

Comedy Hour Inc. (Recommended Time: 90 minutes)

Shirley and Adam Whalen are the stars of the hit online podcast “Comedy Hour”. The show provides a weekly dose of topical satire that manages to be both thought provoking and uproariously funny, and its target audience is adults from 21 to 35 years old. The show quickly gained most of its viewers through message boards on various Internet sites and now runs in syndication in over 30 countries. The show is distributed online via provider of on-demand Internet streaming media like Netflix.

Comedy Hour Inc. (CHI) produces and distributes the Comedy Hour show, and is privately owned by Shirley and Adam. Each owns 50 common shares in CHI. CHI generates its revenues by distributing the Comedy Hour show and earning advertising revenues through the Comedy Hour website. CHI has been profitable since its start-up four years ago. Shirley and Adam have a guaranteed three-year contract beginning April 1, 2016 for the Comedy Hour show with providers of on-demand internet streaming media and therefore expect the show revenue to grow at the same rate it is expected to grow in 2015. Excerpts from the unaudited financial statements for the year ended March 31, 2014 (and forecasted income statement for 2015) are found in Exhibit I. Shirley and Adam are heavily involved in the management of CHI and, as a result, its operations have been described by others as “smooth, efficient, and productive.”

Given the immense popularity of the show, Shirley and Adam decided, in early November, to market for the first time a line of products including Funky T-shirts, hoodies and their trademark photo frames, through CHI. Because the Internet played an integral role in their rise to fame, they have decided to sell their products on their Comedy Hour website. Shirley and Adam anticipate sales from these products to be around \$4 million in the first year (2016). However the new venture is not expected to add significant profit to CHI as the main reason for the venture is to market Comedy Hour and extend the series’ life. Product sales are anticipated to grow at the same rate as existing CHI revenues.

Shirley and Adam want to focus on the production aspects of CHI, so they are going to outsource the merchandising operations. They have been approached by Flipdeals Inc. (FD), a reputable company that has signed several new service agreements in the last 12 months. FD’s customers are said to be very happy with their services. FD takes a unique approach, by making an investment in their customers’ businesses, taking an ownership interest as part of the service agreement (Exhibit II). Neither Shirley nor Adam had considered selling an ownership interest in CHI. However, with no experience in merchandising and given the key role merchandising will play in the continued success of CHI, they believe they need to consider the option. To help assess whether FD is the right partner, Shirley and Adam want to test FD’s controls. CHI has gained a good reputation, and the last thing Shirley and Adam want are dissatisfied customers.

On September 5, 2015, Shirley and Adam held an initial meeting with Dwyane Clarke, the partner-in-charge of the CHI engagement, to present him with the details of the proposed agreement and to seek his advice whether they should proceed. They are in the final stages of negotiation and FD has been willing to provide additional information to help Shirley and Adam reach their decision.

It is now December 15, 2015. Dwyane calls you, CPA, into his office. After bringing you up-to-date on the situation, he adds:

While FD and its auditors acknowledge that a report on internal controls at a service organization would be useful, one could not be completed in the required time frame. However, as an interim solution, FD has offered as part of the contract agreement to allow us, as CHI's representative, access to FD's premises and records to review the relevant processes and controls. After discussion with Shirley and Adam, I've decided to carry out specified audit procedures to test the relevant controls. However, FD wants to approve the detailed listing of procedures beforehand, so I need you to draft a list of specific audit procedures to be presented to FD for approval.

The same processes are apparently used by FD for all its customers. I'd like you to provide Shirley and Adam with a description of the key processes and controls, including the general IT controls that are necessary in the circumstances, based on FD's description of the customer ordering, inventory purchasing, warehousing, distribution, and billing and collections processes (Exhibit IV). If you notice any deficiencies in the controls or notice areas where the documentation is unclear, document them so that we can inform FD on behalf of Shirley and Adam. We'll present our findings to Shirley and Adam in a couple of weeks.

Since I'm quite busy, I'd appreciate you drafting a separate report to Shirley and Adam assessing FD's proposal. I jotted down some comments from Shirley and Adam that could be relevant (Exhibit III).

EXHIBIT I - Draft Financial Statements (Unaudited)

COMEDY HOUR INC

As at March 31, 2014

(in thousands of dollars)

	<u>2014</u>
<u>Assets</u>	
Current assets	
Cash	\$ 512
Accounts receivable	2,340
Other current assets	<u>2,812</u>
	5,664
Show production costs (note 1)	24,792
Property, plant and equipment	13,112
	<u>\$ 43,568</u>
<u>Liabilities</u>	
Current liabilities	
Accounts payable	\$ 7,483
Other current liabilities	4,796
Current portion of long-term debt	<u>4,000</u>
	16,279
Long-term debt	<u>24,000</u>
	<u>40,279</u>
<u>Shareholders' equity</u>	
Common shares	100
Retained earnings	<u>3,189</u>
	3,289
	<u>\$ 43,568</u>

Note 1: Show production costs are expensed over the life of the contract.

COMEDY HOUR INC

For the Year ended March 31, 2014
(in thousands of dollars)

	2014 <u>(unaudited)</u>	2015 <u>(forecasted)</u>
Revenues		
Show distribution	\$ 16,547	\$ 19,856
Advertising	9,089	10,907
	<u>25,636</u>	<u>30,763</u>
Expenses		
Show production costs (note 1)	8,273	9,928
Salaries – non-production	3,745	4,494
Marketing and advertising	2,827	3,392
Amortization	3,425	3,562
General and administration	2,135	2,349
Interest	1,932	1,656
	<u>22,337</u>	<u>25,381</u>
Income before taxes	3,299	5,382
Income taxes	1,188	1,938
Net income	<u>2,111</u>	<u>3,444</u>
Retained earnings, beginning of period	2,063	3,189
Dividends	985	1,000
Retained earnings, end of period	<u>\$ 3,189</u>	<u>\$ 5,633</u>

EXHIBIT II – FlipDeals Offer Details

FD has vast experience in merchandising products on the Internet. We understand inventory management and product availability are critical to the overall success of any outsourcing arrangement. FD works hand in hand with companies to arrange the manufacturing or importing, the warehousing, the distribution of the products, and handles all the billings and collections. Over the past two years, 20 new customers have benefited from our expertise in these areas.

FD agrees to purchase shares to be issued by CHI, representing a 20% ownership stake in CHI, for \$7 million in cash on April 1, 2016. In addition, FD will receive a yearly management fee of 10% of CHI's total net income. In exchange, FD will provide the following services and related goods:

- Develop the transactional portion of the Comedy Hour website so that it can run with the FD systems starting April 1, 2016;
- Purchase, warehouse, and distribute inventory (which includes ownership of the inventory and the risk of inventory obsolescence); and,
- Provide customer billing and collection services on behalf of CHI.

CHI will be responsible for marketing and advertising the merchandising component of the Comedy Hour website. FD will absorb all other costs. FD's yearly goods and services fee will be \$1 million a year plus 35% of any merchandising revenues generated over a threshold of \$1 million.

Upon request, representatives of CHI, as is the case with all FD partners, are allowed an unaccompanied inspection of our premises, including the computer processing and storage rooms. We are sure they will meet your quality standards.

EXHIBIT III – Shirley and Adam's Additional Comments

Since CHI will be responsible for the marketing and advertising component of the Comedy Hour website related to the merchandise, Shirley and Adam will hire two customer service representatives. They will start work on April 1, 2016 at an average starting salary of \$62,000 each. Shirley and Adam also anticipate increasing their marketing and advertising spending by 50% in the first two years to promote their products.

General and administration costs are expected to increase 10% in the first year due to the added operational management time and costs. They are then expected to remain at that increased level. Adam also suspects that employee training will be required around the use of the new website. He estimates those costs will be around \$500,000.

Shirley and Adam have heard that the rate of return for production and production-related businesses is generally 15%.

Shirley and Adam are not sure what they will do with the \$7 million CHI will receive from FD. For now, CHI will invest it at an expected rate of return of 8%.

EXHIBIT IV – Key Processes at FD

Because FD will be performing many of CHI's operational activities, we have provided a description of some of our key processes in the purchasing, warehousing, distribution, and billing and collection areas.

- Customers will not be able to differentiate between the portion of the website managed by CHI and the transactional portion managed by FD. In other words, the entire website will be perceived to be the website of Comedy Hour.
- Because FD has affiliations with other companies, FD reserves the right to use CHI's customer data to solicit sales for FD's other business partners.
- Customers will conduct all ordering via the transactional website that FD will develop and manage.
- To place an order, customers will indicate the number of units of each product they wish to order. They will then enter their delivery address, and either their credit card number or their billing information on the same screen. Once the customer clicks on "Submit," data will be immediately uploaded to the automated inventory management system housed by FD, as well as to the sales and cash receipts journals.
- The current inventory system segregates the product for delivery to the customer. Warehousing personnel will have access to the "segregated inventory" list to prepare and deliver daily shipments. All shipments will be delivered within 48 hours.
- The warehousing system is equipped with "just in time" (JIT) features that ensure adequate inventory is on hand to prevent delays in shipping. The JIT system determines inventory requirements based on the product's ordering history.
- All inventory personnel have access to the inventory management and JIT systems. If they notice a variance in actual inventory levels compared to reported levels, they make the necessary adjustments in the inventory system.
- Billing clerks are responsible for matching the sales (as indicated in the journal) with delivery slips based on their method of payment (either by credit card or by cheque).
- Billing clerks issue refund cheques when customers return items.
- Collections are received either from the credit card companies (directly deposited in the bank) or from customers paying for their purchases by cheque.
- Receivable clerks match the receipts with customer accounts to ensure they are complete and properly recorded.
- Billing clerks have full access to the accounts receivable sub-ledger and cash receipts journal to ensure that any billing errors are promptly corrected.
- Receivable clerks follow up on uncollected amounts exceeding 65 days.

IT controls include the following:

- All data entered on the website will be encrypted.
- CHI data will be stored on a mainframe that houses all the data from other companies that FD partners with.

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- The mainframe is stored in a locked, secure room near the president's office.
- Program changes are conducted by in-house technicians who have full access to live production data to make their changes so that services are not interrupted. Once a change is made, the technician prepares a short report providing details of that change and submits the report to the president.
- All system uploads are conducted automatically. If something goes wrong with the upload, the system itself will page the IT manager for assistance, who will respond as quickly as possible.