QUESTION 1

You are a newly appointed trainee accountant at Winterfell Inc. (‘Winterfell’), a large firm that provides accounting, advisory, external audit and taxation services to their wide range of clients. After you completed the induction week at Winterfell, you were allocated to the audit team of Lannister Holdings Ltd (‘Lannister’). Winterfell is the newly appointed external auditor of Lannister for the financial year ending 30 June 2016 (‘FY2016’).

In addition to the background information, potential business contract with 2Go and the service level agreement with Airbook set out below, the audit senior provided you with the following workpapers:

<table>
<thead>
<tr>
<th>Description</th>
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<tbody>
<tr>
<td>C100       Extract of the system description for the recognition of revenue of Lannister’s car rental division</td>
</tr>
<tr>
<td>F200       Fixed assets – understanding the rental car fleet</td>
</tr>
</tbody>
</table>

1 Background information

Lannister was established as a private company in 1984 by Mr Tyrion Lannister, who was the sole owner of the business. As the company grew it became a public company and then in 2013 it listed on the Johannesburg Stock Exchange. Winterfell was not involved with the listing process of Lannister.

Lannister provides its customers with a range of integrated motor car solutions, including car fleet rental, fleet management and used car sales, through the successful operation of complimentary divisions and subsidiaries.

Lannister does not at present have sufficient cash reserves to fund potential growth opportunities. Lannister requires consolidated financial statements for the year ended 30 June 2016 by 12 August 2016 in order to apply for a loan from Ironthrone Bank.

The board of directors of Lannister is as follows:

<table>
<thead>
<tr>
<th>Name and surname</th>
<th>Position</th>
<th>Shareholding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr Tyrion Lannister</td>
<td>Chief executive officer and chairperson of the board</td>
<td>20%</td>
</tr>
<tr>
<td>Ms Sansa Stark</td>
<td>Chief financial officer</td>
<td>–</td>
</tr>
<tr>
<td>Mr Jaimie Lannister</td>
<td>Communications and marketing director (brother of Mr</td>
<td>5%</td>
</tr>
<tr>
<td></td>
<td>Tyrion Lannister)</td>
<td></td>
</tr>
<tr>
<td>Mr Khal Drogo</td>
<td>Sales director</td>
<td>–</td>
</tr>
<tr>
<td>Ms Deanerys Targaryen</td>
<td>Human resources director</td>
<td>–</td>
</tr>
<tr>
<td>Mr Theon Greyjoy</td>
<td>Non-executive director</td>
<td>5%</td>
</tr>
</tbody>
</table>

During FY2016 the board approved a bonus incentive scheme applicable to all executive directors of Lannister. In terms of the bonus scheme, all executive directors will receive a bonus if the budgeted profit targets for the financial year are met.
IFRS 15 *Revenue from Contracts with Customers* is only effective for reporting periods beginning on or after 1 January 2018, but Lannister’s board has made the decision to early adopt IFRS 15 from 1 July 2015. This is because Ms Stark convinced the board that applying the principles based on IFRS 15 would be easier than applying those of IAS 18 *Revenue*. Ms Stark is also of the opinion that complying with the *Companies Act, 2008* (Act 71 of 2008), as amended, is a waste of time and money. Most of the personnel in the accounting division of Lannister are family members of Mr Tyrion Lannister, with limited knowledge and experience of financial accounting standards.

On 1 January 2016 Lannister changed its information technology (IT) system from a number of separate, less sophisticated application modules to a real-time integrated online application system that combines all the previously standalone financial modules into one central application system called *SmartAccounts*.

Lannister outsourced the development, testing and implementation of the new *SmartAccounts* IT application system to Bravos IT (Pty) Ltd (‘BIT’). This included the migration of data, as well as post-implementation maintenance and support. The outsource agreement further includes training of Lannister personnel, but because the accounting division of Lannister has been understaffed and under pressure, no such training has yet taken place.

2 Potential business contract with 2Go

Lannister’s policy is to use new rental cars for a maximum period of two years. These cars are then replaced with new cars. The replacements are done in terms of a ten-year contract with suppliers of new cars, which was signed five years ago by the company’s directors.

Cars that are two years old (based on the end of the month of first registration in the name of Lannister), are sold through the company’s used car sales division. However, it is taking longer and longer to sell the used cars due to a drop in demand for used cars, and there has also been a decrease in the demand for rental cars. Lannister regards rental cars that have been rented out for less than five days in a month as idle rental cars.

During a meeting of the audit team to discuss the car rental business of Lannister, the audit manager highlighted that the directors are uncertain about the reasons for the continued increase in idle rental car capacity of the company, partly because there is no risk committee and no investigation had yet been undertaken by the client’s management.

The audit manager added that one of the factors that is causing strain on the car rental industry is that international tourism to South Africa decreased by ±10% in 2015 (2014: 6%), partly because of the stricter visa requirements imposed by the South African government on persons travelling with minors. In addition, there has also been a decrease in local tourism over the past number of years.

The audit team has estimated that Lannister’s average lost revenue due to idle rental cars for the first half of FY2016 had reached R10 million. The audit team is of the opinion that these losses will materially impact on Lannister’s 2016 annual financial statements. The audit manager related that he had asked what plans management has to mitigate these revenue losses. Ms Stark mentioned that Lannister is considering the conclusion of an agreement with 2Go.
2Go provides innovative transport solutions, accessible by customers through a smart phone application (app) that can be downloaded free of charge. Customers using the app register their personal details and credit card details on 2Go’s system by means of the app. Registered customers can then request transport of their choice by means of the app.

2Go has provided Lannister with a proposed written contract in terms of which Lannister will make its idle rental car fleet available to 2Go for a period of four years. The contract contains the following terms and conditions:

- If the board of Lannister enters into the proposed contract with 2Go, 1 000 idle rental cars will be provided to 2Go on 1 July 2016.
- 2Go will partner with Lannister by providing registered drivers who will utilise the cars provided by Lannister. These cars will be under the full control of the drivers to whom they are allocated and be their responsibility.
- 2Go will pay Lannister an annual fixed fee for the use of the total number of idle rental cars available plus a monthly fee for each kilometre of 2Go transport provided by Lannister’s rental cars.
- Lannister will receive a fixed annual fee of R15 million on 1 July 2016 and again on 1 July of each of the next three years.
- On the fifth business day of each month, 2Go will pay Lannister R1,00 per km travelled by each Lannister car during the previous calendar month. The fixed fee payable to Lannister per kilometre of 2Go transport will escalate by 25% per annum from 1 July 2017.
- 2Go’s system automatically logs details of all trips accepted and undertaken by each driver, which will be used to account for each trip’s transaction.
- 2Go will provide Lannister with a copy of a system-generated summary of all the 2Go trips undertaken by each car to support the kilometre amount paid over.
- 2Go will return the cars to Lannister’s used car fleet at the end of June 2020. 2Go will have the option to buy the cars from Lannister on that date for 65% of their market value.

The directors of Lannister regard the proposed transaction with 2Go as a way to improve the company’s profits, while also making a positive social impact in South Africa. The directors plan to sign the contract with 2Go as soon as possible.
3 Service level agreement with AirBook

AirBook is a company which provides online accommodation bookings through its own website. Lannister and AirBook signed an SLA on 1 January 2015. In terms of the SLA, Lannister receives revenue from AirBook for advertising and referral services that Lannister provides. The revenue from AirBook makes up about 5% of the total monthly revenue of Lannister.

The SLA includes the following terms and conditions:

- A banner to advertise AirBook must be prominently displayed on Lannister’s website.
- The banner includes an icon (‘click here icon’) which redirects customers that visit Lannister’s website to AirBook’s website when the customer clicks on the icon.
- A referral icon to AirBook’s website after a customer makes a reservation with Lannister. If customers make reservations with Lannister an additional icon appears asking the customer if they would like to book accommodation through AirBook for the same period. If customers click on this referral icon they are directed to the AirBook website where their information is prepopulated in a booking enquiry.
- The SLA stipulates the following fees:
  - A quarterly fee is paid in advance by AirBook to Lannister for the display of the banner.
  - A fee payable by AirBook to Lannister for each customer redirection. The amount of the fee depends on whether the customer is (1) redirected from the banner advert or (2) redirected after having made a reservation with Lannister (at which point additional customer-specific information is already collected).

Each time a user of Lannister’s website is redirected to AirBook’s website through the AirBook icons programmed on the Lannister website, it is logged on both the SmartAccounts and AirBook systems.
Extract of the system description for the recognition of revenue of Lannister’s car rental division

Customers can only book rental cars via Lannister’s website, by visiting www.lannisterrentals.co.za. All bookings take place directly on the SmartAccounts application system of Lannister. Lannister only accepts valid credit cards for making bookings and payment for car rentals. Lannister uses firewalls which are updated continuously by BIT. All electronic communications between Lannister’s system and all other parties and devices are appropriately secured and function optimally.

1 Lannister car rental services – booking of rental cars

At the time of making a booking, a customer is required to provide personal, credit card and driver information as well as destination information and dates.

The system prepares a quote for the customer. The quote contains a message that informs the customer that –

- no changes are allowed to bookings once they have been accepted by the customer;
- if the car is not collected for rental on the exact booked date, the customer’s credit card will be charged for the full amount of the quote on the day after collection should have occurred;
- the customer receives 200 km free travel per day and any distance travelled above this is subject to an additional charge;
- a specified amount of credit available on the credit card will be placed on hold when collecting the rental car to ensure that the customer’s credit will be sufficient to cover the expected car rental charges; and
- the customer is required to take full insurance on the vehicle rented.

The customer is then prompted to tick a box to indicate agreement with these terms and conditions. Once ticked, the customer is prompted to change the booking or accept the quote.

Once the customer accepts the quote, the system generates a unique, pre-numbered preliminary invoice. The system automatically sends a copy of the preliminary invoice, with full details of the booking, to the customer’s email address as well as an SMS to the customer’s contact number with a unique, system-generated security code that the customer is required to use at the time of collection of the rental car.

2 Lannister car rental services – collection of rental cars

Once the customer arrives at the Lannister Car Rental counter at the selected office, he/she is allocated a rental facilitator. Rental facilitators use SmartReaders to process customers’ collection of rental cars. Each SmartReader is a state-of-the-art, mobile, Wi-Fi enabled, smart reader with a biometric key lock. All SmartReaders are fully integrated with Lannister’s SmartAccounts application system by means of a private network. Lannister operates its car rental business in a completely paperless environment.
The rental facilitator uses the SmartReader to read the magnetic strip on the customer’s credit card and the bar code on the customer’s drivers’ licence. The system automatically matches the information with the details provided when placing a booking. The details of the booking appear on the SmartReader’s screen. The rental facilitator then uses the SmartReader to read the barcode on the relevant car’s windscreen and the car’s kilometre reading on the car’s control console.

The system and the screen of the SmartReader are updated with the details of the car as well as the kilometre reading at the time of collection. The SmartReader then displays a message that requires the customer to enter the unique, system-generated security code that was received via SMS at the time of the booking into the SmartReader as confirmation of agreement with the information of the car.

As soon as the customer enters the security code, the system charges the customer’s credit card with the payment as per the preliminary invoice and passes journal entries for the rental income and payment received. The system also generates a hold on the customer’s credit card (for the amount specified at the time of the booking) and passes a journal entry to account for it.

The rental facilitator then releases the car to the customer.

3 Lannister car rental services – return of rental cars

When the customer returns the rental car, a rental facilitator takes delivery of the car. The rental facilitator uses a SmartReader to read the barcode on the car’s windscreen and the kilometre reading on the car’s control console.

The system is updated with the details of the car, the kilometres travelled at the time of return and if necessary, the date. The system then calculates the excess kilometres travelled by the car (in excess of the 200 km per day included in the preliminary invoice), records the journal entries for the additional revenue, generates a final invoice, and processes payment against the customer’s credit card.

The hold on the customer’s credit card is then released.
Fixed assets – understanding the rental car fleet

Lannister’s car rental fleet consists of some 6 000 vehicles at any given point in time.

Rental cars are carried at cost less accumulated depreciation and impairment losses in terms of IAS 16 *Property, Plant and Equipment*. Depreciation is calculated over a two-year period from the date of purchase and all rental cars have a residual value equal to 25% of their cost.

The managers of each of Lannister’s rental outlets are responsible for safeguarding the rental cars under the control of the outlet. Each outlet’s manager is required to send a monthly report to Lannister’s head office that confirms the existence of each rental car under the control of the outlet and describes any operational problems of or damage to rental cars. Evidence of damage to rental cars is also provided by means of photographs. Mr Petyr Baelish, the asset controller at Lannister’s head office, uses the monthly reports from outlet managers to perform the impairment calculation. Ms Stark signs these calculations as approval and Mr Baelish passes the necessary journal entries to update the accounting system.

The fixed asset register of Lannister is fully automated and integrated with the company’s *SmartAccounts* system and its general ledger.

The following are fields contained in the fixed asset register specifically for each rental car:

- Registration number
- Vehicle identification number
- Description of vehicle
- Date of first registration in the name of Lannister
- Date of transfer to used car division
- Cost price
- Depreciation rate
- Residual value
- Carrying amount: 1 July 2015
- Opening balance, at cost
- Opening balance: Accumulated depreciation and impairment losses
- Depreciation for the current financial year
- Carrying amount: 30 June 2016
- Closing balance, at cost
- Closing balance: Accumulated depreciation and impairment losses.
The required section of this question consists of two parts. Answer each part in the correct, separate answer book.

<table>
<thead>
<tr>
<th>QUESTION 1 PART I – REQUIRED</th>
<th>Marks</th>
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<tbody>
<tr>
<td></td>
<td>Sub-total</td>
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<tr>
<td>(a) Identify and discuss the risks of material misstatement at the overall financial statement level with regard to Lannister, evident from the section headed, ‘Background information’, for FY2016.</td>
<td>14</td>
</tr>
<tr>
<td>Communication skills – clarity of expression</td>
<td>1</td>
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<tr>
<td>(b) Describe specific overall audit responses to the risks identified in part (a).</td>
<td>16</td>
</tr>
<tr>
<td>Communication skills – logical argument</td>
<td>1</td>
</tr>
<tr>
<td>(c) Based on the information provided in workpaper C100, design key controls, in addition to those already described in the workpaper, which should be in place to mitigate the risks of material misstatement related to its car rental revenue.</td>
<td>18</td>
</tr>
<tr>
<td>Communication skills – clarity of expression</td>
<td>1</td>
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<tr>
<td>(d) Based on the information provided in workpaper F200, describe the substantive audit procedures applicable to the valuation of the rental car fleet of Lannister for FY2016. Ignore audit work relating to the following:</td>
<td>18</td>
</tr>
<tr>
<td>• Obtaining appropriate audit evidence on the opening balance of the rental car fleet asset; and</td>
<td></td>
</tr>
<tr>
<td>• Evaluating the impact of the idle rental cars discussed under ‘Potential business contract with 2Go’.</td>
<td>1</td>
</tr>
<tr>
<td>Communication skills – clarity of expression</td>
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<tr>
<td>Total for part I</td>
<td>70</td>
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The required section of this question consists of two parts. Answer each part in the correct, separate answer book.

### QUESTION 1 PART II – REQUIRED

<table>
<thead>
<tr>
<th>Marks</th>
<th>Sub-total</th>
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</tr>
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<tbody>
<tr>
<td>(e)</td>
<td>Identify and outline the key factors that Lannister should consider from a business and strategic perspective prior to entering into the proposed agreement with 2Go.</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Communication skills – clarity of expression; logical argument</td>
<td></td>
</tr>
<tr>
<td>(f)</td>
<td>Identify and discuss Lannister’s performance obligations included in the SLA with AirBook, including how the performance obligations should be recognised and measured, in terms of IFRS 15 Revenue from Contracts with Customers.</td>
<td>8</td>
</tr>
<tr>
<td>Total for part II</td>
<td></td>
<td>30</td>
</tr>
<tr>
<td>Total for the question</td>
<td></td>
<td>100</td>
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