Core 1 — Practice Case 1

Sample response

<u>Memo</u>

To: Plant Power Inc. (PPI) audit planning file

From: CPA

Date: August 1, 2024

Subject: Engagement planning memo and financial reporting issues

Financial reporting issues impacting the June 30, 2024 financial statements

Rent Some Green – Impairment of assets

In the spring of 2024 PPI purchased land ($50,000 cost) and constructed a greenhouse ($35,000 cost) for a new rental gardening business called Rent Some Green. Subsequent to year end PPI spent $20,000 to improve the land and noted potential indicators of impairment. The issue is whether there is an actual indicator of impairment and if so, how to account for this.

Per ASPE Section 3063 – Tests for recoverability are made under ASPE when the carrying value may not be fully recoverable (based on an event or circumstance). The gardens did not live up to the expectations of PP's tenants as the soil was low quality and too shady. Because of this, PPI spent $20,000 tilling and fertilizing the land to make the soil fit for gardening, which represents an event/circumstance corroborating a potential indicator of impairment. Under impairment of long lived assets, an impairment will be recognized when the following criteria are met:

1. An impairment will be recognized when the carrying value is not recoverable and exceeds its fair value
   a. MET: the carrying value of the land and building of $85,000 is considered not recoverable if it exceeds the undiscounted cash flows expected from being in use ($3,000 per year x 15 years + $50,000 - $20,000= $75,000). PPI spent $20,000 tilling and fertilizing the land to make the soil fit for gardening which represents an event/circumstance corroborating a potential indicator of impairment.

Recommendation:

The asset impairment test is met, therefore under ASPE, the asset amount is impaired to the fair value. In this case the carrying value will be adjusted by $35,000 which is the difference between carrying value ($85,000) and fair value ($50,000 per the case).

This will reduce PP&E by $35,000 and reduce income by $35,000.

Total Towers shrubs – Revenue recognition

On June 30, 2024, $14,000 of inventory was set aside for a special order to PPI's largest customer. PPI agreed with the customer to a price of $27,000. PPI recorded the transaction as revenue (and COGS) for the inventory when the plants were set aside for delivery.

Per ASPE Section 3400 – Revenue, revenue can be recognized when the following criteria are met:

1. Collection is reasonably assured.
    a. MET: the contract is with an existing customer Total Towers, and we have no indications that there are any issues with the customer from a payment/collection perspective.
2. Performance has been completed: goods are transferred to the buyer with significant risks/rewards of ownership.
    a. NOT MET: The exotic plants were set aside for delivery and planting but not delivered to Total Towers at June 30, 2024. Although ASPE 3400.09 states that delivery may be deemed to have occurred in a bill-and-hold arrangement, it does not appear as though the risks of ownership have passed to Total Towers as Mark still has the ability to reject the shrubs if they do not meet his needs.
3. Reasonable assurance exists in terms of measurement of consideration.
    a. MET: An agreed upon price of the shrubs by the customer of $27,000 exists.

Recommendation:

As the criteria have not been met, revenue should be adjusted down by $27,000 and COGS reduced by $14,000 (thus pre-tax net income reduced by $13,000). Inventory should be increased by $14,000 and accounts receivable reduced by $27,000, which will reduce the current ratio (see below).

Pesticide inventory – valuation/measurement

In May 2024 the municipality banned the sale of pesticides. PPI held $12,000 of banned products in inventory at June 30, 2024 that can not be sold or returned. The issue is whether an adjustment to inventory value is required.

Per ASPE 3031 Inventories – the following criteria apply to the valuation of inventory:

1. Inventories should be measured at the lower of cost and net realizable value
   a. NOT MET: The banned products in inventory at year end have a cost base of $12,000 however due to municipal law changes, have a net realizable value of zero as they have been deemed to be disposed of and cannot be returned or sold.

Recommendation:

Based on the measurement criteria, PPI will need to adjust its inventory value on the banned products. This results in a reduction in inventory of $12,000.

Nordic Bank line of credit

PPI has a line of credit with Nordic bank for $75,000. It fully drew the line to finance the land/greenhouse. The line of credit requires a current ratio above 2:1 or Nordic Bank can demand immediate repayment. Based on the demand aspect of the debt, we treat it as a current liability in the ratio calculations

Calculation of debt covenants

Description	Notes	Current Assets	Current Liabilities	Ratio
Per draft financial statements		$320,000	$154,000	2.08
Total Towers shrubs	1	($13,000)	-	
Pesticide inventory	2	($12,000)	-	
Adjusted financial statements		$295,000	$154,000	1.92

Conclusion:

On draft financials the current ratio is above 2:1, however after adjustments the current ratio of 1.92 falls below the required 2:1 threshold therefore Nordic Bank could demand immediate repayment. Given the line of credit was used to finance a long term asset (land) it may be appropriate for PPI to work with the bank to match the duration of the liability (a long term loan) with the asset acquired during 2024. This could improve the current ratio on a smaller required line of credit if a portion is termed out. This should be an area of additional focus as the immediate repayment could strain PPI and cause a going concern issue.

Notes:

1. Inventory should be increased by $14,000 and accounts receivable reduced by $27,000.
2. Pesticide inventory reduced by $12,000.

Overall financial statement level (OFSL) risk

We note the following assessment of risk factors for PPI

Inherent risk factors that increase risk:

- Competition has increased and margins have reduced by rising costs. Significant competition can pressure management to utilize aggressive revenue policies and demonstrate profitability to ensure access to its line of credit.
- The bank as a primary user and the current ratio covenant calculation. This is a risk given a user specifically interested in the current ratio which management would inherently want to meet in order to avoid immediate repayment of debt.

Control risk factors that increase risk:

- Lack of a full time internal accounting function. PPI terminated its full time accountant and hired a part time bookkeeper. This increases the risk of appropriate controls not being adhered to and risk of errors.
- Management's view towards controls. Joan has become hands-off and admits she is less involved in the business and her reviews are minimal. This increases risk of errors and overall controls.

Factors that reduce risk

- PPI was previously reviewed by Cumby and Menchions and in the prior year risk was assessed as low
- An established client base and strong reputation. PPI has been in business for many years and with a strong reputation and owned by only two individuals there is less incentive for management to manipulate numbers.

Conclusion:

Based on the above factors and changes in the business overall risk of material misstatement at the OFSL is medium to high.

Overall materiality

1. Users
    a. Nordic Bank
        i. Objectives: the bank would be concerned with profitability in order to determine PPI's ability to repay its outstanding loans. Additionally, it would be concerned with liquidity given the current covenant outstanding for a current ratio above 2:1 at year end.
    b. Ellen and Joan Harris
        i. Objectives: As co-owners of a private company they would be concerned with the financial statements to determine profitability and value of the business.
2. Benchmark for materiality
    a. Pre-tax net income is the preferred benchmark for materiality for profit based enterprises with users focused on profitability (such as Nordic Bank and the owners of PPI). The typical range for this benchmark is 3-7%.
    b. Given the bank's objectives of ensuring liquidity and repayment ability we will use the lower threshold of 3%.
3. Determine overall materiality: $23,500 pre-tax net income x 3% = $705 ($700 rounded). We therefore calculate overall materiality to be $700

Engagement approach

Per CSRE 2400, a practitioner's objectives in a review engagement are to obtain limited assurance, primarily by performing inquiry and analytical procedures about whether the financial statements as a whole are free from material misstatement and that nothing has come to the practitioner's attention that would cause it to believe that the statements are not prepared according to ASPE (in this case).

Given the lack of internal controls, the majority of inquiry and analytical procedures would be on classes of transactions and account balances. This approach will allow us to obtain limited assurance associated with the review engagement.