SOLUTION 1

(a) Ethical issues

(i) The FD’s integrity is brought into question due to his inappropriate proposal regarding the audit fee low in return for an introduction to a potential client. A self-interest threat exists if the auditor fear losing the client if they do not respond to the request over fees or decide not to accept any engagements with the client. If any engagements are accepted with then an intimidation threat arises resulting from any continued pressure by the client to keep the audit fee low. The FD’s comments regarding the corruption of the sales ledger as a result of the computer virus highlights an expectations gap regarding the auditor’s responsibilities. A potential conflict of interest/confidentiality risk would arise due to the customer-supplier relationship between the auditor and the auditee

Safeguards
- Allocate more senior staff to the audit if there are doubts over the FD’s integrity.
- Obtain second partner opinion as to threat to objectivity
- Discuss fee setting explaining basis cannot be influenced by introduction.
- Ensure the auditor’s responsibility regarding the computer virus is clearly communicated.
- If appointed, there is the need to:
  - Highlight possible conflict to both clients and obtain written clearance
  - Have separate teams for the two clients
  - Put information barriers in place between the teams

(ii) Advisory work and audit
A question is raised over the integrity regarding her comment on low fees for the advisory work in return for considering the client for the external audit engagement. A self-interest threat arises if the auditor undertakes the advisory work in order to win the external audit. The auditor may set the fee for the advisory work too low and not be able to complete the engagement to appropriate standards. A self-review threat would arise if the external audit work relies on advice given as part of the e-commerce engagement. A management threat may arise if the auditor makes management decisions regarding the e-commerce implementation.

(b) Impact of computer crime on audit procedures planned

The corruption of data in the sales system leads to an increased risk of misstatement in the financial statements. The auditor needs to ascertain what evidence is still available for the audit of sales and receivables and design audit procedures accordingly. These may be alternative procedures to those originally planned.

The composition of the audit team should be reviewed along with the audit timetable. It would be prudent to increase the time available for audit work and the level of experience of staff,
particularly those working on sales/receivables. Consideration should be given to using an expert in IT audit.

The virus and subsequent corruption of data suggests the likelihood of deficiencies in internal control procedures. Tests of controls are unlikely to be appropriate and so an increased level of substantive procedures will be necessary. Whether any back-up information/data is available for audit purposes will need to be ascertained.

Substantive procedures are likely to include:
- Direct confirmation of receivables, as the most appropriate audit evidence, as it does not rely on evidence in the client’s system.
- Analytical procedures
  - Comparing sales and receivables figures to prior year and budget to ascertain if any unexplained variances exist.
  - Comparing gross profit margin with prior year and budget and obtaining explanations for any variances.

Trace sales invoices/receipts to sales ledger to ascertain if data is complete

In addition, the auditor will need to ascertain whether the extent of the virus goes beyond the sales system. It may have compromised accounting and other systems on which planned audit procedures would rely. Enquiry should be made of directors to ascertain the procedures they have used to identify the extent and nature of the data corruption and what procedures have been used to address the issues found.

If sufficient evidence is not available, the auditor will have to consider whether this scenario constitutes a limitation on the scope of the auditor’s work.

As a by-product of the audit, the auditors report any deficiencies identified in a management letter with recommendations to improve systems.

(c) Responsibilities

If an accountant has grounds for suspicion that money laundering is taking place they must report it. Failure to do so is a criminal offence. Suspicions should be reported to the assurance firms officially nominated Money Laundering Reporting Officer (MLRO). The MLRO will then decide if the matter should be reported to the Serious Organized Crime Agency (SOCA). The firm must not “tip off” the client.

Conflicts with Ethical Guidance

A conflict exists with ethical guidance on confidentiality – the responsibility to report overrides any duty of confidentiality to a client in these circumstances.

In addition, tipping-off could result from:
- Requirements in ISA 260 ‘Communication with those charged with governance’ – where auditors are required to report issues arising during the course of the audit to those charged with governance.
The auditor’s responsibility to form an opinion on the financial statements. If the opinion were modified as a consequence of the impact on the financial statements of money laundering, inclusion in the auditor’s report would alert the client.

If the firm concludes that it is unethical to continue to act for a client as a result of suspicions of money laundering, they may choose to resign. However, procedures around resignation would require the firm to:

- Deposit a statement of circumstances at companies registered office
- Communicate with any successor auditor regarding circumstances affecting their appointment.
SOLUTION 2

(a) Level of fees – self interest /fee dependency threat

Safeguards – ensure 15% fee limit not breached

Preparation of company’s corporation tax return
- Gives rise to self-review threat
- Audit staff may place too much reliance on colleagues’ work
- May be reluctant to criticize any shortcomings

Safeguards – tax services are:

- Provided by partners and staff who have no involvement in the audit of the financial statements
- Reviewed by an independent partner/senior tax employee
- External independent advice is obtained on the tax work

Selection of computer package
- Self review threat may arise in subsequent audits as the auditors may be reluctant to identify shortcomings in the system/rely too heavily on it.
- A management threat will arise if he expects the firm to select the package.
- May lead to an erosion of the distinction between the audit firm and client.
- Audit firm may be too closely aligned with views and interests of management.
- Must not make management decision.

Safeguards – if an off-the shelf package the firm can accept the work if:
- Work to be performed by partners and staff with no involvement in the external audit
- The audit is reviewed by an independent partner
- Documentation of the existence of informed management i.e. capable of making decision over which package to select; and
- Audit firm to provide recommendations justified by objective and transparent analyses
- If management is not informed, the audit firm should refuse the engagement.

(b) - It is important a team with appropriate skills and experience is selected for the audit

- Relevant as you do not currently handle many manufacturing companies
- This is your first year of appointment so you do not have knowledge of client on which less experienced staff may be able to rely in later years.
- Quality control system needs to consider risk of client staff being incompetent/negligent.
- Relevant as you do not yet know the client very well
- Monitoring of the engagement in the first year is very important
- Adequate supervision needed to ensure significant issues raised for consideration/review
- Relevant as staff require greater supervision on a new job
- Lack of experience in manufacturing/more experienced reviewer will compensate for this
- You need to consider your ability to resource the assignment
- Relevant as Belushi operates out of three locations geographically quite far apart
- Your firm is based in the south west and you may not have the resources to cover this

(c) – previous auditors would have perceived potential conflict of interest
- May not have been able to act in the best interest of both clients
- Potential confidentiality threat
- Perceived threat of transfer of information from one client to the other

Possible safeguards

- Obtain consent from both parties to act
- Separate teams acting for each company
- Chinese walls/information barriers
- Staff instructed to keep client information confidential
- Disciplinary action for any breaches
SOLUTION 3

(a) Planning notes

- Reason for 16% increase in revenue
  - Volume/new product
  - Inflation/pricing policy
  - Any new outlets opened
  - Any new wholesale customers
  - Any change in income recognition policy/cut off

- Reason for increase in GP margin: 51.6% to 53%
  - Lower cost base due to sourcing from China
  - Increase in sales of the (higher margin) brand
  - Increase in selling price over and above increase in cost of Elite products
  - Impact of exchange rates

- Reason for increase in operating margin: 4.4% to 6.3% (operating costs to revenue 47.2% to 46.7%)
  - Over and above GP margin
  - Impact of new warehouse management system
  - Increased efficiencies

- Reason for reduction in inventory days: 131 to 126 (increase in inventory turnover 2.80 to 2.89)

- Reason for increase in receivables days: 37 to 42
  - Relaxed credit terms to wholesale customers
  - Credit control problems/irrecoverable receivables

- Reason for increase in payables days: 51 to 55
  - New suppliers’ credit terms
  - Cash flow/working capital problems

(b) Conclusions

Whether

- Financial statements are consistent with the auditor’s understanding of the business

- Review procedures corroborate conclusions formed during the course of the audit

- Any previously unrecognized risk of material/financial statements give a true and fair view/can issue unmodified audit report

- Auditor may need to re-evaluate planned audit procedures/posting reporting period date work

- Any new factors which may affect the presentation/disclosures in the financial statements

- Presentation adopted in the financial statements may have been unduly influenced by the desire to present matters in a favourable/unfavourable light (prepared using acceptable/consistent/appropriate accounting policies)
### SOLUTION 4

(a)

<table>
<thead>
<tr>
<th><strong>Audit risk/factors</strong></th>
<th><strong>Procedures</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Errors or omissions in financial statements occur and are undetected by audit procedures</td>
<td>Use more senior and experienced staff to carry out work on risky and subjective areas.</td>
</tr>
<tr>
<td>• First year audit – lack of cumulative audit knowledge and experience</td>
<td>Thorough planning and research to gain an understanding of the business</td>
</tr>
<tr>
<td></td>
<td>Ensure sufficient staff are made available to complete audit work</td>
</tr>
<tr>
<td></td>
<td>Independent quality control review of subjective areas and audit opinion</td>
</tr>
<tr>
<td></td>
<td>Request to review the prior year auditor’s working papers in order to gain assurance over opening balances</td>
</tr>
<tr>
<td></td>
<td>Perform substantive procedures on opening balances if they cannot be verified by other means</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overstatement of revenue</th>
<th>Ascertain what control procedures are in place to ensure deposits taken online are appropriately recorded.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over/understatement of deferred income</td>
<td>Take a sample of bookings for 2012/113 and ascertain whether the deposit and final balance are recorded in the correct periods.</td>
</tr>
<tr>
<td>• A 25% deposit is paid when a booking is made before the holiday is taken</td>
<td></td>
</tr>
<tr>
<td>• 35% decline in 2013 deposits</td>
<td></td>
</tr>
<tr>
<td>• Online booking system</td>
<td></td>
</tr>
<tr>
<td>• Closure of swimming pool may result in holiday cancellations and refunds</td>
<td>Discuss with directions the impact on bookings of the swimming pool closure.</td>
</tr>
</tbody>
</table>
Understatement of transactions in restaurants and shops

- Cash transactions could fail to be recorded
- Cash is susceptible to misappropriation
- Internal controls over cash transactions may not be applied appropriately by temporary staff

Evaluate and test controls over cash receipts and payments in restaurants and shops.

<table>
<thead>
<tr>
<th>Unrecorded/undisclosed liabilities</th>
<th>Ascertain from management the procedures for identifying such liabilities and whether any claims have been made by the customer infected by the swimming pool.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The nature of the business may give rise to legal claims for accidents or health and safety breaches</td>
<td>Review any correspondence to date with the health and safety inspection authority.</td>
</tr>
<tr>
<td>• Risk of failing to comply with laws and regulations</td>
<td>Review correspondence with the company’s lawyers swimming to ascertain the likely outcome of any claims</td>
</tr>
<tr>
<td>• Potential contingent liability for fines relating to the health and safety inspection of the pool</td>
<td></td>
</tr>
<tr>
<td>• Potential legal claim by the customer who was hospitalized</td>
<td>Ascertain what insurance cover the company has in place that might offset any liabilities</td>
</tr>
</tbody>
</table>

Misstated payroll costs and liabilities

- Temporary staff are employed in peak months which may lead to non-compliance with PAYE/NI requirements or employment laws
- Review of HR records to ascertain whether appropriate references/documents are

Discuss with the HR department what controls are in place regarding employment of temporary staff.
The going concern presumption may not be appropriate

- Adverse publicity regarding the swimming pool closure may see damage to the entity’s reputation and loss business
- Loss of goodwill/cancellation of holidays resulting from any further swimming pool closures
- The significant decline in deposits for next year’s holidays may indicate falling customer numbers

Obtained for temporary staff.

Check payroll records to ascertain whether appropriate payroll deductions are made for temporary staff.

Ascertain from management what course of action they are taking with respect to holidays due to be taken in the village with the affected pool.

Discuss with management the likelihood that other villages will be affected by swimming pool closures and review any relevant correspondence.

Examine management’s profit and cash flow forecasts to ascertain the company’s sensitivity to a decline in customer numbers and to ascertain the company’s ability to pay its debts as they fall due.

Review board minutes to ascertain management’s view of the company’s going concern status.

Misstatement of non-current assets

- Items that should be expensed as part of the refurbishment programme may have been capitalized in error (or vice versa)
- Inappropriate determination of Useful Economic Life (UEL)

Ascertain from management the company policy regarding capitalization of assets.

Select a sample of items capitalized in the year and inspect invoices to determine whether they relate to capital or revenue expenditure.
relating to new assets

Check accounting records to ensure that those items in the sample have been appropriately classified.

Compare the UELs assigned to new assets with the UELs of those assets they replaced to determine reasonableness.

Ascertain whether there were any material profits or losses on assets disposed of which may indicate inappropriate UELs.

Inspect repairs and maintenance accounts to identify items of a capital nature inappropriately expensed.

(b) Ethical issues

The same ethical standards adhered to by the firm may not be applicable to the jurisdiction in which the auditor conducts its audit work. The auditor must be independent of the group.

Actions

Identify the ethical standards that the auditors are subject to.

Obtain written confirmation from the auditors that it will comply with ethical requirements relevant to the firm and particularly the requirement for independence from the client.

If the auditors do not meet the independence requirements the firm will have to perform its own procedures on the financial statements of Honex France.

Quality control issues

In order to rely on the audit work performed by the auditor on the financial statements of The auditee, the firm will need to be satisfied that the auditor’s work will be subject to satisfactory quality control procedures. The audit work must be properly planned, supervised, reviewed and documented. The firm must also be satisfied that the audit work performed by the auditor of the subsidiary is carried out with due care, attention and professional competence.
Actions

Discuss with colleagues or reliable third parties whether any issues regarding quality control procedures have arisen previously.

Ascertain whether the firm has any affiliated firms in the country of the subsidiary that could provide this information. Ascertain whether the auditors of the subsidiary operate in a regulatory environment that actively oversees auditors.

Consider visiting the auditor of the subsidiary to discuss the quality control procedures in place and inspect audit documentation.

Review the working papers of subsidiary auditors that were prepared during the audit work on the financial statements of the subsidiary.

Request confirmation in writing from Auditors of the subsidiary that relevant quality control procedures are adhered to.

Obtain direct confirmations of membership/licence from the professional body to which Auditors of the subsidiary belongs or the authorities by which Auditors of the subsidiary is licensed.

Document all findings, reviews and discussions.
SOLUTION 5

(a)

<table>
<thead>
<tr>
<th>Matters</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fixed price contracts</td>
<td>• Cost overruns may result in losses</td>
</tr>
<tr>
<td>• Retentions</td>
<td>• Cost overruns may result in losses</td>
</tr>
<tr>
<td>• Sale of retail operations</td>
<td>• Unable to generate funds from operations to repay loan</td>
</tr>
<tr>
<td>• Operating loss</td>
<td>• Proceeds may not be sufficient to cover loan</td>
</tr>
<tr>
<td>• Legal claim/dispute</td>
<td>• Substantial damages may have to be paid</td>
</tr>
<tr>
<td>• Trading at overdraft limit</td>
<td>• Loss of business as unlikely to retain major customer</td>
</tr>
<tr>
<td>• Going concern status in doubt</td>
<td>• If not a going concern the basis of the preparation of the accounts will be affected</td>
</tr>
<tr>
<td></td>
<td>• May require disclosure in the audit report as an emphasis of matter</td>
</tr>
</tbody>
</table>

(b) Audit reports

- Modified report but unmodified opinion, with emphasis of matter paragraph
  - Material uncertainty about the going concern status and
  - Adequate disclosure in the financial statements of the uncertainty

- Qualified except for disagreement
  - Disagreement over disclosure details
  - But satisfied with basis of preparation

- Adverse – do not give true and fair view
  - Disagreement over basis of preparation

- Qualified except for/disclaimer of opinion/limitation on scope
  - Evidence reasonably expected to be available is not available
  - Management unwilling to make or extend assessment of going concern

(c) Matters to consider

- Income
  - Includes income from retail operations to date of disposal/excludes income from retail operation following disposal
- Allows for loss of income from major customer

**Expenditure**
- Allowance made for any loss of bulk discounts due to reduction of purchase of consumables
- Includes legal costs of fighting legal action
- Wages to reflect reduction in operations due to loss of major customer
- Additional overdraft interest but no loan interest following repayment of loan
- Costs of rectification work
- Profit or loss on disposal of retail operations included
- Accounting policies are consistent with historical financial statements

**Cash flow**

**Receipts**
- Timing allows for retentions
- Reflects disposal proceeds

**Payments**
- Loan repayment made in February
- Includes costs of disposal
- Suppliers paid in accordance with their terms of trading

**General**
- Items in cash flow are consistent with profit forecast