

Icarus B.V.

NL National Audit & Assurance exam – 15 December 2020

This example is based on the national exams in The Netherlands. This exam is (almost) the last exam prior to graduation for the theoretical part of the audit education. Besides, students need to pass the practical part of their education to become a Dutch chartered accountant.

The full exam lasted one day, including 2 parts of 3 hours.

Credit score:

Question 1: 8 points

Question 2: 12 points

Question 3: 10 points

Question 4: 10 points

Question 5: 10 points

Question 6: 16 points

Question 7: 10 points

Question 8: 12 points

Question 9: 12 points

Total number of points: 100 points

For any questions, please contact the authors.

Icarus B.V.

Introduction

Icarus B.V. ('Icarus'), a promising Dutch start-up founded in early 2017, is developing a drone that can deliver small packages. Icarus currently sees opportunities for using the drone in healthcare, for example to quickly deliver defibrillators, provide items to the emergency services or transport tests and medication for infectious diseases. Icarus is based at Lelystad Airport, where a team of 160 technicians is working on research and development (R&D) for the drone.

A private-equity party realized Icarus's potential at an early stage and is now the largest shareholder (with 80% of the shares and control). The strategy of this private-equity party is to remain involved in its investments for five years on average and then to sell them on. The remaining 20% of the shares are held by the founder and current executive director of Icarus.

The private-equity party has provided Icarus with a loan of EUR 50 million, which should be sufficient to develop the drone fully and to get it ready for production.

There is a Supervisory Board consisting of two members from the private-equity party (one of whom is the chairperson of the Supervisory Board), one supervisory director with a technical background and one with a commercial background. The Supervisory Board monitors the company's progress intensively and gives clear guidance to Icarus's executive director.

The project

The drone development project has been broken down into five stages:

1. Feasibility study
2. Design
3. Developing the first prototype
4. Developing the finished product
5. Licencing by the Governmental Human Environment and Transport Inspectorate (*Inspectie Leefomgeving en Transport*).

The Supervisory Board authorizes the start and completion of each stage and the budget for the following stage based on a report from the executive director.

The project is currently in stage 4. At this point, Icarus is merely incurring expenses and still not generating revenue. Given the nature of the company and in accordance with Dutch accounting standards, the development expenses are capitalized and recognized on Icarus's balance sheet. Time eligible for capitalization is derived automatically from 'Time', the time reporting system, and recorded at a fixed hourly rate per job grade. Eligible materials costs are also capitalized. If the project is completed successfully, the development costs will begin to be amortized when sales of the drone start.

Organization

The drones are being developed by a team of 160 technicians with a wide range of specialized knowledge, for example in electrical engineering, artificial intelligence, mechanical engineering, etc. A total of ten team leaders manage the specialisms and they are responsible for progress on developing the drone and also for monitoring the budgets.

The costs of each team and stage are recorded and monitored against a detailed budget. Monthly financial and progress reports are prepared and issued regularly to the executive director and the Supervisory Board. Timelines and the budget are, however, regularly exceeded. Following the auditor's management letter for last year, monitoring of the budgets and achievement of deadlines have been tightened.

Icarus has a finance department led by a controller. In recent years there have been regular changes of personnel in the department as employees whose work was not up to standard were replaced.

The audit

Icarus is classified as a medium-sized organization under Dutch legislation. Audit firm SOLAR audits the financial statements. The financial statements are prepared in accordance with Part 9 of Book 2 of the Dutch Civil Code.

The draft figures for 2019 are attached.

Draft figures for 2019

In thousands of euros

Balance sheet as per 31 december	2019	2018		2019	2018
Capitalized development expenses	29.625	15.250	Equity	-11.250	-5.250
Tangible fixed asset	3.500	2.000			
Deferred tax assets	2.300	-			
Inventory raw materials	1.875	1.250	Long-term loan	50.000	40.000
Receivables	200	300	Current liabilities	750	600
Cash and cash equivalents	2.000	16.550			
Totaal	<u>39.500</u>	<u>35.350</u>	Totaal	<u>39.500</u>	<u>35.350</u>
Income statement	2019	2018			
Revenues	-	-			
Cost of sales	<u>-</u>	<u>-</u>			
Gross margin	-	-			
<i>Operating expenses</i>					
Wages and salaries	-4.500	-2.750			
Amortization of capitalized dev. expenses	-	-			
Depreciation of tangible fixed assets	-300	-150			
Cost of materials	-2.500	-1.260			
Other expenses	<u>-1.000</u>	<u>-280</u>			
Loss before tax	-8.300	-4.440			
Tax	<u>2.300</u>	<u>-</u>			
Net loss	-6.000	-4.440			

The auditor set a materiality level of EUR 1 million for the 2018 audit (the previous reporting period), based on 3% of net assets (rounded), with a reduction of 25% for performance materiality (EUR 750,000). There is some discussion in the audit team about the materiality and performance materiality levels for the 2019 audit. Some team members want to use the same assumptions and calculations as in 2018, which would give levels for materiality of EUR 1.2 million and performance materiality of EUR 900,000. Other team members do not think it is sensible to raise the materiality and performance materiality levels.

Question 1 (8 points)

Explain the auditor's considerations in respect of a possible change in the levels of materiality and performance materiality for the audit of the 2019 financial statements compared with 2018. Incorporate the team members' discussion on this point in your answer.

From 2019 Icarus is recognizing a deferred tax asset for carry-forward losses since the development process is almost complete and it is expected that revenue will be generated within the foreseeable future. The deferred tax asset is recognized at nominal value. The auditor has asked the executive director to provide supporting evidence for capitalizing this deferred tax asset. The executive director has presented a document on his views on the company's future profitability and has also prepared a cash flow forecast and a scenario analysis.

Question 2 (12 points)

Describe the auditor’s risk assessment and related audit procedures for the valuation of the deferred tax assets that the auditor will perform for the audit of the 2019 financial statements.

A lot of technical knowledge has been built up during the development of the drone that can be used for other applications. The executive director has decided to ask some of the technicians to work on these. They are, therefore, constructing a healthcare robot parallel to the development of the drone. The executive director has not yet told the Supervisory Board about this second project. He wants to show them a working prototype as that will be more convincing than just an idea. The executive director is allowing the technicians to continue recording their hours on the drone project, thus bypassing the team leaders’ budget responsibilities. The auditor discovered this during the interim audit from talks with the team leaders and a subsequent meeting with the executive director.

Question 3 (10 points)

Explain with reasons the impact of this interim audit finding on the audit procedures and the reports being issued by the auditor.

The completion of the project to develop the drone is under considerable pressure since deadlines have already been missed a couple of times. Potential customers, including some large healthcare institutions and hospitals, are threatening to lose interest in the drone. The money is also beginning to run out: the entire loan will have been used up by the end of 2019 and there is only EUR 2 million left in the bank account.

In view of this situation, at the end of 2019 the executive director decided to find additional funding. It is expected that the cost of completing the development of the drone and constructing a factory to produce it will be some EUR 25 million. Based on this figure and the organization’s running costs, the executive director assumed EUR 30 million would be sufficient when drawing up the financing application. The executive director is negotiating with the private-equity party and a number of banks. The executive director says the negotiations are going well but there are some significant issues surrounding the financing. For example, the banks are demanding that a significant portion of the long-term loan from the private-equity party is converted into shares to reduce their risk. The private-equity party is considering this condition.

Question 4 (10 points)

Further to this situation, describe the auditor’s procedures on the application of the going concern assumption by Icarus’s executive director in the 2019 financial statements.

The executive director wrote the following on the company’s continuity in the notes to the financial statements:

“The company incurred a net loss of EUR 6.0 million in 2019. There was an EUR 11.3 million equity deficit at 31 December 2019 brought about by the development stage of the drone. Production and sales of the drone will start in the coming year and so the company will begin generating revenue. These sales and the related margins will allow us to cover the costs for the coming year. Consequently, the going concern assumption has been applied in these financial statements.”

Question 5 (10 points)

What comments will the auditor have on the text on the going concern assumption proposed by the executive director? Your answer should incorporate the effect on the independent auditor’s report to be issued.

It is October 2020 – the audit of the 2019 financial statements has been completed and the 2020 interim audit has started. The team is examining the latest developments and thinking about their possible impact on the audit of the 2020 financial statements.

EUR 30 million of additional funding was secured following a successful new financing round in April 2020. In addition, after a tense final stage of the development process, the drone was finally made operational and the necessary licences were obtained from the Human Environment and Transport Inspectorate. Using the new funding, a factory has been set up in Twente, where the drones are manufactured and held in stock’.

The first drones were sold in June 2020. Demand is overwhelming.

To keep costs as low as possible, the production process is highly automated using robots. The factory is high-tech with only a few process operators to resolve any problems that may arise. Those problems are identified by a team of technicians who continuously monitor the production process, which runs day and night. Monitoring tools on the robots in the factory are linked directly to an advanced database called Daedalus. During an initial meeting, SOLAR’s IT auditor made the following notes on Daedalus in the audit file.

Primary registration: All activities at Icarus are recorded in Daedalus, creating an extremely large database where details of each relevant event (financial and non-financial) are recorded. Examples of non-financial records are materials used, the software version loaded in the drone, parts received and used, quantity of drones produced and quality checks.

Reporting: Daedalus makes it possible to use information on an event for various purposes. Icarus has had complex scripts (software) written that automatically generate financial and non-financial reports from the data in Daedalus, including the balance sheet and the income statement.

Script development: Given their specific nature, the scripts are created and maintained by an external company.

Hosting: The servers and storage space in the cloud are rented externally from a major provider.

ISAE 3402: Icarus receives type-2 reports in accordance with standard 3402 from the external scripts developer and the provider which hires out the servers and storage space in the cloud. The reports show that there are no material shortcomings.”

The IT auditor has never previously seen such a system and discusses it with the auditor. In preparation for the discussion, the IT auditor has looked at the work performed, and conclusions shown by the ISAE 3402 type-2 reports and has reached a provisional conclusion that they seem to be adequately supported.

Question 6 (16 points)

Explain with reasons the risks that the auditor will identify in each of the above notes with respect to the 2020 financial statements audit and how the auditor intends to respond to them.

During their work, the IT auditors established that the monitoring tools on the robots used in the production of the drones were not working properly in August and September 2020. As a result, some information recorded in Daedalus was wrong. This related in particular to the quantity of motors built into in the drones and the quantity of drones produced. These errors were only discovered by the finance department staff at a late stage. On the executive director’s initiative, the identified errors were investigated entirely manually and adjusted where necessary in Daedalus. The finance department staff have assured the executive director that the adjustments are correct and now incorporated properly in the reports compiled from information in the database.

Question 7 (10 points)

State the possible impact of these findings on the inventories reported in the 2020 financial statements and the audit procedures that the auditor will perform further to them.

While the interim audit was going on, Icarus suddenly attracted media attention as there seemed to be a security breach in the Daedalus database that was exploited by hackers. There are rumours in the press that confidential company information, including personal details of staff and customers, has been stolen as a result of the breach. The licencing authority, the governmental Human Environment and Transport Inspectorate, wants to know if this breach could affect the air safety of the drones. The software in the drones remains linked to Icarus for after-sale updates.

Question 8 (12 points)

Describe how the matters in the previous paragraph affect the auditor’s risk assessment for the audit of the 2020 financial statements and the auditor’s response to those risks.

The final audit will start in February 2021. The provision for doubtful debts is a material item in the financial statements and the auditor has classified the related risk as significant. The level of this provision is computed by a script that uses data from Daedalus and external data. The script calculates the provision using variables such as the customer's previous billing history, the payment conducts of all customers and external data from credit insurers.

Question 9 (12 points)

Describe the audit procedures planned for the provision for doubtful debts as part of the audit of the 2020 financial statements. Note the points made on the information generated by the IT system in the texts for the previous questions.