the limitation (being imposed by the entity) could have a pervasive effect if the auditor is suspicious that other audit evidence has been withheld. In this case the auditor should disclaim an opinion.

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**DEDZA CO**

(a) Tax investigation

- Kora is a relatively new client. Before accepting the assignment(s) Dedza should have carried out customer due diligence (CDD). Dedza should therefore have a sufficient knowledge and understanding of Kora to be aware of any suspicions that the tax authority might have.

- As the investigation has come as a surprise it is possible that, for example:
  - the tax authority’s suspicions are unfounded;
  - Dedza has failed to recognise suspicious circumstances.

**Tutorial note:** In either case, Dedza should seek clarification on the period of suspicion and review relevant procedures.

- Dedza should review any communication from the predecessor auditor obtained in response to its ‘professional inquiry’ (for any professional reasons why the appointment should not have been accepted).

- A quality control for new audits is that the audit opinion should be subject to a second partner review before it is issued. It should be considered now whether or not such a review took place. If it did, then it should be sufficiently well documented to evidence that the review was thorough and not a mere formality.

- Criminal property includes the proceeds of tax evasion. If Kora is found to be guilty of under-declaring income that is a money laundering offence.

- Dedza’s reputational risk will be increased if implicated because it knew (or ought to have known) about Kora’s activities. (Dedza may also be liable if found to have been negligent in failing to detect any material misstatement arising in the 2004/05 financial statements as a result.)

- Kora’s audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by Kora or error overlooked by Dedza. Tax advisory work should have been undertaken and/or reviewed by a manager/partner not involved in the audit work.

- As tax advisor, Dedza could soon be making disclosures of misstatements to the tax authority on behalf of Kora. Dedza should encourage Kora to make necessary disclosure voluntarily.

- Dedza will not be in breach of its duty of confidentiality to Kora if Kora gives Dedza permission to disclose information to the tax authority (or Dedza is legally required to do so).

- If Dedza finds reasonable grounds to know or suspect that potential disclosures to the tax authority relate to criminal conduct, then a suspicious transaction report (STR) should be made to the financial intelligence unit (FIU) also.

**Tutorial note:** Though not the main issue credit will be awarded for other ethical issues such as the potential self-interest/self-review threat arising from the provision of other services.

(b) Advice on payments

- As compared with (a) there is no obvious tax issue. Xalam is not overstating expenditure for tax purposes.

- The payments being made for security consultancy services amount to a bribe. Corruption and bribery (and extortion) are designated categories of money laundering offence under ‘The Forty Recommendations’ of the Financial Action Task Force on Money Laundering (FATF).

- Xalam clearly benefits from the payments as it receives income from the contract with the major customer. This is criminal property and possession of it is a money laundering offence.

- Dedza should consider the seriousness of the disclosure made by the chief executive in the context of domestic law.
Dedza should consider its knowledge of import duties etc in the destination country before recommending a course of action to Xalam.

Dedza may be guilty of a money laundering offence if the matter is not reported. If a report to the FIU is considered necessary then Dedza should encourage Xalam to make voluntary disclosure. If Xalam does not, Dedza will not be in breach of client confidentiality for reporting knowledge of a suspicious transaction.

**Tutorial note:** *Making a report takes precedence over client confidentiality.*

**c** Financial advisor

- Customer due diligence (CDD) and record-keeping measures apply to designated non-financial businesses and professions (such as Dedza) who prepare for or carry out certain transactions on behalf of their clients.

- Esau is a ‘politically exposed person’ (‘PEP’) (i.e. an individual who is to be entrusted with prominent public functions in a foreign country).

- Dedza’s business relationships with Pholey therefore involve reputational risks similar to those with Esau. In addition to performing normal due diligence measures Dedza should:
  - have risk management systems to have determined that Esau is a PEP;
  - obtain senior partner approval for maintaining business relationships with such customers;
  - take reasonable measures to establish the source of wealth and source of funds;
  - conduct enhanced ongoing monitoring of the business relationship.

- Dedza can choose to decline to act for Pholey and/or Esau (if asked).

- If the business relationship is to be continued senior partner approval should be obtained for any transactions carried out on Pholey’s behalf in future.

**Tutorial note:** *The Pholey family is not described as an audit client therefore no familiarity threat arises in relation to an audit (the family may not have any involvement in entities requiring an audit).*

### 6 DEVELOPMENTS

**General comments**

**Tutorial note:** *The following comments, that could be made in respect of any of the three areas of development, will be given credit only once.*

- Audit scope – the scope of a statutory audit should be as necessary to form an audit opinion (i.e. unlimited).

- Audit work undertaken – the nature, timing and extent of audit procedures should be as necessary to implement the overall audit plan.

**a** Fair value accounting

- Different definitions of fair value exist (among financial reporting frameworks or for different assets and liabilities within a particular framework). For example, under IFRS it is ‘the amount for which an asset could be exchanged (or a liability settled) between knowledgeable, willing parties in an arm’s length transaction’.

- The term ‘fair value accounting’ is used to describe the measurement and disclosure of assets and/or liabilities at fair value and the charging to profit and loss (or directly to equity) of any changes in fair value measurements.

- Fair value accounting concerns measurements and disclosures but not initial recognition of assets and liabilities in financial statements. It does not then, for example, affect the nature, timing and extent of audit procedures to confirm the existence and completeness of rights and obligations.

- Fair value may be determined with varying degrees of subjectivity. For example, there will be little (if any) subjectivity for assets bought and sold in active and open markets that readily provide reliable information on the prices at which exchange transactions occur. However, the valuation of assets with unique characteristics (or entity-specific assets) often requires the projection and discounting of future cash flows.

- The audit of estimates of fair values based on valuation models/techniques can be approached like other accounting estimates (in accordance with ISA 540 ‘Audit of Accounting Estimates’). However, although the auditor should be able to review and test the process used by management to develop the estimate, there may be:
  - a much greater need for an independent estimate (and hence greater reliance on the work of experts in accordance with ISA 620);
  - no suitable subsequent events to confirm the estimate made (e.g. for assets that are held for use and not for trading).

**Tutorial note:** *Consider, for example, how the audit of ‘in-process research and development’ might compare with that for an allowance for slow-moving inventory.*
Different financial reporting frameworks require or permit a variety of fair value measures and disclosures in financial statements. They also vary in the level of guidance provided (to preparers of the financial statements – and hence their auditors). Under IFRS, certain fair values are based on management intent and ‘reasonable supportable assumptions’.

The audit of management intent potentially increases the auditor’s reliance on management representations. The auditor must obtain such representations from the highest level of management and exercise an appropriate degree of professional scepticism, being particularly alert to the implications of any conflicting evidence.

A significant development in international financial reporting is that it is no longer sufficient to report transactions and past and future events that may only be possible. IAS 1 ‘Presentation of Financial Statements’ (Revised) requires that key assumptions (and other key sources of estimation uncertainty) be disclosed. This requirement gives rise to yet another area on which auditors may qualify their audit opinion, on grounds of disagreement, where such disclosure is incorrect or inadequate.

Perhaps one of the most significant impacts of fair value accounting on audit work is that it necessarily increases it. Consider for example, that even where the fair value of an asset is as easily vouched as original cost, fair value is determined at least annually whereas historic cost is unchanged (and not re-vouched to original purchase documentation).

(b) Continuous auditing

Continuous auditing is a methodology that enables independent auditors to give written assurance on a subject matter (e.g. inventory levels, receivables balances, financial statements) using a series of auditor’s reports issued simultaneously with (or a short period of time after) the occurrence of events underlying the subject matter. Thus it increases the frequency of reporting (e.g. may be issued daily, weekly).

Technological development is making increasingly sophisticated information systems available to more entities at a decreasing cost. This has promoted a more widespread dependence on technology to produce more timely information. This has increased the demand for timely assurance on the information provided. Auditors have had to respond with highly automated procedures and audit tools that are integrated with the entity’s systems and controls.

**Tutorial note:** XBRL (eXtensible Business Reporting Language) increases the viability of continuous auditing. It provides a widely agreed-upon set of descriptors for elements in a business report that can be read and interpreted by computer systems. It allows an auditor to review data at any stage and determine the origin of the information and the controls that have been incorporated.

Results of automated audit procedures must be communicated promptly, particularly if anomalies or errors identified require that follow-up procedures be performed by audit personnel. Secure electronic communication links are therefore essential.

Continuous audit work requires the frequent or continuous use of audit tools integrated with the client’s systems. For example embedded audit modules (EAMs) are subroutines that perform control or audit procedures concurrently with the client’s normal application processing.

(c) Non-consolidated entities under common control

- Horizontal groups of entities under common control were a significant feature of the Enron and Parmalat business empires.

- Such business empires increase audit risk as fraud is often disguised through labyrinthine group structures. Hence auditors need to understand and confirm the economic purpose of entities within business empires (as well as special purpose entities (SPEs) and non-trading entities).

- Horizontal groups fall outside the requirement for the preparation of group accounts. It is not only finance that is off-balance sheet when controlled entities are excluded from consolidated financial statements.

- In the absence of consolidated financial statements, users of accounts of entities in horizontal groups have to rely on the disclosure of related party transactions and control relationships for information about transactions and arrangements with other group entities. Difficulties faced by auditors include:
  - failing to detect related party transactions and control relationships;
  - not understanding the substance of transactions with entities under common control;
excessively creative tax planning;
- the implications of transfer pricing (e.g. failure to recognise profits unrealised at the business empire level);
- a lack of access to relevant confidential information held by others;
- relying on representations made in good faith by those whom the auditors believe manage the company when control rests elsewhere.

Audit work is inevitably increased if an auditor is put upon inquiry to investigate dubious transactions and arrangements. However, the complexity of business empires across multiple jurisdictions with different auditors may deter auditors from liaising with other auditors (especially where legal or professional confidentiality considerations prevent this).
Marks must only be awarded for points relevant to answering the question set. Unless otherwise indicated, marks should not be awarded for restating the facts of the question.

For most questions you should award $\frac{1}{2}$ a mark for a point of knowledge, increased to 1 mark for the application of knowledge and $1\frac{1}{2}$ marks for a point demonstrating the higher skill expected in Part 3.

The model answers are indicative of the breadth and depth of possible answer points, but are not exhaustive.

Most questions require candidates to include a range of points in their answer, so an answer which concentrates on one (or a few) points should normally be expected to result in a lower mark than one which considers a range of points.

In awarding the mark to each part of the question you should consider whether the standard of the candidate’s answer is above or below the pass grade. If it is of pass standard it should be awarded a mark of 50% or more, and it should be awarded less than 50% if it does not achieve a pass standard. When you have completed marking a question you should consider whether the total mark is fair.

Finally, in awarding the mark to each question you should consider the pass/fail assessment criteria:

- Adequacy of answer plan
- Structured answer
- Inclusion of significant facts
- Information given not repeated
- Relevant content
- Inferences made
- Commercial awareness
- Higher skills demonstrated
- Professional commentary

In general, the more of these you can assess in the affirmative, the higher the mark awarded should be. If you decide the total mark is not a proper reflection of the standard of the candidate’s answer, you should review the candidate’s answer and adjust marks, where appropriate, so that the total mark awarded is fair.
1 (a) **Audit risks**

Generally \( \frac{1}{2} \) mark for identification of audit risk + 1 mark each point of explanation

### Ideas

Inherent – financial statements level
- listed
- oil industry
- multi-location
- fall in EPS … 2nd half-year prospects

Inherent – assertion level
- grant of licence – cost vs fair value … how estimated?
- intangible assets (IAS 38) – amortisation
- item replacement (IAS 16)
- decommissioning periods – rig platforms
- contingent liabilities (IAS 37) – fines/penalties
- jointly-controlled asset (IAS 31)
- prior year modification – ‘except for’

(b) **Audit work**

Generally \( \frac{1}{2} – 1 \) mark each appropriate suggestion of audit work (i.e. relevant to useful lives) + \( \frac{1}{2} – 1 \) mark for relevance to Shire’s rig platforms

**Tutorial note:** As the useful lives of the rigs vary considerably a ‘proof in total’ is much less suitable than for a fleet of motor vehicles (say) and therefore not principal audit work.

### Ideas

- review of management’s annual assessment
- corroborative evidence – e.g. abandoned rig
- management’s past experience/expertise – evidenced
- industry comparatives
- actual vs budgeted maintenance costs
- actual vs budgeted output (oil extracted)
- results of impairment testing (CGU)

(c) **Performance indicators**

Generally \( \frac{1}{2} \) mark each measure suggested \( \frac{1}{2} \) – 1 mark each source of evidence

### Ideas

**Performance indicators**
- level of investment in sports sponsorship, etc
- numbers/proportions/%s
  - championship events/participating schools/students
  - medals/trophies awarded
  - patients treated/bed occupancy
  - staff – starters/leavers/absenteeism/turnover
  - breaches of health & safety/environmental regulations
  - oil spills
  - accidents/deaths (employees)

**Evidence**
- actual vs budgeted investment
- physical evidence (e.g. medals/cups awarded)
- press coverage/reports
- reduction in fines paid
- legal – correspondence/fees
- insurance claims
2  (a) Opening balances – principal audit work
Generally \( \frac{1}{2} \) – 1 mark each appropriate suggestion of audit work + \( \frac{1}{2} \) – 1 mark for relevance to Indigo max 6

**Ideas**
- consistent application of appropriate accounting policies
- review of predecessor auditor’s working papers (if possible)
- current period audit procedures – receipts/payments, sales
- analytical procedures
- historic accounting records

(b) Financial statement risks and audit approach
Generally 1 mark each financial statement risk max 10

**Ideas**

**Assets**
- inventory (overstatement, measurement, existence, obsolescence)
- tangible non-current assets (furnace parts/linings)
- cash (completeness, existence)

**Liabilities**
- provision overstatement (furnace linings)

**Income statement**
- sales understatement (cash)
- purchases overstatement
- subsidy overstatement
- repair/renewal overstatement

**Disclosure risk**
- going concern (IAS 1)
- contingent liabilities (IAS 37)

Generally \( \frac{1}{2} \) mark each approach identified as suitable/unsuitable + 1 mark each point of explanation max 6

**Ideas**

**Risk-based approach – why suitable**
- high inherent risk at entity and financial assertion levels
- focus on inventory, purchases, sales, cash

**Systems-based/compliance approach – why not suitable**
- lack of controls
- recent appointment – no interim audit – already December

**Detailed substantive/balance sheet approach – why suitable**
- substantiating assets at balance sheet

**Cyclical approach/directional testing – why not suitable**
- no trade payables/receivables (cash-based)

**Analytical procedures – limitations on use**
- fluctuating margins
- lack of reliable/historic information – first year’s audit

max 14
### Marks

#### Extent of financial loss – alleged fraud

**Generally**  \( \frac{1}{2} \) mark each relevant matter + 
\( \frac{1}{2} \) – 1 mark each comment thereon  

**Ideas**
- minimum – estimate 3 days’ sales
- cash bankings – falling trend?
- other managers’ suspicions – if any
- change in lifestyle
- unmodified prior year auditor’s report
- fidelity insurance – amount of cover
- likelihood of recovery – if any

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**3 (i) Matters**

**Generally** 1 mark each comment  
max 6 marks each issue × 3

**Ideas**
- materiality (assessed)
- relevant IFRSs (e.g. IASs 1, 8, 10, 16, 36, 37 and IFRS 5) & ‘The Framework’
- risks (e.g. FS assertions – completeness, measurement)
- all items in a class (vs ‘cherry picking’)
- responsibilities (e.g. socio-environmental)

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**3 (ii) Audit evidence**

**Generally** 1 mark each item of audit evidence (source)  
max 6 marks each issue × 3

**Ideas (ISA 500)**
- oral vs written
- internal vs external
- auditor generated
- procedures

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1 Inspection, Observation, Inquiry, Confirmation, Recalculation, Reperformance, Analytical procedures
4 (a) Auditor’s responsibilities for subsequent events

Generally 1 mark each comment

Idea (ISA 560)
- Consideration of IAS 10
- Addition to routine procedures
- Up to date of auditor’s report
- Accounting and disclosure
- After … but before financial statements are issued
- Qualified or adverse opinion
- After financial statements issued

(b) Implications for auditor’s report

Generally \( \frac{1}{2} \) mark identification and 1 mark a comment

Idea

(i) Corruption of perpetual inventory records
- Data loss (vs asset loss) ⇒ limitation of scope
- Non-adjusting post balance sheet event
- Limitation imposed by circumstances
- Sufficient evidence – records vs alternative (‘rollback’)
- Alternative procedures – analytical procedures
- Material – not pervasive
- Potential adjustment necessary
- Material ⇒ modified opinion (‘except for’)
- Immaterial ⇒ unmodified report
- Not emphasis of matter
- 2006 – restate opening position/comparatives for error
  (if any) therefore unmodified

(ii) Wholly-owned foreign subsidiary
- Management’s oral representation – insufficient evidence
- Non-adjusting post balance sheet event (?) – disclosure?
- Lack of evidence ⇒ limitation of scope
- Limitation imposed by entity?
- Material vs material and pervasive
- Unmodified vs modified ‘except for’ limitation vs disclaimer

(i) max 6
(ii) max 4

15
Ethical and other professional issues
Generally $\frac{1}{2}$ mark each issue identified + 1 mark each comment/action

Idea
(a) Tax investigation
- new client (relatively) – customer due diligence (CDD)
- ‘professional etiquette’ – change in professional appointment
- quality control e.g. second review
- criminal property includes proceeds of tax evasion
- money laundering offence?
- suspicion of fraud (intent) vs error in incorrect tax returns
- disclosure by Dedza vs voluntary (confidentiality)
- need for STR
(b) Advice on payments
- not a tax issue
- corruption and bribery/extortion – designated categories of offence
- clear intent
- seriousness in context of domestic laws
- need to report to FIU?
(c) Financial advisor
- designated non-financial profession
- CDD/record keeping
- politically exposed person (PEP)
- reputational risk
- additional measures
- refusal to act

(a) max 7
(b) max 4
(c) max 4

15
Effect on auditor’s responsibilities and audit work

Generally 1 mark each point contributing to a discussion

Ideas

General (1/2 mark each)
- Audit scope – as necessary to form audit opinion
- Audit work undertaken – nature/timing/extent
(a) Fair value accounting
- meaning/definition
- measurements and disclosures (vs recognition)
- degrees of subjectivity – how fair value is determined
- comparison with accounting estimates
- guidance in financial reporting framework(s)
- management intent
- work of an expert (ISA 620)
- management assumptions (IAS 1)
- one-off historic cost vs annual fair value
(b) Continuous auditing
- meaning/definition
- development (increasing IT sophistication)
- automated procedures
- nature of reports – ‘evergreen’ vs ‘on demand’
- auditor expertise/IT competency
- integrated audit tools/continuous substantive procedures
(c) Non-consolidated entities under common control
- ‘business empires’
- development (as off-balance sheet vehicles)
- increased audit risk – related party/confidentiality issues
- complex fraud risk factor
- reliance on management representation

Marks

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(a) max 6
(b) max 5
(c) max 4

15