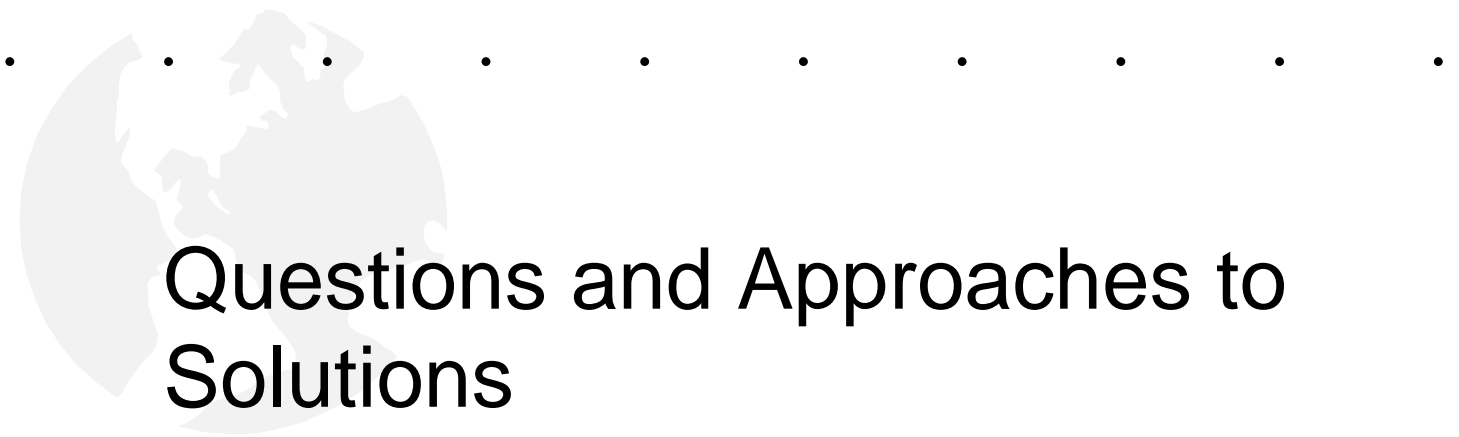




CARE Chartered Accountant Reciprocity Examination 2005

The Institutes of Chartered Accountants in Canada and Bermuda



Questions and Approaches to Solutions

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Chartered Accountant Reciprocity Examination
Summary of Results

Institute	2005		2004		2003	
	Number of Writers	% Pass	Number of Writers	% Pass	Number of Writers	% Pass
British Columbia	19	90	15	80	22	95
Alberta	6	33	8	100	6	83
Saskatchewan	1	100	-	-	-	-
Ontario	55	60	61	75	54	80
Quebec	2	0	2	50	-	-
New Brunswick	-	-	-	-	-	-
Nova Scotia	-	-	-	-	-	-
Newfoundland	-	-	1	100	-	-
Total	83	64	87	78	82	84

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA
CA RECIPROCITY EXAMINATION

DAY ONE – 2005

(100 marks) (3 hours)

NOTES TO CANDIDATES:

1. There are **12 questions and 17 pages** in this examination (including the cover page, appendices and question 1 answer sheet).
2. **Do not** write your name on your examination envelope or answer papers. Use your candidate number only.
3. To assist in budgeting time during the examination, the number of minutes available for each question (calculated at approximately 1.8 minutes per mark) is shown at the beginning of each question.
4. Answers or parts of answers to examination questions will not be marked if they are recorded on the question paper.
5. **Ensure that the answer sheet for question 1**, attached as the last page of this examination, is detached and submitted with your other answer papers in the examination envelope provided.
6. It is recommended that you write your responses in **ink** and write on every other line.
7. Two tables are attached to the examination paper. No other reference sources are allowed.

Question 1 (8 marks) (14 minutes)

The question consists of **4 parts worth 2 marks each**. Select the best answer for each part. Indicate your answer by marking an “X” in the appropriate space on the answer sheet attached as the last page of the examination. If more than one answer is given for a part, that part will not be marked. Marks will **not** be deducted for wrong answers. Explanations given will not be taken into account. **When you have completed your answer sheet, detach it and submit it along with your other answer papers.**

(i) Financial Instruments

Financial Limited has recently issued a financial instrument with the following characteristics:

- The instrument is interest bearing, requiring semi-annual interest payments representing 3% of the face value of the instrument.
- The instrument is secured by a general charge on the tangible assets of the company.
- The principal is not repayable but is secured.
- The legal form of the instrument is debt.

In its year end financial statements, the company should account for the financial instrument in the following manner:

- a. As equity, since the principal is never repayable.
- b. As debt since debt is its legal form.
- c. As debt since the interest represents an obligation.
- d. As part debt and part equity.

Which of the above options **best** represent how the company should account for the financial instrument?

(ii) Contingencies

Countenance Inc. (CI) has guaranteed the debt of Simpatico Limited (SL). Recently, CI learned that SL may default on its debt (at least partially) and that CI might have to make good on its guarantee. The amount owing under the debt is \$4,000,000 and the full amount is due at the end of the month. SL has indicated that it will do its best to repay the debt although it may not be able to come up with the full amount. They are quite certain they will be able to repay \$3,000,000. The remaining balance is uncertain. CI is issuing its annual financial statements within the next week.

Question 1 (continued)

Which of the following **best** represent the course of action CI should take when preparing its financial statements which are GAAP constrained?

- a. Accrue the full \$1,000,000.
- b. Accrue \$500,000 which represents the midpoint.
- c. Do nothing since the default is not certain.
- d. Note disclose only.

(iii) Audit of Accounting Estimates

During the year end audit, the auditors of Complex Corp. (CC) discussed the need for an inventory obsolescence provision with company management. Management had accrued a provision of \$500,000. Materiality has been assessed at \$125,000. The auditors, after having done a substantial amount of work, determined that the provision should fall within a \$600,000 to \$700,000 range – with \$650,000 being the point estimate.

In the audit files, which of the following would **best** represent the amount of the misstatement?

- a. \$100,000 – the minimum amount
- b. \$0 – immaterial – no further action required
- c. \$200,000 – better to be more conservative
- d. \$150,000 – based on the point estimate

(iv) Date of the Auditor's Report

Which of the following statements is **not** true in connection with the date of the auditor's report?

- a. After the date of the auditor's report, management and the auditors have no further responsibility to seek further evidence or monitor events.
- b. The date of the auditor's report is intended to signify the date as of which the auditor expresses his opinion.
- c. The date of substantial completion of examination should be used as the date of the auditor's report.
- d. If, subsequent to the date of the auditor's report, the auditor finds it necessary to seek new evidence, he may have to revisit whether the date should be adjusted.

Question 2 (8 marks) (14 minutes)

Asset Retirement Obligations

Danon Inc. (DI) purchased a working gold mine from Energy Inc. (EI). DI plans to run the mine for five years after which it will retire the mine. Under the terms of the purchase and sale contract, EI has agreed to fill the mine in and reforest the area. Depending on the profitability of the mine, DI may be required to fill the mine in and reforest the area themselves. DI has a good business relationship with EI and would like to do additional deals in future. Prior to the sale, EI had no legal or contractual obligation to refill and reforest.

EI is in the process of completing its annual financial statements. EI and DI both have shares that trade on the national stock exchange.

Required:

Adopt the role of the company controller of EI and discuss the financial reporting issues related to the mine that has been sold.

Question 3 (8 marks) (14 minutes)

Future Income Taxes

Taxtime Limited (TL) suffered an operating loss of \$500,000 in 2005. Prior to that, the company had been profitable showing income before taxes of \$100,000 in each of the past five years. Tax rates are as follows:

2000 – 40%
2001 – 40%
2002 – 41%
2003 – 41%
2004 – 45%
2005 – 50%

There are no Future Tax Assets or Liabilities at the beginning of the 2005 year. Also, there are no temporary or other tax differences in the current year. The current loss is due to a one time incident whereby production was halted due to a fire in the factory. A new sprinkler system has been installed and the problem causing the fire has been rectified.

Required:

Prepare the tax journal entries for the 2005 and 2006 year ends. Explain all reasoning and any assumptions. Assume that in 2006, Taxable income is \$120,000 and the tax rate is 52%. How much of the tax loss if any can be used after 2006 to shelter future income?

Question 4 (12 marks) (22 minutes)

Not for Profit Organizations

Homes for Families (HFF) is a not for profit organization that builds homes for lower income families. In return the families negotiate a mortgage they can afford and volunteer a specified number of hours for HFF.

HFF is able to build and construct affordable homes through donations of cash, materials and volunteer time. During 2005, HFF received the following contributions:

- Land with an appraised value of \$1 million donated by the City of Goodwill for the building of new homes
- Five trucks with an appraised value of \$150,000 donated by a local car dealership
- 1,000 hours donated by skilled building tradesmen e.g. bricklayers, electricians
- 5,000 hours donated by unskilled volunteers
- \$2 million cash from fundraising events for any purpose
- \$3 million cash from corporate donations for the purchase of building materials

Required:

Prepare a report to the Board of Directors of HFF discussing the following:

Part A What is the appropriate method of accounting for the contributions identified above if HFF uses the restricted fund method of accounting with a separate restricted fund for building new homes? (8 marks)

Part B Identify **any differences** in the method of accounting for the contributions identified above if HFF uses the deferral method (without funds) of accounting? (2 marks)

Part C What is the size test for a not for profit organization and would HFF qualify under the size test for capital assets? (2 marks)

Question 5 (10 marks) (18 minutes)

Reporting Options

Vocations Incorporated (VI) is a private corporation incorporated in 2005 that lets individuals try out their dream jobs. Individuals sign up for one to five day apprenticeships at costs ranging from \$400 to \$10,000. Currently, VI has over 100 occupations to try ranging from driving a race car, being an announcer at a baseball game to being a chocolate maker. VI is owned by a brother and sister.

To facilitate obtaining occupations for apprenticeships, VI purchased investments in other companies during 2005 including:

- 2% interest in Major Football League
- 22% interest in T-Shirts Incorporated
- 50% interest in Chocolate Incorporated
- 90% interest in Landscaping Incorporated

Goodwill of \$100,000 was recorded on the purchase of Landscaping Incorporated.

You have been hired by VI to develop their accounting policies.

Required:

Prepare a report to the owners of VI discussing the following:

Part A Identify the reporting option available other than full GAAP for private companies including what is required to qualify. Is VI likely to qualify? (2 marks)

Part B What accounting concept is the basis for allowing the reporting option discussed in Part A and why? (2 marks)

Part C Identify the reporting options that exist in determining the accounting policies for investments and goodwill made by VI in 2005 if they qualify. (6 marks)

Question 6 (8 marks) (14 minutes)

Employee Future Benefits

Hard Times Incorporated (HTI) is a public company encountering financial difficulties. They are trying to negotiate with employees to save costs. Currently, HTI has a defined benefit plan for pensions. They are considering the implementation of a defined contribution plan for any new employees.

Required:

Part A Explain what a defined contribution plan is and how the cost if applicable, is determined for that period. (4 marks)

Part B What discount rate is used to determine interest costs? (2 marks)

Part C Why are the risks lower for HTI with a defined contribution plan? (2 marks)

Question 7 (8 marks) (14 minutes)

Communication with those having oversight responsibility for the financial reporting process

Private Inc. (PI) is thinking of going public by listing its shares on the national stock exchange. Auditor LLP (AL), the company's auditors, are considering the impact that going public will have on the audit of PI. Specifically, you have been assigned to outline the requirements to communicate with the Audit Committee of PI.

Required:

Prepare a memo outlining the GAAS requirements regarding Communication with the Audit Committee of PI.

Question 8 (8 marks) (14 minutes)

Fraud – Auditor’s Responsibility for Fraud or Error

Frank and Frank LLP (FF) have been the auditors of Gring Limited (GL) for many years. GL is a manufacturing company in its mature stage and is very stable, reporting consistent or slightly increasing revenues and profits annually. During the most recent year however, the competitive climate in which the company operates changed. The local market for the company’s products is saturated and this year, a foreign, low cost, high volume competitor entered the market and captured a large percentage of customers – many from GL. In addition, one of GL’s major customers is on the verge of bankruptcy.

These changes have come at a particularly bad time for GL since they had been planning an expansion into foreign markets. They had already approached the bank for additional financing and have been tentatively approved pending a review of the most recent annual financial statements.

Required:

Adopt the role of FF and identify the impact that these events might have on the upcoming year end audit. Specifically, discuss the procedures FF should take to deal with their responsibility to consider fraud and error.

Question 9 (12 marks) (22 minutes)

Quality Control

KBS Ltd. (KBS) is a medium sized public accounting firm that is growing quickly. KBS is in the process of formalizing a system of quality control standards and policies that are to be complied with by all professional staff.

Part A Explain why public accounting firms need a system of quality control. (2 marks)

Part B For each of the issues below provide examples of quality control policies that KBS should implement. (10 marks)

- a) Conflict of interest (1 mark)
- b) Prohibited investments owned by professional staff (1 mark)
- c) Assignment of engagement personnel (1 mark)
- d) Continuing Professional Development (1 mark)
- e) Internal review of engagements (2 marks)
- f) Monitoring quality control (1 mark)
- g) Confidentiality (1 mark)
- h) Complaints and allegations (2 marks)

Question 10 (8 marks) (14 minutes)

Review Engagements

You have recently been hired as a staff accountant for a local CA firm, Smith and Jones (S&J). S&J's client base consists mainly of reviews, compliance and preparing tax returns for small to mid-sized companies.

You are assigned to a review engagement with a senior accountant. Presently S&J's policy is to always obtain a bank confirmation. Due to time overruns on the inventory section, the senior needs to save time in order to meet the budget and would like to eliminate obtaining a bank confirmation. The senior has indicated that "cash is a pretty low-risk account and is either right or wrong and does not need to have that much time assigned to it".

The senior has asked you to review the handbook and document the key procedures that are required for review engagements. In addition, the senior wants you to determine whether obtaining a bank confirmation is necessary for a review engagement. The senior would also like you to provide examples of review procedures that can be performed for the cash account. The senior would like to present this report to the partners to support why obtaining a bank confirmation was not completed.

Required:

Prepare the report suggested by your senior.

Question 11 (4 marks) (8 minutes)

Fair Value

Generally accepted accounting principles (GAAP) permit and or require that certain items be measured at fair value. CICA Handbook – Accounting defines fair value as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act."

Although GAAP may not prescribe the method for measuring fair value of an item, they express a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available that is consistent with the objective of measuring fair value. Management will often use assumptions to determine fair value.

The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value and whether those assumptions are realistic and consistent.

Required:

What factors will the auditor need to assess to determine whether the assumptions regarding fair value are realistic and consistent?

Question 12 (6 marks) (12 minutes)

Annual Report

Natashia Caper, CA, in her role as auditor of BigGold Ltd. (BG), was reading the annual report. After reading the annual report of BG Natashia concluded that there were many inconsistencies between the audited financial statements and other information included in the annual report.

According to the CICA Handbook what is Natashia obligated to do in these circumstances?

TABLE I

PRESENT VALUE OF \$1 RECEIVED AT THE END OF THE PERIOD

<i>Periods</i>	Hence	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.98	0.97	0.96	0.95	0.94	0.93	0.93	0.93	0.92	0.91	0.90	0.89	0.88	0.88	0.87	0.86	0.85	0.85	0.84	0.83
2	0.96	0.94	0.92	0.91	0.89	0.87	0.87	0.86	0.84	0.83	0.81	0.80	0.78	0.77	0.76	0.74	0.73	0.72	0.71	0.69
3	0.94	0.92	0.89	0.86	0.84	0.82	0.82	0.79	0.77	0.75	0.73	0.71	0.69	0.67	0.66	0.64	0.62	0.61	0.59	0.58
4	0.92	0.89	0.85	0.82	0.79	0.76	0.76	0.74	0.71	0.68	0.66	0.64	0.61	0.59	0.57	0.55	0.53	0.52	0.50	0.48
5	0.91	0.86	0.82	0.78	0.75	0.71	0.71	0.68	0.65	0.62	0.59	0.57	0.54	0.52	0.50	0.48	0.46	0.44	0.42	0.40
6	0.89	0.84	0.79	0.75	0.70	0.67	0.67	0.63	0.60	0.56	0.53	0.51	0.48	0.46	0.43	0.41	0.39	0.37	0.35	0.33
7	0.87	0.81	0.76	0.71	0.67	0.62	0.62	0.58	0.55	0.51	0.48	0.45	0.43	0.40	0.38	0.35	0.33	0.31	0.30	0.28
8	0.85	0.79	0.73	0.68	0.63	0.58	0.58	0.54	0.50	0.47	0.43	0.40	0.38	0.35	0.33	0.31	0.28	0.27	0.25	0.23
9	0.84	0.77	0.70	0.64	0.59	0.54	0.54	0.50	0.46	0.42	0.39	0.36	0.33	0.31	0.28	0.26	0.24	0.23	0.21	0.19
10	0.82	0.74	0.68	0.61	0.56	0.51	0.51	0.46	0.42	0.39	0.35	0.32	0.29	0.27	0.25	0.23	0.21	0.19	0.18	0.16
11	0.80	0.72	0.65	0.58	0.53	0.48	0.48	0.43	0.39	0.35	0.32	0.29	0.26	0.24	0.21	0.20	0.18	0.16	0.15	0.13
12	0.79	0.70	0.62	0.56	0.50	0.44	0.44	0.40	0.36	0.32	0.29	0.26	0.23	0.21	0.19	0.17	0.15	0.14	0.12	0.11
13	0.77	0.68	0.60	0.53	0.47	0.41	0.41	0.37	0.33	0.29	0.26	0.23	0.20	0.18	0.16	0.15	0.13	0.12	0.10	0.09
14	0.76	0.66	0.58	0.51	0.44	0.39	0.39	0.34	0.30	0.26	0.23	0.20	0.18	0.16	0.14	0.13	0.11	0.10	0.09	0.08
15	0.74	0.64	0.56	0.48	0.42	0.36	0.36	0.32	0.27	0.24	0.21	0.18	0.16	0.14	0.12	0.11	0.09	0.08	0.07	0.06
16	0.73	0.62	0.53	0.46	0.39	0.34	0.34	0.29	0.25	0.22	0.19	0.16	0.14	0.12	0.11	0.09	0.08	0.07	0.06	0.05
17	0.71	0.61	0.51	0.44	0.37	0.32	0.32	0.27	0.23	0.20	0.17	0.15	0.13	0.11	0.09	0.08	0.07	0.06	0.05	0.05
18	0.70	0.59	0.49	0.42	0.35	0.30	0.30	0.25	0.21	0.18	0.15	0.13	0.11	0.09	0.08	0.07	0.06	0.05	0.04	0.04
19	0.69	0.57	0.47	0.40	0.33	0.28	0.28	0.23	0.19	0.16	0.14	0.12	0.10	0.08	0.07	0.06	0.05	0.04	0.04	0.03
20	0.67	0.55	0.46	0.38	0.31	0.26	0.26	0.21	0.18	0.15	0.12	0.10	0.09	0.07	0.06	0.05	0.04	0.04	0.03	0.03
21	0.66	0.54	0.44	0.36	0.29	0.24	0.24	0.20	0.16	0.14	0.11	0.09	0.08	0.06	0.05	0.04	0.04	0.03	0.03	0.02
22	0.65	0.52	0.42	0.34	0.28	0.23	0.23	0.18	0.15	0.12	0.10	0.08	0.07	0.06	0.05	0.04	0.03	0.03	0.02	0.02
23	0.63	0.51	0.41	0.33	0.26	0.21	0.21	0.17	0.14	0.11	0.09	0.07	0.06	0.05	0.04	0.03	0.03	0.02	0.02	0.02
24	0.62	0.49	0.39	0.31	0.25	0.20	0.20	0.16	0.13	0.10	0.08	0.07	0.05	0.04	0.03	0.03	0.02	0.02	0.02	0.01
25	0.61	0.48	0.38	0.30	0.23	0.18	0.18	0.15	0.12	0.09	0.07	0.06	0.05	0.04	0.03	0.02	0.02	0.02	0.01	0.01

TABLE II

PRESENT VALUE OF AN ANNUITY OF \$1 RECEIVED AT THE END OF EACH PERIOD

<i>No. of Periods Received</i>	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.98	0.97	0.96	0.95	0.94	0.93	0.93	0.92	0.91	0.90	0.89	0.88	0.88	0.87	0.86	0.85	0.85	0.84	0.83
2	1.94	1.91	1.89	1.86	1.83	1.81	1.78	1.76	1.74	1.71	1.69	1.67	1.65	1.63	1.61	1.59	1.57	1.55	1.53
3	2.88	2.83	2.78	2.72	2.67	2.62	2.58	2.53	2.49	2.44	2.40	2.36	2.32	2.28	2.25	2.21	2.17	2.14	2.11
4	3.81	3.72	3.63	3.55	3.47	3.39	3.31	3.24	3.17	3.10	3.04	2.97	2.91	2.85	2.80	2.74	2.69	2.64	2.59
5	4.71	4.58	4.45	4.33	4.21	4.10	3.99	3.89	3.79	3.70	3.60	3.52	3.43	3.35	3.27	3.20	3.13	3.06	2.99
6	5.60	5.42	5.24	5.08	4.92	4.77	4.62	4.49	4.36	4.23	4.11	4.00	3.89	3.78	3.68	3.59	3.50	3.41	3.33
7	6.47	6.23	6.00	5.79	5.58	5.39	5.21	5.03	4.87	4.71	4.56	4.42	4.29	4.16	4.04	3.92	3.81	3.71	3.60
8	7.33	7.02	6.73	6.46	6.21	5.97	5.75	5.53	5.33	5.15	4.97	4.80	4.64	4.49	4.34	4.21	4.08	3.95	3.84
9	8.16	7.79	7.44	7.11	6.80	6.52	6.25	6.00	5.76	5.54	5.33	5.13	4.95	4.77	4.61	4.45	4.30	4.16	4.03
10	8.98	8.53	8.11	7.72	7.36	7.02	6.71	6.42	6.14	5.89	5.65	5.43	5.22	5.02	4.83	4.66	4.49	4.34	4.19
11	9.79	9.25	8.76	8.31	7.89	7.50	7.14	6.81	6.50	6.21	5.94	5.69	5.45	5.23	5.03	4.84	4.66	4.49	4.33
12	10.58	9.95	9.39	8.86	8.38	7.94	7.54	7.16	6.81	6.49	6.19	5.92	5.66	5.42	5.20	4.99	4.79	4.61	4.44
13	11.35	10.63	9.99	9.39	8.85	8.36	7.90	7.49	7.10	6.75	6.42	6.12	5.84	5.58	5.34	5.12	4.91	4.71	4.53
14	12.11	11.30	10.56	9.90	9.29	8.75	8.24	7.79	7.37	6.98	6.63	6.30	6.00	5.72	5.47	5.23	5.01	4.80	4.61
15	12.85	11.94	11.12	10.38	9.71	9.11	8.56	8.06	7.61	7.19	6.81	6.46	6.14	5.85	5.58	5.32	5.09	4.88	4.68
16	13.58	12.56	11.65	10.84	10.11	9.45	8.85	8.31	7.82	7.38	6.97	6.60	6.27	5.95	5.67	5.41	5.16	4.94	4.73
17	14.29	13.17	12.17	11.27	10.48	9.76	9.12	8.54	8.02	7.55	7.12	6.73	6.37	6.05	5.75	5.47	5.22	4.99	4.77
18	14.99	13.75	12.66	11.69	10.83	10.06	9.37	8.76	8.20	7.70	7.25	6.84	6.47	6.13	5.82	5.53	5.27	5.03	4.81
19	15.68	14.32	13.13	12.09	11.16	10.34	9.60	8.95	8.36	7.84	7.37	6.94	6.55	6.20	5.88	5.58	5.32	5.07	4.84
20	16.35	14.88	13.59	12.46	11.47	10.59	9.82	9.13	8.51	7.96	7.47	7.02	6.62	6.26	5.93	5.63	5.35	5.10	4.87
21	17.01	15.42	14.03	12.82	11.76	10.84	10.02	9.29	8.65	8.08	7.56	7.10	6.69	6.31	5.97	5.67	5.38	5.13	4.89
22	17.66	15.94	14.45	13.16	12.04	11.06	10.20	9.44	8.77	8.18	7.65	7.17	6.74	6.36	6.01	5.70	5.41	5.15	4.91
23	18.29	16.44	14.86	13.49	12.30	11.27	10.37	9.58	8.88	8.27	7.72	7.23	6.79	6.40	6.04	5.72	5.43	5.17	4.93
24	18.91	16.94	15.25	13.80	12.55	11.47	10.53	9.71	8.99	8.35	7.78	7.28	6.84	6.43	6.07	5.75	5.45	5.18	4.94
25	19.52	17.41	15.62	14.09	12.78	11.65	10.68	9.82	9.08	8.42	7.84	7.33	6.87	6.46	6.10	5.77	5.47	5.20	4.95

ANSWER SHEET

Question 1

CANDIDATE NUMBER: _____

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY ONE - 2005

NOTE:

For each of the 4 parts below, indicate your answer by marking an "X" in the appropriate space.

DETACH THIS ANSWER SHEET from your question paper and submit it with your other answer papers in the examination envelope provided. Do not submit your examination question paper.

- (i) (a) _____ (b) _____ (c) _____ (d) _____
- (ii) (a) _____ (b) _____ (c) _____ (d) _____
- (iii) (a) _____ (b) _____ (c) _____ (d) _____
- (iv) (a) _____ (b) _____ (c) _____ (d) _____

THIS SPACE	

TOTAL	_____
	<u> X 2</u>

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY TWO – 2005

(100 marks) (3 hours)

NOTES TO CANDIDATES:

1. There are **7 questions and 15 pages** in this examination (including the cover page and the appendices).
2. **Do not** write your name on your examination envelope or answer papers. Use your candidate number only.
3. To assist in budgeting time during the examination, the number of minutes available for each question (calculated at approximately 1.8 minutes per mark) is shown at the beginning of each question.
4. Answers or parts of answers to examination questions will not be marked if they are recorded on the question paper.
5. It is recommended that you write your responses in **ink** and write on every other line.
6. Two tables are attached to the examination paper. No other reference sources are allowed.

SECTION A - TAXATION

Question 1 (10 marks) (18 minutes)

Pete Paris is the sole shareholder of Paris Inc., a Canadian-controlled private corporation. During the current year Paris Inc. earned net income in excess of \$1,000,000. The income was earned from the following sources:

- Active business income
- Interest income from investment in long-term bonds
- Dividend income from Canadian public companies
- Capital gains

Pete is concerned about the amount of tax being paid by the corporation and himself. Paris Inc. distributes half its after-tax profits to Pete annually in the form of dividends. Pete thinks that this results in half the income being taxed twice.

Required:

Describe the income tax treatment for each of the sources of income earned by Paris Inc., making recommendations where appropriate. Be sure to include the concept of integration in your discussion.

Question 2 (18 marks) (32 minutes)

This question consists of three parts. Each of the three parts is independent.

Michael Blanchfield purchased 100% of the issued shares of Sentry Select Inc., a Canadian company which owns and operates an assisted-living home for seniors in Ontario. The transaction closed on October 1, 2004. At that time the values of the assets owned by Sentry Select were as follows:

	<u>Cost</u>	<u>UCC/CEC</u>	<u>FMV</u>
Land	\$120,000	N/A	\$300,000
Building	240,000	\$190,000	290,000
Furniture and equipment	100,000	65,000	50,000
Computer equipment	12,000	6,000	8,000
Supplies inventory	55,000	N/A	52,000
Marketable securities	24,000	N/A	10,000
Incorporation & organization costs	10,000	1,000	500

Michael selected December 31, 2004 as the first fiscal year-end for Sentry Select after his purchase. The following is a schedule of Sentry Select's income and unused losses for the period January 1, 2003 through December 31, 2005.

<u>Period</u>	<u>Business Income</u>	<u>Taxable Capital Gain</u>	<u>Net Capital Loss</u>
January 1, 2003 - December 31, 2003	\$ (100,000)	\$Nil	\$ (22,000)
January 1, 2004 - September 30, 2004	(200,000)	Nil	Nil
October 1, 2004 - December 31, 2004	(70,000)	Nil	Nil
January 1, 2005 - December 31, 2005	40,000	10,000	Nil

Required:**Part A (12 marks)**

Assuming an election is **NOT** made by Sentry Select under paragraph 111(4)(e) of the *Income Tax Act* to recognize accrued gains or recapture,

- (i) Calculate the business loss for tax purposes for the period January 1, 2004 through September 30, 2004. **(3 marks)**
- (ii) State the tax value e.g.: Cost, ACB, UCC, or CEC for each of the assets at October 1, 2004. **(4 marks)**

Question 2 (continued)

- (iii) What conditions must be met in order for the non-capital losses incurred in the period January 1, 2003 through December 31, 2004 to be deductible by Sentry Select in 2005 and future taxation years? **(2 marks)**
- (iv) What is the maximum amount of non-capital losses that can be deducted for the year ended December 31, 2005? Explain. **(2 marks)**
- (v) What is the maximum amount of net capital losses that can be claimed for the year ended December 31, 2005? Explain. **(1 mark)**

Part B (4 marks)

Assume Michael expects to be able to use Sentry Select's losses by amalgamating Sentry Select with another corporation that he owns. Should Sentry Select make an election under paragraph 111(4)(e) of the *Income Tax Act* to recognize capital gains and recapture at September 30, 2004? Explain, including the benefit, if any, to Sentry Select of making such an election. Show all your calculations.

Part C (2 marks)

Michael is the sole shareholder of two other corporations, M Ltd. which operates a margarine distribution business with annual income of \$600,000 and R Ltd. which operates a retirement home with annual income of \$200,000. Both corporations are located in Ontario. Which one of these two corporations should be amalgamated with Sentry Select in order to save tax? Explain.

Question 3 (22 marks) (40 minutes)

Deborah Yedlin was employed by BBC Corp., a Canadian public company, until June 30, 2004 when she was forced to quit her job and retire due to serious injuries sustained in an automobile accident. She received payments from the employer’s sickness, accident, and income maintenance insurance plan totaling \$7,200 in 2004. The employer’s private medical insurance plan paid the hospital expenses of \$5,000. At her retirement party, her employer presented her with a diamond bracelet costing \$4,000 and a cheque for \$30,000 in recognition of her twelve years of valued service.

Between January 1 and June 30, 2004 Deborah received a salary of \$60,000. She negotiated contracts for her employer and was also paid 1% of the value of the contracts negotiated. As of June 30, 2004, this amounted to \$20,000 and was paid in two installments of \$10,000 each on October 15, 2004 and January 15, 2005. The following amounts were withheld from Deborah’s salary and remitted to the appropriate payees on her behalf:

Income tax	\$18,000
Canada Pension Plan and Employment insurance	2,600
Registered Pension plan	5,400

Deborah’s employer pays the premiums for private medical insurance (\$400 in 2004) and group sickness, accident, and income maintenance insurance (\$600 in 2004).

To carry out her duties of employment, Deborah used a company car that was also available for her personal use. She returned the car to her employer on June 30, 2004. She drove the car 8,000 km for business and 6,000 km for personal use in 2004. The employer purchased the car in 2002 for \$46,000, including PST @8% and GST, and has claimed the maximum capital cost allowance (CCA) since the purchase. Deborah’s employer also pays the operating costs for the car. These costs amounted to \$2,000 for January through June 2004.

Deborah repaid her \$100,000 interest-free employee loan on June 30, 2004. She received the loan on April 5, 2002 when the prescribed rate of interest was 2%. Deborah used half of the loan to assist with the purchase of her home and the other half to exercise an employee stock option on BBC Corp shares. She acquired 10,000 shares of BBC Corp at a cost of \$5 per share. The shares were trading on the stock market at that time at \$12 per shares. The stock option grant date was July 15, 2000 and at that time the shares were trading on the market at \$4 per share. Deborah filed an election with her 2002 tax return to defer the entire stock option benefit. The entire 10,000 shares of BBC Corp. were sold in 2004.

Deborah maintains an office in her home as required under her employment contract. This workspace is her only available office. Deborah estimates that approximately 10% of the total square footage of her home is occupied by her home office. Her home expenses for the entire 2004 year were as follows:

Question 3 (continued)

Mortgage interest	6,000
Property taxes.....	3,000
House insurance	600
Repairs and maintenance	1,200
Utilities.....	2,500
Office supplies consumed in the course of employment	800

On January 15, 2004, Deborah purchased a computer for \$4,000 on time payments. She incurred interest costs of \$220. Until her retirement, she used the computer for employment activities 80% of the time. She also leased a fax machine. The 2004 lease payments were \$300 to June 30th. She used the fax entirely for employment until her retirement.

Deborah was required by her employment contract to pay her own travel and entertainment costs incurred in carrying out her duties of employment. In 2004 she incurred the following expenses:

Fitness club membership	\$2,400
Advertising	800
Entertainment meals for clients	5,000
Meals for meetings out of town with clients (she was out of town for more than 12 hours on all occasions)	1,200
Travel costs (excluding automobile)	3,000
Accommodation for meetings out-of-town	1,800

Required:

Determine Deborah Yedlin’s net income from employment for 2004. Comment on any items that have been excluded from the calculation.

SECTION B - LAW

Question 4 (10 marks) (18 minutes)

Mobile Foods Inc. (“MFI”) is an entity which provides mobile catering services. In May, 2005, MFI acquired all the assets, and employees, of the soft ice cream division of Chapstick Ice Cream Inc. (“CICI”). Included in these assets were a series of ice-cream trucks that operated in residential neighbourhoods. Typically the neighbourhoods selected were ones heavily populated by young families with younger children. The ice-cream trucks operated by driving slowly down the residential streets, ringing bells and playing loud “carnival” type music from speakers mounted on the top of the truck. These trucks were generally able to charge a premium rate for ice-cream as the consumers were not very price sensitive.

Sarah Smiley was talking on her telephone with an old high school friend she had not spoken with for ten years. Sarah’s children, Mike (age 6) and her twins Jacqui and Jilly (age 3) heard the ice-cream music. They ran to their mother to ask for ice-cream. Sarah, while remaining on the telephone, gave a twenty-dollar bill to Mike and told him to watch his sisters.

The ice-cream truck was being driven by Tom James. James saw the three children on the opposite side of the road and stopped his truck abruptly. The three kids then darted across the street to be on the side of the road in the lane James was driving down. Jilly was first to order and ordered a chocolate sundae. Upon James passing it to her, she yelled, “I want Mommy to see this.” Jilly then ran from the ice-cream truck, where she was hit by a garbage truck driven by Frank Furter and operated by the City of Maintown. The garbage truck was full and was en route to a waste transfer station.

Jilly was badly injured by the impact. The other children were traumatized as well by seeing Jilly get struck.

A spokesperson for MFI has stated that they have no liability, in part because James was trained by CICI.

Required:

Prepare a memorandum which discusses and analyzes the basis of any claims which may be made on Jilly’s and her siblings’ behalf. Your memorandum should clearly identify the various defendants and discuss in details what would have to be proven, along with any defences that could be put forward by the defendants.

Question 5 (10 marks) (18 minutes)

Chris Lau, was recently drafted to become a hockey player by the Yourtown Bullcats hockey franchise. The Bullcats is a professional hockey franchise operating in a major Canadian city. Chris and his family were very proud of this accomplishment as Chris had just completed high school and was now destined to earn between \$500,000 and \$750,000 before any other commercial endorsements.

Chris had always been an avid fisherman. In celebrating his new professional hockey career, Chris and his brother Jonathan went together to Mermaid Boats Inc. (“MBI”). While at MBI, they met with Willie Fox, a salesperson at MBI. Fox showed the brothers a 2006 (model year) - 30 foot, Bass Cutter fishing boat – Model XP3. The boat that Fox showed them was on a boat trailer and was outfitted with an additional “back up motor” and fishing downriggers. The price was \$47,000.00. Chris indicated that he wanted that boat. Fox told him that the one they looked at was a “demo” but they had another Model XP3 at their other dealership location that was “almost the same”. Fox wrote up an invoice noting, “*2005 XP3 fishing boat*” *Price agreed to by customer - \$47,000.00 plus PST/GST*”. Chris left a \$40,000.00 deposit and signed an acknowledgement on the invoice.

The next day Chris went to his local Yoda dealership (“Yourtown Yoda”), where he looked at their line of pick up trucks. While there he picked up the Yoda brochure that described the Y1600 model pick up truck. The brochure described the pick-up as having a “towing capacity of 7,500 lbs”. Based on reading this, Chris purchased a 2006 Yoda Y1600 4x4 pick-up. He paid extra for their special tow package. Chris signed all the “standard dealership” documentation.

The next day Chris drove his new pick up to MBI to pick up his new boat. Chris saw the boat parked in the lot with a big “SOLD” sticker on it. However Chris was disappointed since although the boat was an XP3 it did not have any fishing equipment, nor a back up motor. As well, the upholstery on the seating was inferior to what he saw on the demo. He thought it generally looked “cheap”. To make matters worse, when Willie Fox came out, he told Chris that it would be another \$10,000.00 for the trailer that it was sitting on. When Chris said “I thought the trailer was included”, Fox answered, “You only bought a boat kid. He then showed Chris the invoice, which on the back stated, “*7. All prices quoted are for boats only. Boat trailer, pre-delivery inspection and administrative costs are all additional.*” Fox then said, “There is no way that your truck can tow a boat of this size. This baby weighs 6,000 lbs. and when it is coming out of the water at the dock you need way more power.”

Chris left MBI feeling rather frustrated and without a boat. Fox told him as he was leaving, “we got your \$40,000.00 and if you do not pick up the boat by tomorrow – we will resell it and keep your deposit for our damages.”

Chris went back to Yourtown Yoda. In response to a question about the towing capacity and the brochure, the salesman replied, “It may be a typo, but then again, it might be correct but based on your towing on a flat surface for a short distance. Those stats would not incorporate pulling a heavy trailer out of the water”. When Chris asked for a refund, the salesman told him, “Your

Question 5 (continued)

truck is used now, we will buy it back but will take \$15,000.00 off the original price for depreciation.”

You are a friend of Chris’ and have some knowledge of law. Chris does not feel very good about what has happened to him. He has asked you to prepare a memorandum to him that sets out the legal issues which relate to his boat and truck purchase and analyzes the issues. In particular, Chris would like to know if he may be able to get out of the contracts, or get his money back. Chris knows that if he goes to court that he would be the Plaintiff, and he wants to know who has the onus of proof in such a situation.

Required:

Prepare the memorandum requested.

SECTION C - RULES OF PROFESSIONAL CONDUCT

Question 6 (26 marks) (47 minutes)

In each of the unrelated situations outlined below, breaches or possible breaches of professional ethics have occurred or may occur or Rules of Professional Conduct may have been inappropriately applied.

Required:

In each situation, Part A, B and C, identify and discuss the relevant Rule(s) of Professional Conduct (and Council Interpretations) which should have guided the actions of the chartered accountant(s) (CA) or CA firm involved.

Part A (8 marks)

Charlie Lake, CA, practices as a public accountant in a small community. Until late 2003, Lake had been employed as the controller of a small manufacturer that manufactured parts for the automotive sector. Lake's employer has decided to re-locate and Lake decided not to make the move. Lake and his employer negotiated a severance package, wherein Lake received a lump-sum payment of \$50,000.00, in part for pension benefits foregone. The amount was paid to Lake in 2003. As Lake was the controller at year end, he was responsible for completing the tax information filings (e.g. employee T-4 slips etc.). Lake did not include the \$50,000.00 on the slip he prepared for himself, although he included similar payments on the tax information slips for other employees. Lake thought that these amounts were not taxable. Lake did not include the amount on his tax return when he filed his 2003 return in April 2004.

In February, 2005, Lake was retained by Sheryl Armstrong to prepare her personal tax returns for 2004. Armstrong provided the various information slips necessary to Lake. Armstrong also told Lake that she sold two pieces of property during 2004 and provided to Lake both the cost information along with the selling price. Lake included the sale of both properties as "capital gains" when completing the tax returns for Armstrong. Lake and Armstrong never discussed the nature of the transactions. At the time of completing the tax return for Armstrong, Lake had concerns about the high "cost" amount for one of the pieces of property. Lake was familiar with the location of the property and the cost data provided by Armstrong did not seem reasonable. Lake asked Armstrong to provide him with some support on the cost information, to which she responded, "I provide the info – you put it together. How I get the numbers is really none of your business."

In 2006 the tax return for Armstrong was selected by Canada Revenue Agency ("CRA") for audit. CRA denied the capital gains treatment on the sale of one of the properties – arguing that it was in fact business income. CRA is also reassessing the other disposition, claiming the amounts included are "incorrect and unsupported". CRA is considering whether the situation is in fact "evasion".

Question 6 (continued)

Armstrong called Lake and told him that “the tax returns you prepared and audited for me are all wrong.” When she told Lake that the capital gains treatment was denied, he responded, “I thought all land sales are capital gains.”

Lake reviewed his Armstrong file. The only document in it was a sheet of paper with Armstrong’s address and telephone number. Everything else that was in the file was shredded in order to save filing space.

Part B (10 marks)

Junko Financial Services Inc. (“JFSI”), a public company, is involved in the financial services sector, primarily in the leasing of capital assets to manufacturers. The leases are generally financing leases. The VP Finance at JFSI is Sarah Hall, CA. Hall obtained her CA designation in 1994 and for the years 2001 to 2003 was an audit partner with Lee, Jones LLP, Chartered Accountants. Hall was considered a “brilliant technical star” at the firm and was appointed by the other partners as the party responsible to develop quality and professional standards for the firm, a task she never had the time to complete. Her leaving was considered a major blow to the firm and no one else was appointed to replace Hall for this task.

In 2004, JFSI requested proposals for the selection of auditors. Three firms submitted proposals, including Lee, Jones LLP. The bids each included a quote for audit services. The Lee, Jones LLP proposal team was led by audit partner, Jerome Snooker, CA. Snooker who was also hired in 1994 has a close personal relationship with Hall and through this relationship was able to obtain information of the competitive proposals. The bid submitted by Lee, Jones LLP, was accordingly priced at \$10,000 less than the lowest bid, and this helped ensure that they obtained the audit. Hall had advised Snooker that once they had the audit, they could get all sorts of “other work”.

JFSI was growing rapidly. In 2004 JFSI incorporated a subsidiary, Dental Financial Resource Limited (“DFRL”). The long term objective is to have DFRL lease equipment to dentists and dental practices. Hall appointed Lee, Jones LLP as auditor of the DFRL as well. In the first year, DFRL had no active operations. The transactions at DFRL consisted primarily of setting up a bank account, paying the lawyers for the incorporation, paying a consultant for a business plan and some inter-company loans. Probably a total of 10 transactions in all. As a client service, Lee, Jones LLP, set up the original books, recorded the ten journal entries and prepared the opening and ending balance sheet. As operations had not commenced, all costs were capitalized as start up.

As a “by-product” of the JFSI audit engagement, the firm received “other work”, as promised by Hall, both from JFSI (e.g. tax and consulting) and from JFSI referrals. One such referral led to a meeting between Snooker and George Fifer, owner-manager of Fifer Construction Limited (“FCL”). Fifer and Snooker met to discuss if certain construction equipment was leased by FCL, if it could be treated by FCL as an operating lease, thereby not having a detrimental effect on the FCL debt:equity ratio. Snooker reviewed the draft lease agreement and wrote a letter to FCL

Question 6 (continued)

ensuring them that “in accordance with Canadian accounting standards, the said lease can be treated as an operating lease ...” FCL was billed \$2,500 for services rendered by Snooker. In addition, upon JFSI and FCL signing the lease, Lee, Jones LLP was paid a further “facilitation fee” of 2% of the gross lease payments.

Part C (8 marks)

James Richards, CA, was a close friend of Thomas Lopez for many years – going back to when they were both teenagers. Richards each year did the personal tax return for Lopez and his wife, Lorraine – generally not charging a fee. When Thomas started his own catering business, Lunches R’Us Inc. (“LRI”), Richards took on the role of business advisor and confidant. When LRI required a bank loan, Richards was appointed the public accountant responsible for completing a Review engagement (s. 8200).

In May 2003, Thomas Lopez died unexpectedly. In his Last Will and Testament (the “Will”), Thomas Lopez appointed Richards as Executor and Trustee. The Will established a spousal trust for Lorraine and provided that the shares of LRI be transferred to Frank Lopez and Sharon Lopez, the son and daughter of Thomas. The spousal trust required trust assets to be invested in a list of “conservative” investments.

Richards had a very busy public accounting practice and was caught unexpectedly in this new role. He tried his best to deal with his new responsibilities – but had limited time. Lopez had a fairly substantial stock portfolio, as well as several different series of Canada Savings Bonds. While administering the trust property, Richards did not consider the various risks associated with the stock portfolio and modify the investment mix. Richards also failed to renew Canada Savings Bonds as they became due, missing the opportunity for interest income. Richards also missed the trust tax reporting deadlines and when he filed the trust tax returns, he failed to include certain income and claim allowable deductions.

Richards did manage to transfer the shares of LRI to the children, who in turn appointed a national public accounting firm as auditors. When this new firm contacted Richards regarding the engagement and to access some of his working papers, Richards failed to reply.

Lorraine, Frank and Sharon each contacted Richards to request an accounting of the various trust assets and the administration of the Will. Over two years had passed without any accounting or update. The only response from Richards was a telephone call stating, “the work is in progress.”

Lorraine, Frank and Sharon subsequently contacted the provincial Institute of Chartered Accountants to launch a complaint. Letters sent to Richards by the Institute received no reply. A subsequent visit by an Institute investigator resulted in the receipt of the necessary information.

Question 7 (4 marks) (7 minutes)

“A member or firm engaged in the practice of public accounting or in a related business or practice shall, before accepting any professional engagement, determine whether there is any restriction, influence, interest or relationship which, in respect of the proposed engagement ...” which would result in a conflict of interest.

Required:

Dealing with and avoiding conflicts of interest is an important part of practice management. Briefly describe the three main types of conflicts that may arise and the process for dealing with conflicts of interest.

TABLE I

**A FORMULA FOR CALCULATING THE PRESENT VALUE OF
REDUCTIONS IN TAX PAYABLE DUE TO CAPITAL
COST ALLOWANCE**

$$\text{Investment Cost} \times \text{Marginal Rate of Income tax} \times \text{Rate of Capital Cost Allowance} \times \left(1 + \frac{\text{Rate of Return}}{2} \right)$$

$$\left(\text{Rate of Return} + \text{Rate of Capital Cost Allowance} \right) \times \left(1 + \text{Rate of Return} \right)$$

**MAXIMUM
CAPITAL COST ALLOWANCE RATES
FOR SELECTED CLASSES**

Class 1	4%
Class 3	5%
Class 8	20%
Class 10	30%
Class 10.1	30%
Class 12	100%
Class 13	original lease period plus one renewal period (Minimum 5 years and Maximum 40 years)
Class 14	Length of life of property
Class 17	8%
Class 39	25%
Class 43	30%
Class 44	25%

SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

Maximum depreciable cost - Class 10.1	\$30,000 + GST
Maximum monthly deductible lease cost	\$800 + GST
Maximum monthly deductible interest cost	\$300

Operating cost benefit – employee	17 cents per kilometre of personal use
Non-taxable car allowance benefit limits	
- first 5,000 km	42 cents per kilometre
- balance	36 cents per kilometre

TABLE II

2004 INDIVIDUAL FEDERAL INCOME TAX RATES
Income Tax Rate Schedule - Individuals

<u>Taxable Income</u>	<u>Tax</u>
\$35,000 or less	16%
\$35,001 to \$70,000	\$5,600 + 22% on next \$35,000
\$70,001 to \$113,804	\$13,300 + 26% on next \$43,804
\$113,805 or more	\$24,689 + 29% on remainder

**SELECTED NON-REFUNDABLE TAX CREDITS
 PERMITTED TO INDIVIDUALS
 FOR PURPOSES OF COMPUTING INCOME TAX**

The tax credits are 16% of the following amounts:

Basic personal amount	\$8,012
Married and equivalent to spouse amount	6,803
Net income threshold for married or equivalent amount	681
Age 65 or over in the year	3,912
Disability amount	6,486
Disabled dependents who reach 18 in the year	3,784
Net income threshold for disabled dependents 18 and over	5,368
Basic amount for:	
Age credit and GST credit	29,123
Child tax benefit	34,592
OAS clawback	59,790

CORPORATE FEDERAL INCOME TAX RATE

The tax payable by a corporation under Part I of the Income Tax Act on its taxable income is 38% before any additions and/or any deductions.

PRESCRIBED INTEREST RATES

<u>Year</u>	<u>Jan. 1 - Mar. 31</u>	<u>Apr. 1 - June 30</u>	<u>July 1 - Sept. 30</u>	<u>Oct. 1 - Dec. 31</u>
2004	5	5		
2003	5	5	6	5
2002	5	4	5	5
2001	8	8	7	7
2000	7	8	8	8
1999	7	7	7	7

The rate is 2 percentage points higher for late or deficient income tax payments and unremitted withholdings.

The rate is 2 percentage points lower for deemed interest on employee and shareholder loans.

Introduction

The solutions outlined in the following material represent comprehensive approaches to questions and are based on the full range of available marks. They do not represent responses that candidates could realistically expect to produce in the prescribed time limits. The solutions provide examples of how issues can be dealt with and do not represent the only acceptable responses.

References to sections of the CICA Handbook, the Income Tax Act and the Rules of Professional Conduct have been included solely to assist candidates in their review.

Question 1 (8 marks) (14 minutes)

i) Financial Instruments (CICA HB 3860)

The correct answer is (c) since the requirement to pay interest creates a liability. The value of the instrument is driven by the present value of the interest payments (CICA HB 3860)

(A) is incorrect since the interest is what creates the value. (B) is incorrect since the instrument should be accounted for according to its economic substance rather than its legal form. (D) is incorrect as noted above. There would be no value attributed to the principal.

ii) Contingencies (CICA HB 3290)

The correct answer is (d). The amount would be accrued only if the loss was likely and measurable. There is no indication that a loss will be likely nor is the potential amount measurable. It could be anywhere between \$0 and \$1,000,000.

(A) is incorrect as noted above. Likewise, (b) is incorrect. Where an amount is more likely to occur than other amounts in a range, that amount would be accrued however, the midpoint of the range is no more likely to occur than other points in the range. Where no amount is any more likely to occur than any other amount in a range, the minimum amount would be accrued (CICA HB 3290.13). (C) is incorrect since the occurrence of the future event is not determinable (CICA HB 3290.15).

iii) Audit of Accounting Estimates (CICA HB 5305.06)

The correct answer is (d). The best estimate appears to be \$650,000 and therefore the amount accrued is less than this amount by \$150,000.

(B) is incorrect as the misstatement would not be deemed to be immaterial as it would have to be considered with other potential misstatements in order to determine if Net Income were misstated on a cumulative basis. (A) and (c) are incorrect since the point estimate represents the best estimate within the range.

iv) Date of the Auditor's Report (CICA HB 5405.02)

The correct answer is (a). Management has a continuous responsibility to monitor events and consider their impact on the financial statements. The auditor may have to revisit the audit report and the financial statements if facts or events subsequently come to his attention that may affect the financial statements or his opinion (CICA HB 5405.02).

Question 1 (continued)

(B) is true per CICA HB 5405.02. (C) is true per CICA HB 5405.06. (D) is true per CICA HB 5405.07 and CICA HB 5405.08.

Question 2 (8 marks) (14 minutes)

Asset Retirement Obligations

The obligation to fill the mine in and reforest the area represents an asset retirement obligation as follows (CICA HB 3110.03 (a)):

- Represents a legal obligation since contractually based per purchase and sale agreement
- Associated with a tangible long-lived asset – the mine
- Required to be settled according to an existing contract.

EI should recognize this liability in the period in which it was incurred and when a reasonable estimate can be made (CICA HB 3110.05). Prior to the sale, there was no legal duty to do this (no law, statute, ordinance or contract or under the doctrine of promissory estoppel). The liability arose due to the sale.

The question arises as to whether the potential liability is estimable. EI may be able to get estimates for the filling and reforestation from a third party. These estimates of cash outflows would be discounted using a traditional or expected cash flow approach (CICA HB 3110.09). The expected cash flow approach provides the better estimate since an asset retirement obligation will usually have uncertainties in both timing and amount of cash flows (CICA HB 3110.09).

There is an additional factor adding to the uncertainty and that is DI may choose to waive the requirement and complete the site restoration themselves. This uncertainty may be factored into the measurement of the liability using the expected cash flow approach through assigning probabilities to various outcomes.

The liability would be remeasured each year to reflect the passage of time as well as any changes in the obligation (CICA HB 3110.16). Since the obligation does not relate to an income generating asset, the cost should be expensed and offset against any gain on sale. Subsequent changes in the liability would be expensed as a change in estimate (CICA HB 3110.19).

Question 3 (8 marks) (14 minutes)

Future Income Taxes

The loss may be carried back three years and forward seven years to shelter operating income.

TL may therefore carry the loss back to 2002, 2003 and 2004 to recover the following amounts of taxes:

$$2002 = \$100,000 \times 41\% = \$41,000$$

$$2003 = \$100,000 \times 41\% = \$41,000$$

$$2004 = \$100,000 \times 45\% = \$45,000$$

Dr. Income taxes receivable	\$127,000
Cr. Current tax benefit	\$127,000

The remaining \$200,000 in losses would be carried forward as long as it is more likely than not that the benefits of the loss will be recognized. In this case, since the loss appears to be a one time loss (the cause has been isolated and rectified) and since past history would indicate an otherwise profitable company, it appears that the benefits from the \$200,000 loss will be more likely than not to be realized (CICA HB 3465.24). Therefore, the benefit may be recognized in 2005 at the current rate (which is the best estimate of the future rate) as follows:

$$\$200,000 \times 50\% = \$100,000$$

The remainder of the journal entry would therefore be as follows:

Dr. Future tax asset	\$100,000
Cr. Future tax benefit	\$100,000

In 2006, the company would pay no current taxes since the \$120,000 income would be sheltered by \$120,000 of the \$200,000 remaining tax loss. The following journal entry would be booked to adjust the Future tax asset:

Dr. Future tax benefit	\$62,400
Cr. Future tax asset	\$62,400

(\$120,000 X 52%)

Note that \$120,000 of the tax loss is therefore used up and only \$80,000 remains to shelter future income.

Question 4 (12 marks) (22 minutes)

Not for Profit Organizations – Contributions and Capital Assets (CICA HB 4410 and 4430)

Part 1 – Accounting for Donations – Restricted Fund Method of Accounting

Land

Donated land appraised at \$1 million could be recognized since a fair market value can be estimated (CICA HB 4410.16) (not a capital asset) and the land would be used in the construction of homes. Land could be treated as inventory. Land would be recognized in the restricted fund since the land has an external restriction to be used for the construction of homes.

Truck

Donated trucks appraised at \$150,000 could be recognized since a fair market value can be estimated and the trucks can be used in operations e.g. delivering supplies to sites. Trucks would be recognized in the general fund since there is no external restriction. The trucks would be amortized over the useful life of the asset.

Volunteer Hours

Volunteer hours (5,000 and 1,000) are usually not recorded since it is hard to estimate the fair market value. Volunteer hours for skilled workers (1,000) could be recognized if the fair market value is available (CICA HB 4410.16). This is likely since skilled workers would be used in the construction of houses.

\$2 million cash from Fundraising

The \$2 million cash contribution from fundraising events should be recognized in the general fund since there is no external restriction on the funds. The cash would be recognized as revenue when received.

\$3 million cash from Corporate Donations

The \$3 million cash contribution for building materials should be recognized in the restricted fund since there is an external restriction that the cash be used for building supplies. The cash would be recognized as revenue when received. Note disclosure is required of the restrictions e.g. land for building.

Part 2 – Accounting for Donations – Deferral Method of Accounting

Restricted contributions are deferred and recognized as revenue in the period of the related expenses. Donated land would be recognized at fair market value in the general fund. The \$3 million cash would be recognized in the general fund. It would not be recognized as revenue until related expenses for building supplies are incurred.

Question 4 (continued)

Part 3 – Size Test for Capital Assets (CICA HB 4430.03)

If the average of annual revenues for the current and the preceding period is less than \$500,000 (gross revenues not net revenues) the not for profit organization only needs to provide note disclosure of the capital assets. The not for profit organization would be exempt from capitalizing and amortizing the capital assets. Once the size test fails to meet the required criteria the organization must follow all the recommendations for capital assets. HFF has revenues over the size test and therefore would not qualify.

Question 5 (10 marks) (18 minutes)

Differential Reporting (CICA HB 1300)

Part 1 – Reporting Options and Qualifying Enterprises

Differential reporting allows reporting options with respect to full GAAP for qualifying enterprises. An enterprise is a qualifying enterprise when it is a non-publicly traded enterprise and the owners unanimously consent to the application differential reporting. VI is likely to qualify since it is a private corporation (non-public) and there are only two owners thus the shareholders of VI are likely to agree or provide unanimous consent.

Part 2 – Accounting Concept

Cost benefit trade-off is the accounting concept for the basis of allowing differential reporting. With few users likely to have access to information differential reporting is beneficial for private closely held organizations. The cost of compliance of full GAAP reporting is high relative to the benefits if there are few users of the financial statements which further supports the purpose of differential reporting.

Part 3 – Accounting for Investments

2% interest in Major Football League

The 2% interest in the Major Football League results in likely no influence. The transaction would be recorded at cost. No reporting option exists under differential reporting.

22% interest in T-Shirts Incorporated

The 22% interest in T-shirts Incorporated would likely be significant influence. The transaction would be recorded using the equity method under full GAAP reporting. One could elect under differential reporting to use the cost method instead of the equity method.

50% interest in Chocolate Incorporated

The 50% interest in Chocolate Incorporated would likely be joint control. The transaction would be recorded using proportionate consolidation. One could elect under differential reporting to use the cost method or equity method.

90% interest in Landscaping Incorporated

The 90% interest in Landscaping Incorporated would likely be control. The transaction would be recorded using consolidation. One could elect under differential reporting to use the cost method or equity method.

Question 5 (continued)

Goodwill

Goodwill would be recorded and tested for impairment on an annual basis. There is a differential reporting option for the testing of goodwill impairment. VI could elect to test goodwill impairment only when an event or circumstance indicates impairment instead of on an annual basis.

Question 6 (8 marks) (14 minutes)

Employee Future Benefits (CICA HB 3461)

Part 1 – Defined Contribution Plan

A defined contribution plan is a benefit plan that specifies how an entity's contributions to the plan are determined. A defined contribution plan does not have an actuarial valuation (CICA HB 3461.014). A defined benefit plan is a benefit plan that specifies the benefits to be received by the employee (CICA HB 3461.010). For a defined contribution plan, an entity should recognize a cost for a period comprising of the current service cost, the interest cost for the period, the amortization of past service costs and the reduction for the interest income for the period on any unallocated plan surplus (CICA HB 3461.015).

Part 2 – Discount Rate

The discount rate for determining interest costs is determined by reference to market interest rates at the measurement date and high quality debt instruments (e.g. corporate bonds) that match timing and cash flows (CICA HB 3461.050).

Part 3 – Risks

A defined benefit plan has risks related to the following (CICA HB 3461.010 and CICA HB 3461.011):

- Actuarial risk (amount is not known)
- Investment risks (return on assets)
- An entity with defined contributions have no responsibility except for the amount required to contribute to the fund each period
- Employees are at risk with a defined contribution plan

Question 7 (8 marks) (14 minutes)

Communication with those having oversight responsibility for the financial reporting process

For entities with public accountability the auditor should communicate with the audit committee (CICA HB 5751.08). Public accountability means public companies (like PI will be), co-operative business enterprises, not-for-profit organizations, pension plans and governments and other entities (CICA HB 5751.07).

Prior to the completion of the audit, the auditors should communicate the following:

- 1) Audit and non-audit services that the auditor is providing to the entity and its related entities (CICA HB 5751.12). This enables the audit committee to assess whether the services the auditor is providing will give the audit committee all the communications its needs. If additional work is required over and above the audit, the auditor would confirm in writing with the audit committee the additional work the auditor has agreed to undertake.
- 2) The level of responsibility assumed by the auditor under GAAS with respect to the financial statements covered by the auditor's report (CICA HB 5751.13) (e.g.: management is responsible for the preparation of the f/s, auditor's responsibility is to express opinion on the f/s based on audit, a sufficient understanding of internal control will be obtained to plan the audit, an audit is performed to obtain reasonable but not absolute assurance as to whether the f/s are free of material misstatement).
- 3) The auditor communicates a summary of the audit approach that would be helpful to the audit committee in discharging its responsibilities (CICA HB 5751.14). This would include the general audit approach, materiality and audit risk levels that the audit is based on, preliminary assessment of internal control, the effects of new developments in accounting standards, use of specialists, the timing of the audit etc.

The auditor should communicate with the audit committee matters arising from the financial statement audit which include:

- 1) Matters set out in other assurance standards concerning communications with the audit committee (CICA HB 5751.16) (e.g.: management is responsible for the preparation of the f/s, auditor's responsibility is to express opinion on the f/s based on audit, a sufficient understanding of internal control will be obtained to plan the audit, an audit is performed to obtain reasonable but not absolute assurance as to whether the f/s are free of material misstatement).
- 2) Matters that have significant effect on the qualitative aspects of accounting principles used in the entity's financial reporting (CICA HB 5751.17). This would include items that have a significant effect on the understandability, relevance, reliability and comparability of the financial statements (e.g.: selection of & changes in significant acctg. policies – adoption of new acctg. pronouncements, effect of significant acctg. policies in controversial/emerging

Question 7 (continued)

areas, existence of acceptable alternative policies and methods, effect on the financial statements of significant unusual transactions, factors affecting asset & liability carrying values, timing of transactions that affect the recognition of revenues or avoid recognition of expenses.)

The auditor at least annually should communicate (CICA HB 5751.32) in a letter to the audit committee matters relating to the auditors independence (CICA HB 5751.32). This includes confirmation of the auditor's independence, disclosure of all relationships between auditor and his or her related business or practice and when publicly traded, disclosure of the total audit fees charged for audit and for non-audit services provided by the auditors and his or her related business or practice to the entity and its related entities during the last year.

Question 8 (8 marks) (14 minutes)

Fraud – Auditor’s Responsibility for Fraud or Error (CICA 5135)

The increasing competition, loss of business and bankruptcy of a major customer represent fraud risk factors since they might place undue pressure on the company to misstate revenues and profits. This is especially true due to the fact that the bank will make a decision as to providing further financing based on the financial statements.

The partner on the job should ensure that these issues are discussed and communicated to all members of the audit team (CICA HB 5135.002 (e)). The audit team must obtain sufficient understanding of the business including how management identifies and deals with risks that the financial statements may be materially misstated due to fraud and error (CICA HB 5135.033).

The audit team must make enquiries of the audit committee, management, internal audit and others at GL to determine whether they have knowledge of any fraud or material errors (CICA HB 5135.032 (a)). The audit team must understand how those charged with governance exercise oversight over management and its processes.

When assessing inherent risk and control risk, the fraud risk factors must be considered.

Once the information is gathered, the auditor should design and perform further audit procedures that are responsive to the assessed risk. Care should be taken to ensure the appropriate level of personnel and supervision. Care should also be taken to design audit procedures to address the risk of management override.

All of the above must be properly documented (CICA HB 5135.115) and if problems are found, communicated to management and/or the audit committee (CICA HB 5135.094). The auditor may have to communicate to regulatory authorities in certain situations (overriding confidentiality) (CICA HB 5135.107)

Question 9 (12 marks) (22 minutes)

Quality Control

The Need for a System of Quality Control

Unlike many other professional organizations in Canada, the public accounting profession has multiple responsibilities — to the public at large, to those who receive professional services, to professional colleagues, and to authoritative bodies and regulators. Within the last fifteen years, two significant studies have acknowledged these responsibilities and resulted in recommendations that were acted upon to strengthen the profession.

Both the 1978 Adams Report 6 (the Report of the Special Committee to Examine the Role of the Auditor) and the 1988 Macdonald Commission Report 7 (Report of the Commission to Study the Public's Expectations of Audits) raised the need, either directly or indirectly, for establishing quality control standards and for firms to have systems of quality control. The development of this Guide was initiated with the support and cooperation of the Provincial Institutes of Chartered Accountants' Interprovincial Committee to Harmonize the Rules of Professional Conduct and the CICA Auditing Standards Board.

Firms of all sizes have to continually guard against problems arising from substandard performance of professional staff. Several regulatory agencies in Canada have recently expressed grave concerns over auditors' ethics and standards in the wake of a few major public company collapses. In this regard, Securities Commissions have recently undertaken initiatives to discipline negligent professionals.

Recent changes in requirements for the Provincial Institutes have further emphasized the need for uniform quality control standards. For example, all have mandatory professional practice inspection programs. These programs concentrate on testing individual engagement compliance with CICA Handbook standards, as no established benchmarks exist in Canada for review of the conduct and quality of the overall practice.

Provincial Institutes have commenced amending their by-laws to bring firms, as well as individual members, within the authority of their disciplinary processes. This appropriate action, however, presents a further problem. With no standards against which a Provincial Institute can measure the adequacy of the firm's system of quality control, it becomes difficult to enforce any charges of professional misconduct against a firm. The future development of this additional disciplinary process will dictate the extent of new guidelines that may be required.

The adoption of quality control standards by professional accounting bodies in a few countries, the move by some to provide guidance, and the preliminary consideration of quality control issues by others, suggests an increasing level of concern with this area. The International Federation of Accountants issued a statement of policy, "Assuring the Quality of Audit and Related Services." This policy proposes that its member bodies provide guidance on the development of quality control systems.

Question 9 (continued)

The preceding discussion highlights the need for public accounting firms to have quality control systems in place. Perhaps the most persuasive factor is the litigious environment in which firms practice today. The initial best line of defense against claims brought against a firm either by its clients, or by third parties who believe they have suffered damage through the firm's negligence, rests with the firm's ability to demonstrate compliance with professional standards. With a good system of quality control in place, a firm can minimize the risk of loss from litigation.

Regardless of the system of quality control a firm may have, there will always be circumstances beyond a firm's control that increase the risk of having to settle claims. Therefore, it is essential for firms to obtain and maintain professional liability insurance.

Examples of Quality Control Policies

a) Conflict of interest

- I. Consider whether accepting an assurance engagement may give rise to an actual or perceived conflict of interest. Where such a conflict is identified, the firm would consider whether it is appropriate to accept the engagement.
- II. Have procedures in place that require professional staff to identify/communicate any potential conflict of interests.
- III. Determine if conflict of interests can be eliminated or mitigated/managed.

b) Prohibited investments owned by professional staff

- I. Professional staff and their families are prohibited from holding, directly or indirectly, or dealing in securities of clients or their associates.
- II. Professional staff who inadvertently find they have violated this policy must report the circumstances to e.g.: a partner and dispose of the security as soon as possible.
- III. Professional staff must immediately advise e.g.: a partner designated responsibility for independence of new clients, existing clients and/or their associates who have securities traded publicly so that they may be added to the Prohibited Investment Listing.

c) Assignment of engagement personnel

- I. Professional staff assigned to engagements should be competent.
- II. Professional staff assigned to engagements should be adequately supervised.

Question 9 (continued)

d) Continuing Professional Development

- I. Professional staff are required to accumulate professional education hours.
- II. Professional education hours consist of a minimum of 120 continuing professional education hours (CPE) over a three year period, with at least 20 hours per year.

e) Internal review of engagements

- I. An inspection of an engagement would be undertaken by individuals/partners who, whenever possible, were not involved in performing the engagement or acting as an engagement quality control reviewer for it.
- II. Internal reviews of engagements should be completed on a regular basis.
- III. Findings from the review must be initially discussed with, and agreed to, by the partner subject to review. Partners must develop action plans to correct identified deficiencies.
- IV. All documentation pertaining to the internal review is to be destroyed on a timely basis. Under no circumstances are review memoranda or copies thereof to be filed with client working papers.

f) Monitoring quality control

- I. The firm should communicate to relevant practitioners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

g) Confidentiality

- I. Professional and administrative staff should, at all times, keep confidential the affairs of the firm's clients.

h) Complaints and obligations

- I. The firm should establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal.
- II. The firm would investigate such complaints and allegations in accordance with established policies and procedures. In addition, the firm would include involving legal counsel as necessary.
- III. Complaints, allegations and the responses to them would be documented.

Question 10 (8marks) (14 minutes)

Review engagements

Review procedures consist primarily of (CICA HB 8100.19):

- a) Making enquires concerning financial, operating, contractual and other information, and considering responses that in addition to oral responses, may take the form of listings, schedules or other documents.
- b) Applying analytical procedures such as comparing the current and prior period information and considering the reasonableness of financial and other inter-relationships
- c) Analytical procedures performed during a review engagement would normally be less extensive than analytical procedures performed during an audit.
- d) Explanations for relationships and individual items that appear to be unusual would be obtained by directing enquires to appropriate personnel of the enterprise, the responses to which the public accountant to accept without examination of supporting evidence as long as such responses appear plausible.
- e) Having discussions with appropriate officials of the enterprise (management) concerning information received and information being reported on.

Obtaining a bank confirmation is not necessary for a review engagement as review procedures are limited to enquiry, discussion and analysis. A review does not require the public accountant to seek supporting or independent evidence such as a bank confirmation (1) (CICA HB 8100.06). In addition, obtaining a bank confirmation is typically an audit procedure

Additional procedures, such as obtaining a bank confirmation would be necessary when the results of the enquiry, and analytical procedures and discussions cause the public accountant to doubt the plausibility of the information being reported on (CICA HB 8100.20). It is important to note that if audit procedures are done as a result of the public accountant doubting the plausibility of information being reported, the review engagement is not converted to an audit engagement (CICA HB 8100.06).

Rather than obtaining a bank confirmation, the accountant should perform the following review procedures in order to assess the plausibility of the cash balance:

- (a) Enquire whether there has been a reconciliation of the bank balance to the general ledger.
- (b) Review bank reconciliations and enquire if they are regularly prepared and reconciled to the bank statements.
- (c) Enquire whether old or unusual outstanding items in the bank reconciliations have been reviewed and adjusted where necessary.
- (d) Enquire how management provided for the proper cut-off of cash transactions.
- (e) Analytical review of cash related to prior year balance or monthly cash balances.

Question 11 (4 marks) (8 minutes)

Fair Value (CICA HB 5306.48)

The assumptions on which the fair value measurements are based will individually and taken as a whole, need to be realistic and consistent with:

- (a) The general economic environment and the entity's economic circumstances;
- (b) Existing market information;
- (c) The plans of the entity, including what management expects will be the outcome of specific objectives and strategies;
- (d) Assumptions made in prior periods; if appropriate;
- (e) Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;
- (f) Other matters relating to the financial statements (for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures); and
- (g) If applicable, the risk associated with cash flows, including the potential variability of the cash flows and the related effect on the discounted rate.

Question 12 (6 marks) (12 minutes)

Annual Report (CICA HB 7500)

If the auditor, after reading and considering the other information in the annual report, concludes that the other information raises questions regarding, or appears to be otherwise inconsistent with the financial statements, he or she would discuss the matter with management and determine whether the financial statements require correction and/or the other information requires revision (CICA HB 7500.26).

If the financial statements require correction, the auditor's course of action will depend on whether the report has been released. For example, if the report has not been released and management will not correct the misstatement, he or she would express a reservation in the report (CICA HB 7500.28 (a)). If the report has been released the auditor could consider double dating the report per Handbook Section 5405 (CICA HB 7500.28 (b)). In some circumstances, the auditor may be required by statute to inform the board of directors of the misstatement (CICA HB 7500.27).

If the other information included in the annual report is inconsistent with the financial statements and require revision but are not revised the auditor should inform the audit committee of the unresolved matter, notify the board of directors that he or she does not consent to the use of his or her report or the use of their name in the document and consider whether to resign from the engagement (CICA HB 7500.35). In addition, the auditor may wish to consult legal counsel concerning the legal implication of such actions.

Question 1 (10 marks) (18 minutes)

The basic corporate tax rate is 38%, reduced by 10% for taxable income earned in Canada, reducing the tax rate to 28%. Federal surtax of 1.12% is added to arrive at a federal rate of 29.12%.

Active Business Income: first 250,000 (\$300,000 in 2005 and future years) is eligible for the 16% Small Business Deduction (SBD). Federal rate of 13.12% including the surtax. Combined federal & provincial tax rate of around 20%.

Active Business Income above the amount eligible for the SBD (other than income qualifying for the Manufacturing & Processing Deduction) receives a 7% rate reduction which results in a federal rate of 22.12%. Provincial tax is added to this base.

At a corporate tax rate of 20% (federal & provincial combined) integration is nearly perfect. Where integration is nearly perfect, the tax paid by Paris Inc. when added to the tax paid by Pete on the dividend distribution equals the tax Pete would have paid if he had earned the income directly, as opposed to through the corporation. In addition, while the after-tax earnings remain in the corporation, the tax paid by Pete on the dividend is deferred. When the corporate tax rate exceeds 20%, an element of double taxation exists such that there is a tax cost to earning the income through a corporation.

Recommendation: Active Business Income should be reduced to \$250,000 (\$300,000 in 2005 and future year), the amount eligible for the SBD, by paying a bonus to Pete (assuming Pete is active in the business). The after-tax earning should be left in Paris Inc. until Pete needs the funds in order to benefit from the tax deferral.

Interest Income: Investment income earned by a Canadian-controlled private corporation is subject to an additional 6 2/3% tax which brings the federal rate to almost 36%. Provincial tax is added to this base. However, tax equal to 26 2/3% of the corporation's investment income is refundable to Paris Inc. when dividends are paid to Pete. This results in an effective federal rate of about 9%. When provincial tax is added, a combined federal & provincial rate of about 20% results. Thus, nearly perfect integration occurs, but only when the dividends are paid out to Pete. The corporation receives the tax refund at the rate of \$1 refund for each \$3 taxable dividend paid out.

Recommendation: Pay sufficient dividends to Pete annually to recover the refundable Part I tax.

Dividend income: Dividends received from taxable Canadian corporations are not subject to tax levied under Part I of the *Income Tax Act*. Instead, they are subject to Part IV tax at the rate of \$1 tax for each \$3 dividend received. Part IV tax is fully refundable. The refund is triggered by the payment of dividends by Paris Inc. to Pete. Paris Inc. receives a refund of the Part IV tax at the rate of \$1 refund for each \$3 dividend paid to Pete. Thus, there is no tax cost or saving from earning this type of dividend income through a corporation.

Recommendation: Pay sufficient dividends to Pete annually to recover the refundable Part IV tax.

Capital gains: One half of the capital gain is taxed in the same manner as the interest income.

Question 1 (continued)

The other half can be paid out to Pete tax-free as a Capital Dividend. Thus, there is no tax cost or savings from earning capital gains in a corporation.

Recommendation: Pay Capital dividends to Pete whenever Paris Inc. has a balance in its Capital Dividend Account. Pay sufficient taxable dividends to Pete to recover the refundable Part I tax on the taxable portion of the capital gain.

Question 2 (18 marks) (32 minutes)

Part A (16 marks)

(i)	Business loss (given)	\$200,000
	Supplies inventory decline in value	3,000
	Deemed CCA on furniture & equipment	15,000
	Deemed CECA on organization costs	<u>625</u>
	Business loss for tax purposes	<u>\$218,625</u>

(ii)		<u>Tax Value (\$)</u>
	Land (ACB)	120,000
	Building (UCC)	190,000
	Furniture and equipment (UCC)	50,000
	Computer equipment (UCC)	6,000
	Supplies inventory (Cost)	52,000
	Marketable securities (ACB)	10,000
	Incorporation & organization costs (CEC)	375

(iii) In order for the \$100,000 non-capital loss incurred in 2003 and the \$218,625 non-capital loss incurred in the period ended September 30, 2004 to be deductible in 2005 and future years the business in which the losses were incurred (the ‘seniors’ home) must be carried on throughout the year the losses are to be deducted, at a profit or with a reasonable expectation of profit. \$70,000 non-capital loss for the period ended December 31, 2004 is not subject to this restriction.

(iv) The maximum non-capital loss claim in 2005 is \$50,000 (\$40,000 + \$10,000) limited to the amount required to reduce taxable income to Nil. Since AOC, Non-capital losses incurred prior to October 1, 2004 are deductible against income from the seniors’ home business and against income from a business selling similar products providing similar services (\$40,000). The \$10,000 non-capital loss from Dec 31/04 is not restricted because it was incurred after AOC.

(v) Nil. The net capital losses incurred in 2003 of control, cannot be used after the acquisition of control, October 1, 2004.

Question 2 (continued)

Part B (6 marks)

Net capital loss from 2003	\$22,000
Allowable capital loss on Marketable securities recognized on September 30, 2004	<u>7,000</u>
Total losses expiring on September 30, 2004	<u>\$29,000</u>

Sentry Select should elect to recognize a taxable capital gain of \$29,000 (\$58,000 capital gain).

The land, the building, and the computer equipment are eligible assets for the election. An election on the computer equipment will result in recapture of \$2,000 and no capital gains. An election on the building will result in recapture of \$50,000 in addition to the desired capital gain. Since recapture will reduce the 2004 business loss, it is not beneficial to elect on either of these assets. The election should be made on the land only. The elected proceeds should be \$178,000 (cost \$120,000 + \$58,000). This results in the desired taxable capital gain of \$29,000 and enables Sentry Select to deduct the \$29,000 of losses that would otherwise expire. The benefit to Sentry Select is that the ACB of the land is increased by \$58,000 to \$178,000 and thus tax will be saved on a sale of the land in the future.

Part C

R Ltd. should be amalgamated with Sentry Select. Since R Ltd. is carrying on a business which provides services similar to those provided by the business carried on by Sentry Select, the non-capital losses of Sentry Select will be deductible against the income earned from the retirement home business of R Ltd. Since the retirement home business earns annual income of \$200,000, the remaining non-capital losses of Sentry Select, \$338,625 (\$100,000 + \$218,625 + 70,000) - \$50,000 used in 2005) will be used within two years and result in tax savings of approximately \$67,725 (\$338,625 x 20%).

Amalgamating Sentry Select with M Ltd. will not provide the same tax savings since the losses cannot be deducted against the income earned from the margarine distribution business.

Question 3 (22 marks) (40 minutes)

Salary		\$ 60,000
Commission received in 2004		10,000
Gift – bracelet		4,000
Automobile benefits:		
- standby charge $6,000\text{km}/(1,667\text{km} \times 6\text{mo}) \times 2\% \times 6\text{ mo} \times \$46,000$	3,311	
- operating benefit $\$0.17 \times 6,000\text{ km}$	1,020	
(Since the car is used more than 50% for employment purposes, Deborah qualifies to use $\frac{1}{2}$ x standby charge which would equal \$1,656. It is not in Deborah’s best interest to do so.)		
Payments from income maintenance insurance plan	7,200	
Employee loan – interest benefit:		
• home portion (prescribed rate protection rule applies) $\$50,000 \times 2\% \times 182/366$	497	
• BBC Corp shares portion $\$50,000 \times 5\% \times 182/366$	1,243	
Stock option benefit $(\$12 - \$5) \times 10,000\text{ shares}$	<u>70,000</u>	
	156,152	
RPP contributions	(5,400)	
Office supplies	(800)	
Home office expenses not subject to commission income limitation:		
Repairs & maintenance	\$1,200	
Utilities	<u>2,500</u>	
	$\$3,700 \times 10\% \times \frac{1}{2}\text{ year}$	(185)
Home office expenses subject to commission income limitation:		
Property tax	\$3,000	
House insurance	<u>600</u>	
	$\$3,600 \times 10\% \times \frac{1}{2}\text{ year}$	\$ (180)
Travel:		
• Meals $\$1,200 \times \frac{1}{2}$	\$ 600	
• Accommodation	1,800	
• Other travel costs	<u>3,000</u>	(5,400)
Fax machine lease payments	(300)	
Advertising	(800)	
Entertainment meals $\$5,000 \times \frac{1}{2}$	<u>(2,500)</u>	
	(9,180)	
Amount does not exceed commission income		<u>(9,180)</u>
Net employment income		<u>\$140,587</u>

Question 3 (continued)

The following items were excluded from the employment income calculation:

- \$5,000 hospital expenses paid by employer's insurance plan are not taxable benefits.
- \$30,000 retiring allowance is not employment income. Instead, it is included in other income.
- \$10,000 commission income received January 15, 2005. This amount will be included in Deborah's 2005 income since employment income is recognized for tax purposes in the year received.
- \$2,600 CPP and EI premiums are not deductible in computing employment income. She will receive a non-refundable tax credit in computing taxes payable.
- \$400 private medical insurance premium and \$600 group sickness, accident, and income maintenance premium are not taxable benefits.
- Deborah is deemed to have paid interest equal to the imputed interest benefit on half the loan used to acquire shares of BBC Corp. However, the interest is not deductible in computing employment income. It is deductible in computing property income.
- Stock option deduction not deductible in computing employment income. A stock option deduction of \$35,000 will be claimed in computing Deborah's taxable income.
- \$6,000 mortgage interest is not deductible in computing employment income.
- Computer – CCA and \$220 interest expense on the computer are not deductible in computing employment income.
- Fitness club membership is not deductible for tax purposes.

Question 4 (10 marks) (18 minutes)

Part One – Assessment of basis that Dr. Monia may have liability

The primary source of liability is professional negligence.

The following needs to be proven:

- James/MFI (“D”(defendant)) owed a duty of care to Jilly
 - MFI could be vicarious liable as MFI is James’ employer and therefore would be responsible for his actions.
 - MFI/James owed a duty of care. It is reasonably foreseeable that Jilly/plaintiff/siblings could be injured by James/MFI’s carelessness since MFI targets children in residential neighbourhoods in order to generate sales.
 - CICI liability is likely too remote. CICI is no longer an employer since MFI acquired all the assets and employees of the soft ice cream division of CICI. Thus CICI does not owe a duty of care.
- James/MFI breached their duty and fell below the standard of care that you would expect a reasonable person to demonstrate when selling ice cream to young children.
 - James saw three children on the opposite side of the street and stopped. He did not aid in the children crossing the street.
 - Harm was reasonably foreseeable as James knew cars could be coming in the direction of the children.
 - In addition James should have known that the likelihood of harm and potential severity of harm is high in the residential ice cream business as children may run to the truck. James should have taken extra precautions.
 - One could argue that there was no breach on part of MFI since the parents should be responsible to ensure that their small children are supervised when crossing the street.
 - However, Jilly seemed to have suddenly darted and there was nothing James did or did not do to have prevented injury.
- Jilly/siblings suffered damages – physical injury/trauma
 - Mental damage (e.g. trauma; nightmares etc.) is a form of damages
 - Since MFI is the employer they could be vicariously liable for the physical injury/trauma suffered. The physical injury/trauma is not too remote.
- Could discuss that the accident was in fact the mother’s fault as she did not supervise her children as she gave them money and had her six year old child supervise the other children while she was on the phone.

Other

- Could argue that contributory negligence exists. Jilly contributed to the injury since she ran in front of the truck.
- Could argue that this was just an accident and there is no negligence.

Question 4 (continued)

- The damages could also be apportioned between the various parties.

Frank Furter/City of Maintown

- The City of Maintown could be vicariously liable since Frank Furter is an employee of the City of Maintown.
 - It would have to be shown that the truck was driving too fast and therefore Frank Furter should have taken additional precautions due to the presence of the ice cream truck

Conclusion: James/MFI is negligent professionally negligent.

Question 5 (10 marks) (18 minutes)

General

- The case primarily focuses on contract law.
- Since Chris just completed high school it should be determined if he is over 18 and therefore is considered an adult. If Chris is under 18 years old the contract could be refuted.
- As a result of Chris being the plaintiff, he will have the “burden of proof”. Since this is a civil matter Chris has to prove his case based on a “balance of probabilities”.

MBI Contract

Misrepresentation

- Fox had shown Chris a boat on a trailer which had fishing equipment on it and a back up motor
 - Could argue that there was misrepresentation since when Chris went to pick up the boat his boat did not have any fishing equipment nor a back up motor.
 - Could also argue that since Fox omitted telling Chris that his boat would not come with a fishing equipment nor a back up motor this resulted in misrepresentation
 - Should consider if the misrepresentation was innocent, negligent or fraudulent.
 - Potential remedies include rescission of the contract and or damages in tort.

Parol Evidence Rule

- Could apply the Parol Evidence Rule since the agreement was in writing (2005 XP3) and contract does not provide details of the boat that was viewed and the various options that were included. The parol evidence rule presumes that a written contract embodies the complete agreement between the parties involved.
- Consider if exceptions to the parol evidence rule exists (e.g. fix a mistake in contractual document)

Standard form contract/signed form

- The contract is legal. Chris signed the invoice which stated that the boat trailer and pre-delivery inspection and administrative costs are all additional.
- Chris could still be liable even though the additional costs were not brought to his attention since he signed the invoice acknowledging he was accepting the term and conditions of the agreement.
- In general Chris would be bound by the agreement however there may be some exceptions which are further discussed below.

Mistake

Chris may have been mistaken about the subject matter. He may have thought that the boat he saw with the fishing rig, extra motor and upholstery was the same as the boat he was buying. Fox knows that the display model and the boat that Chris is purchasing differs but perhaps he thinks Chris is aware of the differences. Both parties entering into the contract are doing so based upon mistake assumptions (lack of meeting of minds). Thus, a rescission may be possible.

Question 5 (10 marks) (18 minutes)

Other

- One could consider the transaction “unconscionable” which is defined as an agreement that no right-minded person would make. The court would not support Fox keeping the \$40,000 deposit and the boat. The \$40,000 does not represent contractual damages.

Conclusion: Since Chris signed the contract and is assumed to be over 18 he is bound to the terms and conditions.

Yoda vehicle

General

- The contract that Chris signed is between the Yourtown Yoda dealership and Chris; yet the brochure was likely prepared by the manufacturer (Yoda). Consider the issue of privity of contract.
- The brochure may represent a “misrepresentation” since the brochure described the pick-up truck as having a towing capacity of 7,500 lbs. Chris could make a claim against Yoda the manufacturer for breach/misrepresentation.

Question 6 (26 marks) (47 minutes)

Part A (8 marks)

Rules of professional conduct applies both to members that are engaged and members that are not engaged in public practice (with exceptions). Therefore, rules of professional conduct would apply to Lake when he was employed by the manufacturer.

While employed/in practice the following rules of professional conduct were breached:

203.1 Professional competence – Lake failed to sustain professional competence

- While being controller he did not properly record employment income
- In preparing tax returns Lake demonstrated a lack of competence as to taxation matters (business income/capital gains)

202 Integrity and due care – Lake failed to perform professional services with integrity and due care:

- While completing T4 slips
- When completing tax returns. If Lake was not sure about various issues then in exercising due care he should have researched the issue, not guessed

213 Unlawful activity - A member, student or firm shall not knowingly associate with any unlawful activity. It is important to determine whether Lake intentionally left out the \$50,000 lump sum severance payment on his T4 slip and 2003 tax return in order to evade tax.

218 Retention of documentation and working papers – breached

- Lake shredded all information in the tax return file of Armstrong and accordingly had no documentation to support what was discussed/done

206 Compliance With Professional Standards – appears to have been breached

- s. 5020/other standards requires when associated to attach proper communication; engagement letter – Armstrong refers to an audit – when in fact a compilation

205 False or misleading documents and oral representations - appears to have been breached by Lake

- Both in preparing the T4/tax returns and Armstrong return
- Lake had concerns about cost base but continued to complete the tax return

RPC 201.1 – in light of above breaches, Lake failed to maintain the good reputation of the profession

Part B (10 marks)

RPC 201 failing to maintain good reputation (due to breaches cited below)

- Applies to the firm **and** actions of Snooker – both charged
- Activity of using “insider information” to obtain audit

Question 6 (continued)

501 Firm’s maintenance of policies and procedures for compliance is breached

- With professional standards A firm shall establish, maintain and uphold appropriate policies and procedures designed to ensure that its services are performed in accordance with generally accepted standards of practice of (a) the profession, including the Recommendations set out in the *CICA Handbook*

214 Fee quotations - breached

- Did not obtain information to make a bid – rather just “low balled”

204.1 requires independence in fact and appearance – which appears to have been breached

- Hall was a partner with Lee Jones
- 204.2 requires identification of threats/safeguards; 204.3 requires documentation of the same
- This was not undertaken with respect to the engagement of JFSI or FCL
- Lee, Jones – completed journal entries/financial statements which should have been prepared by management. This is a serious breach of independence.

206 Compliance With Professional Standards - was breached

- CICA Handbook sets out standards regarding expressing assurance on accounting treatment; Snooker met with Fifer and gave assurance as to an accounting treatment without complying

210 Conflict of Interest - possible conflict as between JFSI and FCL – not considered by Snooker

- Breached rules with respect to addressing conflict

207 Unauthorized benefits was breached

- Snooker/Lee Jones – received a 2% fee – FCL not aware of the same

Other:

- RPC 202 – performance of work with integrity - failing to comply with standards on audit/other work
- RPC 208 – Hall breached confidentiality of her employer in providing info re: audit

Part C (8 marks)

RPC 201 failing to maintain good reputation (due to breaches cited below)

- Also failed to reply to client requests
- Did not co-operate with successor

104 Requirement to reply in writing breached – by failing to respond to letter from Institute

202 Integrity and due care breached

212.1 Handling of trust funds and other property was breached

Question 6 (continued)

- Failing to properly invest trust assets

203.1 Professional competence – Richards failed to sustain professional competence

- Did not properly prepare trust return

303 Co-operation with successor .1 A member or firm shall upon written request of the client supply on a timely basis reasonable information to the member's or firm's successor about the work done or being assumed

- Richards failed to deal with the national accounting firm doing the audit

204.1 requires independence in fact and appearance – which appears to have been breached

- Richards completed the Review – which requires objectivity – while at the same time acting as Executor (basically like shareholder)

206 Compliance With Professional Standards was breached

- Failed to maintain objectivity per GAAS

Question 7 (4 marks) (7 minutes)

3 types of conflict:

- 1) Professional Conflicts – practitioner places themselves in a position where they have difficulty complying with professional standards
- 2) Legal Conflicts – conflict between legal/contractual obligations (e.g. legal obligation owed to a client)
- 3) Business Conflicts – e.g. Business conflicts occur when the business interest of a client is contrary to the business interest of the member or his or her firm

The process to deal with the above conflicts is as follows:

Step 1: Identify Conflicts or Potential Conflicts

Step 2: Assess the Conflicts

Step 3: Develop a Conflict Management Approach

Step 4: Assess the Effectiveness of a Conflict Management Plan

Step 5: Re-evaluate the Plan During Engagement