ACAF National Examination – Sample Examination Solution

Section I: Constructed-Response Questions

Note to students:

The suggested solution below is not intended to provide a comprehensive solution or be representative of a response that could necessarily be prepared under the time constraints of an exam. It represents only one of many possible approaches and should not be regarded as being the only acceptable approach. When comparing the solution to your response, you should therefore focus on whether you communicated the relevant ***concepts*** *rather than fixating on the specific words used.*

Question 1

Gary should decline the request from KL's president to attend the strategic planning conference for the following reasons:

- Participation in the strategic planning conference is a management responsibility. As Gary is part of the external audit firm auditing KL, he is unable to perform any management responsibilities.
- Acting in a management role with a client is such a significant threat to independence that it cannot be reduced to an acceptable level.
- It is probable that advising the client on the accounting implications of proposed actions would violate the independence of Gary's audit firm.
- The benefits Gary would receive in going to a five-star vacation resort would likely result in a self-interest threat.

Question 2

To: Olive Jones
From: Student
Re: California Co.'s financial statements

I have reviewed the accounting issues you noted and evaluated each.

Machine

At the date of purchase, California Co. (CC) had information indicating that depreciation should have been based on an eight-year life with a $50,000 residual value. CC therefore made an error in recording the depreciation with a 10-year life and no residual value.

The error needs to be corrected retrospectively.

See Exhibit I for the calculations and adjustment required.

Expenses versus assets

Assets are items that have future benefit to a company, while expenses relate to operations to earn income in a fiscal period and have no further benefit. Annual repairs should not be capitalized, as they do not add future benefit to the asset; these should be expensed.

See Exhibit I for the adjustment required.

Supplies inventory

The supplies left on hand at year end have future benefit to CC and should be capitalized as an asset at year end. An adjustment should be made to bring the balance to actual, based on the inventory count.

See Exhibit I for the adjustment required.

Question 3

To: **Nancy Nickerson**
From: **Pierre Richet**
Re: **Hangla Shoes Inc.**

REPORT ON HANGLA SHOES INC. OPPORTUNITY

I have responded to your questions about the Hangla Shoes Inc. (HSI) opportunity, and included three exhibits in an accompanying Excel file.

Earnings projections

I have prepared the projections in Exhibit II. The HSI franchise appears to be viable and should be able to generate positive earnings from the first year onward.

However, this analysis does not provide for any compensation for you, the interest on any debt, depreciation on any existing or additional capital expenditures that may be required or the recognition of any corporate income taxes.

Break-even point

I have calculated break-even sales levels in Exhibit III by first segregating the expenses in Exhibit II by cost behaviour (variable costs versus fixed costs). Based on this analysis, the HSI franchise would cover its fixed costs in the first year of operations with annual sales of approximately $273,000 (or $22,750 per month). This equates to approximately 4,266 pairs of shoes at $64 per pair.

To replace your present annual earnings of $50,000, sales would have to reach approximately $386,000 in the first year of operations. This equates to approximately 6,031 pairs of shoes at $64 per pair. Based on the information provided by the franchisor, these sales levels appear reasonable.

Note that sales levels would need to increase in Year 3 to approximately $371,000 (or $490,000 including replacing your present annual earnings), which also seems reasonable based on the earnings projections.

Financing

I have calculated the net financing requirements for the business as $120,000 in Exhibit IV. Arguably, you would not have to obtain the additional inventory immediately. However, you should also leave a cushion for unforeseen expenditures and negative cash flows in the startup months.

You should be able to obtain the $120,000 by refinancing your existing mortgage to its original level. In fact, if your home has appreciated in value since you obtained the original mortgage financing, you may have even more borrowing capacity. The bank should also be willing to provide a line of credit that is secured by inventory. A blend of these two options would be best. You should be careful that you do not use up your entire savings or all the equity in your home.

Accounting system

Financial reporting

Financial statements will be required to support the computation of the franchise royalties and the percentage rent payment, to support requests for loans from the bank, to compute taxes payable and to evaluate business performance. As the statements are to be used externally and some level of assurance is required, I recommend that you purchase an off-the-shelf accounting package rather doing all of the accounting using Excel. These off-the-shelf systems are generally inexpensive and well proven, they have the ability to generate financial reports and develop budgets needed for good decision-making, and they generate an audit trail that should be easily understood by the firm that reviews or audits the financial statements.

Audit versus review

A compilation engagement does not provide any assurance and therefore would not be appropriate for the franchise agreement.

An audit engagement provides moderate assurance that based on the work done, the financial statements are fairly stated within the framework of appropriate criteria. It requires extensive work by the auditor, potentially including both tests of controls and substantive tests of details. Procedures can include inspection, observation, external confirmation, recalculation, reperformance, analytical procedures and inquiry.

Reviews have a lower scope than audits and provide negative assurance with the statement that the public accountant has not identified anything to indicate the statements are other than as presented. A review consists primarily of inquiry, analytical procedures and discussion related to information supplied to the public accountant by the enterprise. The limited objective is to assess whether the information being reported on makes sense within the framework of appropriate criteria.

A review would be a suitable engagement in your circumstance, as it will be less costly and more efficient than an audit, and it would meet the requirements of the franchise agreement.

Internal controls

As the store will be operated from time to time by employees, it is necessary to have a good system of internal control. Inventory should be managed using a perpetual inventory system (for example, integrated with a point-of-sales terminal) that tracks inventory by shoe type and size. In addition, inventory should be physically counted regularly. The employee should total the cash and credit card slips for the day, which you should then reconcile with computer totals from the point-of-sales terminal. Comparing the inventory from the records to what is on the promises would identify missing inventory (items stolen). Also, tracking the inventory by shoe type and size would indicate what is in inventory and what has been sold. You can use the sales by type and size to determine what to order.

To address the concern about employees providing discounts to family and friends, your signature should be required on all discounted receipts. In the future, if you increase the number of employees, you could instead require two signatures (one from the employee purchasing the item and one from the employee making the sale). You may also want to consider putting a limit on the number of discounts for each employee per month. For example, you could allow employees to only purchase two pairs of shoes per month at a discounted rate to ensure that the discount does not become excessive. As the franchise grows and the number of employees increases, you will need to track the sales discounts for each employee to ensure that the limit is not exceeded. You will also need to make sure you have a signed receipt for each sales discount to ensure that excessive discounts are not being provided. If limits are exceeded, or no signed receipt is provided, you should be able to track the time of the sale in the system to determine which employee provided the discount so that you can follow up.

You will have to maintain a separate business bank account instead of using your personal bank account. If an employee is making bank deposits, it will be especially important to reconcile the deposits to the bank statement to ensure that the correct amounts were deposited, and prepare a bank reconciliation regularly (monthly). It is also a good idea to have the employee bonded.

All store assets should be safeguarded with the appropriate security (such as electronic surveillance and theft-detection equipment). You should obtain adequate insurance coverage for property and liability coverage.

You should check physical inventory receipts against receiving reports and then receiving reports against invoices to ensure that you are only paying for inventory that you have received.

You should develop budgets to help you monitor the franchise’s performance and to plan and control your operations. Cash budgets will help you determine your cash needs and will be useful when approaching a bank for loans. In addition, budgets will provide a benchmark against which you can compare your actual results, thus helping you to decide what courses of action you should take to improve the business (for example, by focusing on significant variances between actual and budgeted results).

Section II: Multiple-Choice Questions

1. (a) is correct.
2. (a) is correct.
3. (b) is correct.
4. (d) is correct.
5. (c) is correct.
6. (d) is correct.
7. (b) is correct.
8. (c) is correct.
9. (c) is correct.
10. (d) is correct.
11. (a) is correct.
12. (c) is correct.
13. (c) is correct.
14. (b) is correct.
15. (c) is correct.
16. (b) is correct.
17. (b) is correct.
18. (a) is correct.
19. (a) is correct.
20. (a) is correct.
21. (b) is correct.
22. (c) is correct.
23. (b) is correct.
24. (d) is correct.
25. (a) is correct.
26. (b) is correct.
27. (a) is correct.
28. (c) is correct.
29. (b) is correct.
30. (c) is correct.
31. (a) is correct.
32. (b) is correct.
33. (c) is correct.
34. (a) is correct.
35. (b) is correct.

36. (b) is correct.
37. (d) is correct.
38. (a) is correct.
39. (b) is correct.
40. (b) is correct.
41. (d) is correct.
42. (b) is correct.
43. (a) is correct.
44. (a) is correct.
45. (b) is correct.
46. (d) is correct.
47. (d) is correct.
48. (d) is correct.
49. (a) is correct.
50. (c) is correct.