

BUSI 3007A: Midterm # 2: The Sequel

November 8th 2:35pm – 4:05 pm (**90 minutes**)

Professor Garth Sheriff

Student First Name: _____ Student Last Name: _____

Student ID: _____

Instructions:

1. Circle multiple choice answers on provided Scantron card AND the exam paper.
2. Write all answers for Sections II and III (the non-multiple choice questions) in the **provided space** on the exam. Appropriate space has been provided to answer the question. **Point form is acceptable. State any assumptions as necessary.**
3. Follow the suggested time frames for each question
4. Calculators are permitted

Section	Total Marks	Suggested Time	Grade
Section I: Multiple Choice	15	15 minutes	
Section II: Short answer Question 1: (5 marks) Question 2: (5 marks) Question 3: (10 marks)	20	30 minutes	
Section III: Case Question	25	45 minutes	
Total	60	90 minutes	

*Note: All of the solutions below are **suggested** solutions. A student may have responded with an acceptable response outside of the suggestion solution. And the response makes sense within the context of the case info.*

Section II: (20 marks 30 minutes)

Question 1: (5 marks)

Charlie Keen is a year first co-op student at the auditing firm, Aiy Win LLP and is currently working on his first audit engagement. The year end for the client is November 30, 2011 and it is now January 5, 2012 and the audit has been in progress for two weeks. Charlie has been given the task of performing alternative audit evidence gathering procedures for accounts receivable confirmations that have not been returned from the company's customers. There are five customer accounts for which the confirmation letter has not been returned and alternative procedures need to be applied. Charlie was given instructions by his manager on how to perform these alternative audit procedures, but Charlie cannot remember what he was told to do for these five customer accounts. All that Charlie remembers is that his manager told him that the client's key incentive is to overstate assets although he is not sure what that means. Furthermore, Charlie does not have a clear idea what purpose accounts receivable confirmations serve in performing the audit.

Identify the **key** assertion (s) that is being tested by sending out accounts receivable confirmation. Also, help Charlie remember what his audit manager would have asked him to do with the five customer accounts for which a confirmation has not yet been received.

- *Assertions: Existence and valuation (2 mark)*
- *Procedure: Vouch (1 mark)*
Procedure description (2 marks): Vouch customer account year end balances to subsequent receipts. Review subsequent bank statements or cheque stubs to see if the company has cashed a cheque for the amount that was outstanding as of year end. This will provide audit evidence for the existence and valuation of the accounts.

Question 2: (5 marks)

A public nickel mining company, Nickelback Inc., has been in operation for two years and trades on the Vancouver Stock Exchange (VSE). The company has been mining in an area of the Yukon where a public geologist report indicates there is a significant deposit of nickel. The CEO of the company is very excited about the future as there has been significant capital expenditure in exploring the area and indications are that nickel will be mined in large quantities in the next six months. The CEO and other executives have stock based compensation with Nickelback Inc which becomes more lucrative over the long term success of the company. The National Post has reported recently that another company, Outco Inc. has shown great interest in acquiring Nickelback Inc. as soon as their annual financial statements are released and analyzed. Your firm, Bond & James LLP, has been the auditor of Nickelback Inc. since the company's inception. It is now, December 15th and your firm has been presented with Nickelback Inc.'s draft financials for the year ended November 30, 2011 (with the prior year comparatives).

Nickelback Inc. Trial Balance Year ending Nov.30, 2011		
	<u>Nov.30/11</u>	<u>Nov.30/10</u>
Cash	\$ (15,000)	115,000
Prepaid expenses	5,000	10,000
Investments	10,000	50,000
Mining Development costs	500,000	2,000,000
Bank Loan	(550,000)	(650,000)
Accrued Liabilities	(225,000)	(25,000)
Miscellaneous liabilities	(100,000)	-
Common Shares	(2,500,000)	(2,500,000)
Revenue	(75,000)	-
Operating Expense	2,950,000	1,000,000
	-	-
	Note: Balance dr/(cr)	

- (a) Based on the above, what is the incentive(s) of Nickelback Inc's management with regards to the financial statements? **(1 mark)**
- *Incentive to understate revenues and overstate expenses (or understate assets and equity) to be looked upon as an unfavourable investment so that Outco Inc. will not be drawn to purchase Nickelback Inc. This is indicated by the significant increases in operating expenses and the decrease in a capitalized asset (mining development costs).*
 - *There can be other variations of this answer (as long as it makes sense within the context of the info above)*
- (b) Based on (a) and Nickelback Inc. Inc's trial balance, identify an account(s) and the related management assertion(s) that directs your attention toward a possible significant risk(s) and fully explain why. **(4 marks)**
- *This question depends on the response in part (a). However, regardless one account that must be selected is the mining development costs **(1 mark)**. There is judgment/estimates (capital vs expense – **1 mark**) and the assertions that are most attention directing given the incentives of management would be completeness **(2 mark)** and valuation.*

Question 2: (10 marks)

Burrito Boyz Ltd. is a franchise fast food restaurant business. When customers order food, the counter person presses the appropriate buttons on the cash register. There is a button for each menu item. The point of sale (POS) system retrieves the current item prices from the price files, extends for quantities ordered, and displays the sale total on the cash register screen. A sales entry is also generated in the daily sales register. The customer's payment is then entered and their food order is displayed on a screen in the food preparation area. The POS system generates a cash receipt entry for the cash register and also in the daily cash receipts register. Food preparation staff put together the order and place it in the pick-up area behind the front counter. When the food order is filled, the staff clears the order from the system; this generates an entry in the inventory system to remove the food and packaging items sold from the perpetual inventory listing.

A restaurant manager is on duty at all times. The manager circulates between the counter and food services areas, observing that cash received is placed in the register and spot-checking that food orders match with cash sales. If a customer receives an incorrect order, the manager can void the sale entry using a special key in the cash register and a secret password for the POS entries. A corrected order is then input by the usual method, if required. At the close of each day's business, the cash in the register is totalled and agreed to the cash, debit card, and credit card slips collected in the register during the day. Differences of less than \$10 are recorded in an account named "Cash over/under." Larger discrepancies will be investigated by scrutinizing the day's entries and interviewing all counter people using the register. The sales and cash information from the POS is then uploaded over a phone line to the franchise company head office, where it is consolidated with the reports from all the restaurants in the system. On a weekly basis, the food and packaging inventory on hand in the restaurant is counted and reconciled to the inventory system. The inventory usage is also compared with the sales records for reasonability.

Required:

(a) Identify and describe two control strengths and two control weaknesses based on the case facts for Burrito Boyz Ltd.. Be sure to describe identified strengths and weaknesses in terms of control objectives. **(4 marks)**

Any one of the following as long as there are two strengths and two weaknesses. Two marks each.

Validity	Only authorized employees with access codes can use POS terminals [S]
	Supervisory control by manager circulating and spot-checking ensures food is prepared only when order was entered [S]
Completeness	POS entry required to prepare/serve food. [S]
	Cash reconciliation to POS is performed regularly [S]
	Cash balanced and deposited daily - may be large amount of cash on premises inviting theft [W]
	Cash collection and order entry not segregated [W]
Authorization	Only employees with authorized access codes can use POS [S]
	Order entry and food service segregated [S]
Accuracy	Programmed prices and processing control accuracy [S] (auditor needs to test the programming to assess controls)
Classification	POS and processing will classify sales, returns [S] (auditor needs to test the programming to assess controls)
Accounting	Summary reports are reviewed by manager and head office [S]
	Pricing and summarization automatically by POS system function means any program errors, e.g. incorrect product prices, can result in large errors [W]
Proper period	Programmed dates determine period sales are entered in [S] (auditor needs to test the program to assess this control)

(b) For one of the control strengths identified in part (a) describe how you might test the control to ensure that it is operating effectively (**1 mark**)

All that is required is a reasonable description of a test of control for a strength (but not a weakness as you would not test a control weakness).

For example,

Only authorized personnel able to use POS – auditor can attempt to access the POS system to determine there are controls for authorization

End of Section II

Section III: Case (25 marks 45 minutes)

Getflick, Inc., is a Canadian provider of on-demand internet streaming media in Canada. The company was established in 1997 and is headquartered in Toronto, Canada. The company has been public since 2008 and is traded on the Toronto Stock Exchange (TSE).

Getflick Inc. offers Internet video streaming ("Watch Instantly") of selected titles to computers running Windows or Mac OS X and to compatible devices. Viewing is initiated by pressing a "Play Instantly" button, and played back on the PC monitor. Films can be paused or restarted at will. Initially, the feature offered subscribers one hour of media for approximately every dollar they spent on their subscription. (A \$16.99 plan, for example, entitled the subscriber to 17 hours of streaming media.) In January 2010, however, Getflick lifted this restriction. Virtually all subscribers now are entitled to unlimited hours of streaming media at no additional cost beside their monthly subscription cost. As of 2011, Getflick's "Watch Instantly" service holds first-run rights to films from Paramount Pictures, MGM, Lions Gate Entertainment along with films from Sony Pictures, Walt Disney Motion Pictures Group, Alliance Atlantis and Anchor Bay Entertainment. Getflick also has an extensive suite of television, film and direct to cable titles available for streaming.

Getflick has had a first mover's advantage in the industry of online film streaming as it was one of the first companies to provide this type of service in Canada and has had exclusive contracts with many of the major film and television studios in the industry. However, in 2011 the company had a series of missteps that resulted in significantly decreased earnings and share price for the year. As a result of increasing costs associated with licensing film and television for streaming, the company decided to increase the monthly subscription rate from \$16.99 per month to \$28 per month. This announcement was made in June of 2011 and enacted in September 2011. Customers were outraged by the significant fee increase and Getflick Inc. lost 15% of its market share by October 2011. The loss of market share was also accelerated by the entrance of new competitors onto the market such as Bluebox Inc. and Video Stream Ltd.

Getflick Inc. also had to make a major restatement to revenue in 2011 based on a significant accounting error. The unearned subscription revenue was understated by \$1,000,000 as a result of poor internal controls over financial reporting.

As a result of the missteps, Getflick Inc. fired its CEO in November 2011. Furthermore, there was concern over the competency of the remaining staff in the accounting department. The company made an immediate search for a new CEO and hired Dennis Kolslaw in December of 2011. Dennis was a CEO known in the industry for taking a very short time to bring a company back to its former profitability. Dennis took a nominal salary for the position but also required a bonus of 15% of net income before tax starting with the 2012 fiscal year. One of the plans Dennis has to restore profitability to Getflick Inc. is to offer a service of mail ordered DVDs for an additional subscription fee of \$8 a month. This expansion of services was based on the success of a profitable U.S. company that offered mail ordered DVDs in the U.S. Besides this service expansion, Dennis feels that many cost cutting measures need to be made before the start of the new year.

As required by Ontario Securities Commission, Getflick Inc. has been audited since it has been publicly traded. Getflick Inc. has decided to change auditors this year and has hired your firm, Dunn & Done LLP, to perform the December 31, 2011 year-end audit. It is now January 10th, 2012 and you are the audit senior on Getflick Inc. You have obtained the draft comparative trial balance for Getflick Inc. for the year ended December 31, 2011.

Getflick Inc. Trial Balance December 31/11		
	Year end December 31/11	Year end December 31/10
	(unaudited)	(audited)
Cash and cash equivalents	\$ 4,500,000	\$ 12,500,000
Short term investments	3,900,000	9,000,000
Subscriptions receivable	4,750,000	8,800,000
Technology and development costs	3,350,000	9,600,000
Content library	17,225,000	15,500,000
Property, plant and equipment (net of accumulated depreciation)	9,775,000	14,450,000
Other assets	1,500,000	1,750,000
Unearned subscription revenue	(2,750,000)	(1,750,000)
Accounts payable and accrued liabilities	(1,250,000)	(400,000)
Bank loan payable	(1,500,000)	(2,000,000)
Common Stock	(55,000,000)	(50,000,000)
Retained Earnings	18,310,000	15,500,000
Subscription revenue	(49,900,000)	(67,000,000)
Interest income	(500,000)	(825,000)
Interest expense	190,000	225,000
Salaries expense	5,750,000	4,900,000
Technology and development expense	4,500,000	1,250,000
Licensing fees	22,800,000	17,700,000
Other expenses	14,350,000	10,800,000
	-	-
	Note: Balance dr/(cr)	

Required: Base your responses on the case information provided above

- a) Identify one business risk of Getflick Inc for three of the five categories in understanding a business and its environment (6 marks).

(The list below is not exhaustive)

- *Nature of business: increasing competition from new entrance of competitors. Significant loss of market share. (2 mark)*
- *Internal controls: Information identifying lack of competency of accounting staff and also accounting error a result of poor controls over financial reporting (2 marks)*
- *Measurement of financial performance – based on the draft financial statements there are major decrease in net income (2011 - \$2,810,000 and 2010 - \$32,950,000). To get full two marks must show some numerical analysis leading to business risk. Also current ratio has decrease significantly from 2011 to 2010 (in 2010 it was 7.3 to 1 in the current year it is 2.39). The calculations may also be in Part (f) (2 marks)*
- *Strategy: Expanding line of business to mail over DVDs (2 marks)*

b) Evaluate the fraud risk(s) of Getflick Inc. (**4 marks**)

Fraudulent financial reporting (0.5 marks)

Incentive - Opportunity for CEO to take “big bath accounting” to make bonus next year. Company will also show a recover last year as write offs reverse in the following year 2012. (**1 mark**)

Opportunity - Poor controls over financial reporting and not competent accounting staff. (**1 mark**)

Rationalization – Conservative accounting – “we are not increasing net income we are expensing major items which means we are doing the right thing” (**1 mark**)

Conclusion: Fraud risk high (0.5 marks)

Note: 0.5 is given each for identifying incentive, opportunity and rationalization

c) Identify the incentive(s) of management (**2 mark**)

Overstatement of expenses, understatement of revenues (overstatement of Assets). For CEO to meet bonus in 2012 (2 marks)

Can have other responses for 1 mark. But full 2 marks given for the above incentive

d) Calculate both a preliminary and performance materiality and explain your calculations (**2 mark**)

- *Any calc as long as it makes sense given the identified primary uses (1 mark for identified users, 0.5 each for calc of preliminary materiality and performance materiality)*
- *Suggestion would be either revenue or Net income as a primary F/S user is the shareholders*

e) Identify one overall financial statement risk for Getflick Inc. (**1 mark**)

- *Incompetent account staff - effects entire set of financial statements (1 mark)*

- f) Based on your responses (a) through (d), use your professional judgment to identify and assess the highest risk account(s) and their relevant assertion(s) for Getflick Inc. Explain your answer fully (e.g. use preliminary analytics, case info etc. to support your answer). **(10 marks)**

Financial statement analysis (ratios or vertical analysis) showing a comparison of current year to prior year. From this the analysis should be fairly evident. Also want to see a calculation of Net income for both years (2011 and 2010) to show the significant decrease in net income.

*Financial analysis was key to arrive at the incentives and biases of management – **4 marks** will be awarded if there is sufficient analysis (based on professional judgment – but no marks if there are no calculations – but even basic calcs such as below is acceptable).*

- *For example decrease in technology development costs (a capitalized asset which involves judgment) by \$6,250,000.*
- *Decrease in net PPE by \$4,675,000 – an estimate (Accum Depreciation)*
- *Decrease in Subscriptions receivable (written off) – by \$4,050,000.*
- *Decrease in revenue by \$17,100,000*

These could form 4 of the significant risks (all four have significant decreases from the prior year consistent with our belief in management's incentive).

Then a discussion would take place on the riskiest assertions related to this accounts (e.g. PPE would be completeness and valuation, Technology & Development would be completeness and valuation, Subscription receivable and Revenue would be completeness)

There needs to be internal logic in the discussion of what the highest risk accounts are (e.g. consistent with other parts of the question).

Account and assertion analysis (max 6 marks)

- *The analysis that flows from here depends on the response above and from (a) to (e). Including the above (the setup was necessary so that your selected accounts had some context)*
- *0.5 mark for each account identified and relevant assertion. 0.5 mark for explanation for why account was chosen (in line with incentives). 1 mark if supported by preliminary analytics (2 marks). Explanation must make sense given your responses (a) through (e) and case facts*

End of Exam

Bonus Question:

What was the name of the case we looked at when discussing how to write accounting cases?

Warmth Homes Ltd