Section A – ALL THREE questions are compulsory and MUST be attempted

Shire Oil Co (‘Shire’), a listed company, is primarily an oil producer with interests in the North Sea, West Africa and South Asia. Shire’s latest interim report shows:

<table>
<thead>
<tr>
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<th>30 June 2005 Unaudited</th>
<th>30 June 2004 Unaudited</th>
<th>31 December 2004 Audited</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$22,000</td>
<td>$18,300</td>
<td>$37,500</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>$5,500</td>
<td>$4,200</td>
<td>$7,500</td>
</tr>
<tr>
<td>Total assets</td>
<td>$95,900</td>
<td>$92,300</td>
<td>$88,400</td>
</tr>
<tr>
<td>Earnings per share (basic)</td>
<td>$1.82</td>
<td>$2.07</td>
<td>$3.53</td>
</tr>
</tbody>
</table>

In April 2005, the company was awarded a new five-year licence, by the central government, to explore for oil in a remote region. The licence was granted at no cost to Shire. However, Shire’s management has decided to recognise the licence at an estimated fair value of $3 million.

The most significant of Shire’s tangible non-current assets are its 17 oil rigs (2004 – 15). Each rig is composed of numerous items including a platform, buildings thereon and drilling equipment. The useful life of each platform is assessed annually on factors such as weather conditions and the period over which it is estimated that oil will be extracted. Platforms are depreciated on a straight line basis over 15 to 40 years.

A provision for the present value of the expected cost of decommissioning an oil rig is recognised in full at the commencement of oil production. One of the rigs in South Asia sustained severe cyclone damage in October 2005. Shire’s management believes the rig is beyond economic recovery and that there will be no alternative but to abandon it where it is. This suggestion has brought angry protests from conservationists.

In July 2005, Shire entered into an agreement to share in the future economic benefits of an extensive oil pipeline.

You are the manager responsible for the audit of Shire. Last year your firm modified its auditor’s report due to a lack of evidence to support management’s schedule of proven and probable oil reserves to be recoverable from known reserves.

Required:

(a) Using the information provided, identify and explain the audit risks to be addressed when planning the final audit of Shire Oil Co for the year ending 31 December 2005. (12 marks)

(b) Describe the principal audit work to be performed in respect of the useful lives of Shire Oil Co’s rig platforms. (6 marks)

(c) You have just been advised of management’s intention to publish its yearly marketing report in the annual report that will contain the financial statements for the year ending 31 December 2005. Extracts from the marketing report include the following:

‘Shire Oil Co sponsors national school sports championships and the ‘Shire Ward’ at the national teaching hospital. The company’s vision is to continue its investment in health and safety and the environment.

‘Our health and safety, security and environmental policies are of the highest standard in the energy sector. We aim to operate under principles of no-harm to people and the environment.

‘Shire Oil Co’s main contribution to sustainable development comes from providing extra energy in a cleaner and more socially responsible way. This means improving the environmental and social performance of our operations. Regrettably, five employees lost their lives at work during the year.’

Required:

Suggest performance indicators that could reflect the extent to which Shire Oil Co’s social and environmental responsibilities are being met, and the evidence that should be available to provide assurance on their accuracy. (6 marks)

(24 marks)
Your firm was appointed as auditor to Indigo Co, an iron and steel corporation, in September 2005. You are the manager in charge of the audit of the financial statements of Indigo, for the year ending 31 December 2005.

Indigo owns office buildings, a workshop and a substantial stockyard on land that was leased in 1995 for 25 years. Day-to-day operations are managed by the chief accountant, purchasing manager and workshop supervisor who report to the managing director.

All iron, steel and other metals are purchased for cash at ‘scrap’ prices determined by the purchasing manager. Scrap metal is mostly high volume. A weighbridge at the entrance to the stockyard weighs trucks and vans before and after the scrap metals that they carry are unloaded into the stockyard.

Two furnaces in the workshop melt down the salvageable scrap metal into blocks the size of small bricks that are then stored in the workshop. These are sold on both credit and cash terms. The furnaces are now 10 years old and have an estimated useful life of a further 15 years. However, the furnace linings are replaced every four years. An annual provision is made for 25% of the estimated cost of the next relining. A by-product of the operation of the furnaces is the production of ‘clinker’. Most of this is sold, for cash, for road surfacing but some is illegally dumped.

Indigo’s operations are subsidised by the local authority as their existence encourages recycling and means that there is less dumping of metal items. Indigo receives a subsidy calculated at 15% of the market value of metals purchased, as declared in a quarterly return. The return for the quarter to 31 December 2005 is due to be submitted on 21 January 2006.

Indigo maintains manual inventory records by metal and estimated quality. Indigo counted inventory at 30 November 2005 with the intention of ‘rolling-forward’ the purchasing manager’s valuation as at that date to the year-end quantities per the manual records. However, you were not aware of this until you visited Indigo yesterday to plan your year-end procedures.

During yesterday’s tour of Indigo’s premises you saw that:
(i) sheets of aluminium were strewn across fields adjacent to the stockyard after a storm blew them away;
(ii) much of the vast quantity of iron piled up in the stockyard is rusty;
(iii) piles of copper and brass, that can be distinguished with a simple acid test, have been mixed up.

The count sheets show that metal quantities have increased, on average, by a third since last year; the quantity of aluminium, however, is shown to be three times more. There is no suitably qualified metallurgical expert to value inventory in the region in which Indigo operates.

The chief accountant disappeared on 1 December, taking the cash book and cash from three days’ sales with him. The cash book was last posted to the general ledger as at 31 October 2005. The managing director has made an allegation of fraud against the chief accountant to the police.

The auditor’s report on the financial statements for the year ended 31 December 2004 was unmodified.

Required:

(a) Describe the principal audit procedures to be carried out on the opening balances of the financial statements of Indigo Co for the year ending 31 December 2005. (6 marks)

(b) Using the information provided, state the financial statement risks arising and justify an appropriate audit approach for Indigo Co for the year ending 31 December 2005. (14 marks)

(c) Comment on the matters to be considered in seeking to determine the extent of Indigo Co’s financial loss resulting from the alleged fraud. (6 marks)
You are the manager responsible for the audit of Albreda Co, a limited liability company, and its subsidiaries. The group mainly operates a chain of national restaurants and provides vending and other catering services to corporate clients. All restaurants offer ‘eat-in’, ‘take-away’ and ‘home delivery’ services. The draft consolidated financial statements for the year ended 30 September 2005 show revenue of $42.2 million (2004 – $41.8 million), profit before taxation of $1.8 million (2004 – $2.2 million) and total assets of $30.7 million (2004 – $23.4 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention:

(a) In September 2005 the management board announced plans to cease offering ‘home delivery’ services from the end of the month. These sales amounted to $0.6 million for the year to 30 September 2005 (2004 – $0.8 million). A provision of $0.2 million has been made as at 30 September 2005 for the compensation of redundant employees (mainly drivers). Delivery vehicles have been classified as non-current assets held for sale as at 30 September 2005 and measured at fair value less costs to sell, $0.8 million (carrying amount, $0.5 million).

(b) Historically, all owned premises have been measured at cost depreciated over 10 to 50 years. The management board has decided to revalue these premises for the year ended 30 September 2005. At the balance sheet date two properties had been revalued by a total of $1.7 million. Another 15 properties have since been revalued by $5.4 million and there remain a further three properties which are expected to be revalued during 2006. A revaluation surplus of $7.1 million has been credited to equity.

(c) During the year Albreda paid $0.1 million (2004 – $0.3 million) in fines and penalties relating to breaches of health and safety regulations. These amounts have not been separately disclosed but included in cost of sales.

Required:

For each of the above issues:

(i) comment on the matters that you should consider; and
(ii) state the audit evidence that you should expect to find,

in undertaking your review of the audit working papers and financial statements of Albreda Co for the year ended 30 September 2005.

NOTE: The mark allocation is shown against each of the three issues.
4 (a) Explain the auditor’s responsibilities in respect of subsequent events. (5 marks)

(b) You are the audit manager of Jinack Co, a private limited liability company. You are currently reviewing two matters that have been left for your attention on the audit working paper file for the year ended 30 September 2005:

(i) Jinack holds an extensive range of inventory and keeps perpetual inventory records. There was no full physical inventory count at 30 September 2005 as a system of continuous stock checking is operated by warehouse personnel under the supervision of an internal audit department.

A major systems failure in October 2005 caused the perpetual inventory records to be corrupted before the year-end inventory position was determined. As data recovery procedures were found to be inadequate, Jinack is reconstructing the year-end quantities through a physical count and ‘rollback’. The reconstruction exercise is expected to be completed in January 2006. (6 marks)

(ii) Audit work on after-date bank transactions identified a transfer of cash from Batik Co. The audit senior has documented that the finance director explained that Batik commenced trading on 7 October 2005, after being set up as a wholly-owned foreign subsidiary of Jinack. No other evidence has been obtained. (4 marks)

Required:

Identify and comment on the implications of the above matters for the auditor’s report on the financial statements of Jinack Co for the year ended 30 September 2005 and, where appropriate, the year ending 30 September 2006.

NOTE: The mark allocation is shown against each of the matters. (15 marks)

5 You are an audit manager in Dedza, a firm of Chartered Certified Accountants. Recently, you have been assigned specific responsibility for undertaking annual reviews of existing clients. The following situations have arisen in connection with three client companies:

(a) Dedza was appointed auditor and tax advisor to Kora Co, a limited liability company, last year and has recently issued an unmodified opinion on the financial statements for the year ended 30 June 2005. To your surprise, the tax authority has just launched an investigation into the affairs of Kora on suspicion of underdeclaring income. (7 marks)

(b) The chief executive of Xalam Co, an exporter of specialist equipment, has asked for advice on the accounting treatment and disclosure of payments made for security consultancy services. The payments, which aim to ensure that consignments are not impounded in the destination country of a major customer, may be material to the financial statements for the year ending 30 June 2006. Xalam does not treat these payments as tax deductible. (4 marks)

(c) Your firm has provided financial advice to the Pholey family for many years and this has sometimes involved your firm in carrying out transactions on their behalf. The eldest son, Esau, is to take up a position as a senior government official to a foreign country next month. (4 marks)

Required:

Identify and comment on the ethical and other professional issues raised by each of these matters and state what action, if any, Dedza should now take.

NOTE: The mark allocation is shown against each of the three situations. (15 marks)
Discuss how developments in each of the following areas has affected the scope of the audit and the audit work undertaken:

(a) fair value accounting; (6 marks)

(b) continuous auditing; (5 marks)

(c) non-consolidated entities under common control. (4 marks)

(15 marks)