INSTRUCTIONAL NOTES

COMPLETING THE AUDIT:
The Winery At Chateau Americana

INSTRUCTIONAL OBJECTIVES

- Understand and identify audit procedures to detect contingent liabilities and commitments
- Understand and identify audit procedures to detect subsequent events
- Understand and evaluate information relevant to the assessment of the going concern assumption
- Evaluate and recognize potential limitations of responses to letters of inquiry sent to legal counsel
- Identify information that must be included in a management representation letter
- Understand and evaluate a summary of unadjusted differences schedule
- Prepare an audit report that is appropriate in light of client circumstances
- Understand the required communications with those charged with governance

KEY FACTS

- A former employee has filed a lawsuit against Chateau Americana seeking damages in the amount of $500,000 for injuries sustained on the job. No settlement has been reached as of the end of the audit. An attorney's letter has been received which states that the attorney is unable to express an opinion as to the merits of the claim against the company.
- The company has purchase contracts with certain grape growers which require minimum purchases of grapes at prices either based on market conditions or minimum purchase prices.
- The company has been negotiating changes to the terms of its long term debt with several financial institutions; however, no final agreement has been reached.
- The company leases certain equipment from the company's president in the monthly amount of approximately $9,000.
- Subsequent to year-end the company's board of directors voted to establish an audit committee comprised of three non-employee board members.

SUGGESTED SOLUTIONS

1. ***ASC Topic 450, Contingences prescribes how companies must treat contingent liabilities in various circumstances. The likelihood that a contingency will arise in any given situation may be considered as probable, reasonably possible, or remote. If an auditor believes that an attorney's response is ambiguous as to the possible outcome of pending litigation, how may an auditor obtain evidence to assess the need for a possible accrual of a loss contingency or disclosure of the matter in the notes to the financial statements? You may wish to refer to AU 501: Audit Evidence – Specific Considerations for Selected Items for help in answering this question.***

   This question is intended to cause students to question how auditors reach such judgments. The case materials (i.e., client interviews and attorney's letter) do not provide sufficient information for students to reach a definitive judgment. The attorney's evaluation of the litigation presented in the case is ambiguous and does not offer sufficient clarification to the auditor to form a judgment.

   Auditors should seek additional information by requesting the client to arrange a meeting with the attorney so that the auditor can request additional clarification about the case. If it is not possible for the attorney or client to provide additional information, then the auditor may find it necessary to modify the audit report. The auditor should consider materiality in assessing the adequacy of the disclosure associated with the litigation.

2. ***Describe three to five audit procedures that auditors commonly perform to search for contingencies.***

   An auditor may perform one or more of the following procedures to search for contingencies:

   a. Inquire of management regarding the existence of unrecorded contingencies.
   b. Review correspondence from the Internal Revenue Service, state departments of revenue, and other taxing authorities.
   c. Review minutes from the board of directors' meetings.
   d. Analyze legal expenses for the period.
   e. Request management to send a letter of inquiry to attorneys who performed services on the company's behalf during the period.
   f. Review other audit documentation such as bank confirmations for evidence of potential contingencies.

3. ***AU 570*: *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, *requires auditors to perform an evaluation of an entity's ability to continue as a going concern as part of each audit. Describe several audit procedures that may be used in the auditor's evaluation of going concern. What audit documentation is required if an auditor concludes there is substantial doubt about an entity's ability to continue as a going concern?***

   Auditors may perform any of the following procedures to evaluate the going concern assumption:

   a. Perform analytical procedures on the final audited balances (e.g., ratio analysis and trend analysis)
   b. Conduct a review of subsequent events.

c. Review client records and audit documentation for evidence of compliance with the terms of debt agreements.
d. Read minutes from the board of directors' meetings.
e. Inquire of the client's legal counsel.
f. Request confirmation from related and third parties of the details of arrangements to provide or maintain financial support.

If the auditor believes, before consideration of management's plans there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the auditor should document the following (taken from AU 570):

a. The conditions or events that led the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.
c. The audit procedures performed to evaluate the significant elements of management's plans and evidence obtained.
d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the auditor's conclusion as to the need for, and, if applicable, the adequacy of, disclosure of the principal conditions or events that initially caused the auditor to believe there was substantial doubt.
e. The auditor's conclusion with respect to the effects on the auditor's report.

4. ***Generally accepted auditing standards require auditors to obtain written representations from management as part of each audit. To what extent should an auditor rely solely on a client's written representations? At what point in the audit should a representation letter be obtained and as of what date should the client make the representations? What are the implications of management's refusal to provide requested representations?***

Management makes numerous representations during an audit. *AU 580: Written Representations* makes it clear they are not a substitute for the application of auditing procedures the auditor views as necessary to afford a reasonable basis for an opinion regarding the financial statements. Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstandings concerning the matters that are the subject of the representations." In essence, written representations act as corroboration of evidence otherwise obtained during an audit.

Auditors generally request management to prepare a representation letter during the wrap-up phase of the audit. The letter should be dated no earlier than the date of the audit report because auditors are concerned with events occurring through the date of their report. Management's refusal to provide written representations is a scope limitation that may be sufficient to cause the auditor to disclaim an opinion or withdraw from the engagement. Nonetheless, AU 580 states that "based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate." The auditor should also consider whether other management representations obtained during the course of the audit can be relied upon.

5. ***Claire Helton, the engagement partner has been very impressed with your work on Chateau Americana. As a consequence, she has asked you to identify the appropriate audit report for the company. Assuming that each of the following situations is independent from the others, determine the type of audit report which is most appropriate.***

   a. ***Assume that subsequent to year-end, but before issuance of the audit report that one of Chateau Americana's customers filed bankruptcy. The customer's year-end account receivable was $50,750, an immaterial amount. Chateau Americana's CFO indicates that he neither wants to write-off the customer's account, nor record a specific reserve.***

      Because the amount is immaterial, there is no reason to modify the auditor's report. Therefore, an unqualified audit report is appropriate.

   b. ***Assume the litigation discussed in the case is settled subsequent to year-end for $200,000. The financial statements for the year ended 12/31/20XX did not include a loss accrual. The company does not want to include disclosure regarding the settlement in the financial statements.***

      Because the financial statements properly excluded a loss accrual, there is no need to adjust the financial statements; however, disclosure in the financial statements for the year ended 12/31/20XX is appropriate. The auditor should explain the significance of the disclosure to management and request that they reconsider. If management includes the disclosure, the auditor should issue an unqualified audit report. If management refuses and the auditor deems the disclosure to be material to the fair presentation of the financial statements, the auditor should issue a qualified audit report.

   c. ***The company renegotiates certain terms associated with its long term debt subsequent to year-end. The new terms are more favorable than the previous terms, but the principal amount of the outstanding debt did not change as a consequence of the renegotiation. No disclosure is being provided in the financial statements.***

      The renegotiation of terms is certainly good news for the company, but it does not have to be described in the financial statements under audit. The renegotiation does not affect year-end balances; rather, the effects will be recognized in the next year's financial statements. The auditor should issue an unqualified audit report.

   d. ***A flood destroys one-third of the company's vineyard shortly after year-end. The company is currently attempting to secure access to more grapes from the open market. While the company had some insurance on its vineyards, it appears likely that the company will not be indemnified for the full market value of its loss. The value of the lost inventory is material to the financial statements. Management does not intend to include a footnote in the financial statements.***

      Disclosing the flood in the footnotes to the financial statements is necessary because of its significant effects. The auditor should tell management of the importance of the disclosure and the need to qualify the audit report if no disclosure is provided. The auditor may also need to include a going concern modification given the material nature of the lost inventory.

6. ***Subsequent to year-end, Chateau Americana's board of directors passed a resolution to establish an audit committee. Does this action require any response by your audit team? Describe matters that your firm may discuss with such a committee in future years. Is your audit team required to have such discussions with Chateau Americana's audit committee?***

   The establishment of an audit committee is a positive step which indicates that corporate governance matters are being addressed by the board of directors. The establishment of the audit committee does not require any current response; however, the audit team will need to learn more about the committee's members and examine minutes from their meetings during future audit engagements. The audit team will need to communicate a number of matters to those charged with governance inside Chateau Americana including members of the audit committee. The following paragraph describes the required communications.

   According to *AU 260: The Auditor's Communication with those Charged with Governance* the following general matters should be discussed with those charged with governance:

   a. The auditor's responsibilities under GAAS.
   b. An overview of the planned scope and timing of the audit.
   c. Significant findings from the audit.

   Additional more specific matters that would be discussed include:
   a. The auditor should inform those charged with governance about adjustments that could, either individually or in aggregate, have a significant effect on the financial statements and uncorrected misstatements aggregated by the auditor that management deems to be immaterial.
   b. The auditor should discuss the quality, not just the acceptability, of the company's accounting principles.
   c. The auditor should discuss with those charged with governance his or her responsibility for other information in documents containing the audited financial statements.
   d. The auditor should discuss with those charged with governance any disagreements with management, whether or not satisfactorily resolved, about matters that could have a significant effect on the financial statements.
   e. If the auditor becomes aware that management sought consultation with other accountants during the audit, he or she should discuss with those charged with governance his or her views about significant matters that were the subject of such consultation.
   f. The auditor should discuss with those charged with governance any issues that were discussed with management in connection with the initial or recurring retention of the auditor including matters related to accounting principles and auditing standards.
   g. The auditor should discuss with those charged with governance any difficulties he or she encountered in dealing with management related to the performance of the audit.
   h. Independence matters.

Audit Program Procedures

7. ***Review the response received from the client's attorney for information related to contingencies. Document issues related to ongoing or pending litigation.***

   Student responses to this requirement will vary. It may be instructive to share with students a sample of the documentation prepared by fellow students. This will highlight the potential for significant variability in audit documentation.

Chateau Americana is currently engaged in a single lawsuit. The lawsuit was filed against the company by a former employee who is seeking damages in the amount of $500,000. The attorney's letter provides the following summary of the case:

> On November 21, 20XX, a suit was filed against The Winery at Chateau Americana, Inc. by a former employee who is seeking damages for injuries sustained while employed by the Company. The suit alleges that William Simmons (the "Employee") was injured as a result of the Company's negligent maintenance of workplace safety equipment as required by the Occupational Safety & Health Administration. In addition, the suit claims that Simmons was not instructed in the proper use of the safety equipment as required by applicable federal and state laws. According to the suit, Simmons was performing routine maintenance on one of the Company's wine storage tanks when a safety harness he was wearing failed. The fall resulted in a loss of work time, hospitalization, and significant physical therapy.
>
> In preparation of providing this letter to you, we have reviewed the merits of the claim against the Company. After careful consideration, we are unable to express an opinion as to the merits of the litigation at this time. The Company believes there is absolutely no merit to the litigation.

A key issue in the above attorney's response lies in the second sentence of the second paragraph. Such a response from an attorney is likely to be considered to be unclear or ambiguous. Instructors should expect students to document the need for either a follow-up letter or a conference with the attorney and client before proceeding (AU 501.A65).

8. ***Review the minutes of the board of directors meeting for subsequent events affecting the current year financial statements. Note items for follow-up during next year's audit.***

   Minutes from the April 3, 20XY meeting of the board of directors include no discussion of subsequent events that affect the current year financial statements. However, there are several issues that should be considered during next year's audit. First, the board established an audit committee. The committee is chaired by Ms. Susan Martinez, a non-employee director and has two other members, Mr. Bill Jameson and Mrs. Charlotte Summerfield. Each of these individuals is also a non-employee director. It should be noted that Mrs. Summerfield is married to the company's president. Second, there was a confidential discussion of current litigation. Because of its confidential nature, no details were included in the minutes. Third, the company is currently renegotiating terms of its long-term debt. As of the date of obtaining the minutes, the negotiation has not been completed.

9. ***Complete the Summary of Unadjusted Differences. Conclude whether the financial statements are fairly stated in all material respects.***

   See the completed Summary of Unadjusted Differences below. Note that materiality for Total Assets is based on 2.5% of total assets of $42,029,000 (i.e., $1,050,725). While materiality thresholds vary across firms and circumstances such a level is not unreasonable for a first-year audit which would likely be viewed as having moderate audit risk. The materiality for Income Before Taxes is based on 5% of $1,997,000 (i.e., $99,850). This percentage is a relatively standard percentage that is commonly used by auditors. Please note that materiality is a matter of professional judgment.

10. ***Prepare a memo to summarize your assessment of the validity of the going concern assumption for Chateau Americana.***

Student responses to this requirement will vary greatly. The instructor may choose to share a sample of student prepared memos to illustrate the range of comments regarding the going concern assumption. The following comments are relevant to the assumption and are likely to be included in student prepared memos.

Chateau Americana has a strong balance sheet with a solid asset base. The company has a record of increasing sales and has been profitable for the last three years. Uncertainty related to the outstanding lawsuit is a concern; however, it appears as though the company can absorb the related financial loss without substantial adverse effects on operations. In sum, there is no significant evidence that raises doubts about the company's ability to continue as a going concern.

11. ***Document matters to be included in the current year's management representation letter.***

This requirement is intended to force students to carefully consider the contents of a management representation letter. Many students will likely refer to *AU 580: Written Representations* to assist in the preparation of the letter. The instructor may modify this requirement by simply requiring students to identify issues that should be included in the letter. A complete management representation letter has not been reproduced here, but is available in the *Professional Standards* (see AU 580.A35).

Management representation letters should include representations related to the following:

a. Management's acknowledgement that it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
b. Management's acknowledge of its responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
c. Management has provided the auditor with all relevant information and access.
d. All transactions have been recorded and are reflected in the financial statements.
e. Management's acknowledgement of its responsibility for the design, implementation, and maintenance of internal controls to prevent and detect fraud.
f. Management's acknowledgement that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
g. Management's acknowledgement that it has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control, or others when the fraud could have a material effect on the financial statements.
h. Management's acknowledgement that it has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, regulators, or others.
i. The auditor should request management to provide written representations that all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor.
j. The auditor should request management to provide written representations about whether it believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation.

k. The auditor should request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.
l. The auditor should request management to provide written representations about whether it believes significant assumptions used by it in making accounting estimates are reasonable.\
m. The auditor should request management to provide written representations that it has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which it is aware and it has appropriately accounted for and disclosed such relationships and transactions.
n. The auditor should request management to provide written representations that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Summary of Unadjusted Differences

Client: The Winery at Chateau Americana, Inc.
Year ended: December 31, 20XX

Reference: *CA-4*
Prepared by: *WJ, 3-2-XY*
Approved:

				Possible Misstatements Overstatements / (Understatements)			
Audit Schedule Reference	Description of Misstatement	Type of Misstatement	Total Amount	Current Assets	Noncurrent Assets	Current Liabilities	Income Before Taxes
R-210	*Write-off of customer account receivable*	*P*	*$13,488*	*$13,488*			*$13,488*
R-210	***Under-recorded sales***	***A***	***420***	***(420)***			***(420)***
R-210	***Reduce accounts for wine returned by customer***	***A***	***5,880***	***5,880***			***5,880***
E-210	*Unrecorded accounts payable*	*P*	*61,917*	*(31,200)*	*($20,717)*	*($61,917)*	*10,000*
I-210	*Unrecorded capital acquisitions*	*A*	*48,610*	*48,610*	*(48,610)*		
I-210	*Misstatement in depreciation expense*	*A*	*13,368*		*13,368*		*13,368*
				$ 36,358	*($55,959)*	*($61,917)*	*$42,316*

P – projected misstatement
A – actual misstatement

Conclusion: None of the above items, individually or in the aggregate, has a material effect on the financial statements in total or with respect to the relevant financial statement component. Thus, no adjustments are proposed and the financial statements are fairly stated in all material respects.

	Possible Overstatement (Understatement)	Materiality
Total Assets	*($19,601)*	*$1,050,725*
Income Before Taxes	*$42,316*	*$99,850*