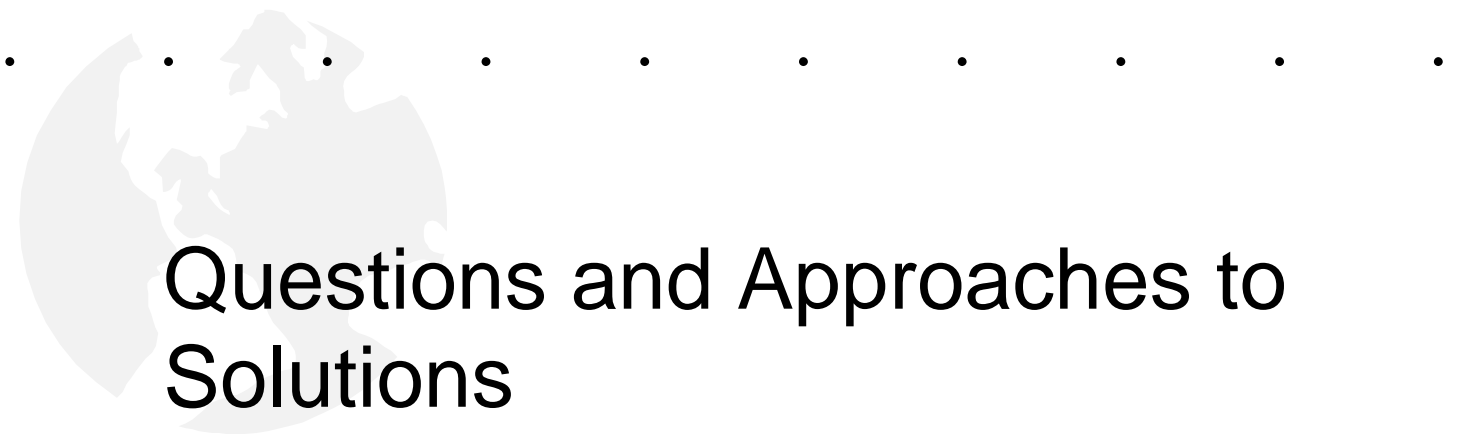




CARE Chartered Accountant Reciprocity Examination 2006

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	2006		2005		2004	
	Number of Writers	% Pass	Number of Writers	% Pass	Number of Writers	% Pass
British Columbia	15	87	19	90	15	80
Alberta	6	50	6	33	8	100
Saskatchewan	–	–	1	100	–	–
Ontario	57	67	55	60	61	75
Quebec	6	67	2	0	2	50
New Brunswick	–	–	–	–	–	–
Nova Scotia	–	–	–	–	–	–
Newfoundland	–	–	–	–	1	100
Total	84	69	83	64	87	78

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

DAY ONE – 2006

(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) Impairment of Long Lived Assets

TGF Limited has a building in the city, which has a book value of \$3,000,000 and is being amortized at \$300,000 per year (10 years straight line). In recent years the building has begun decaying rapidly. A recoverability test was done and the current market value was determined to be \$2,000,000.

Which one of the following **best** represents how TGF Limited should account for the building in the current year?

- a. The carrying amount should remain at \$3,000,000 and the amortization should be increased to reflect a shorter life span.
- b. The carrying amount should be adjusted to \$2,000,000 but the amortization should remain the same.
- c. The carrying amount should be adjusted to \$2,000,000 and the amortization should be adjusted to reflect the new cost base.
- d. No adjustment should be made, as the decrease in market value may not be permanent.

(ii) Revenue Recognition

Reany Limited sells cell phones along with monthly service plans, which allow users to use the phones. Normally, the service includes a 2-year non-cancellable contract that allows a certain number of minutes per month. The bundle sells for \$150. Sold separately, the phone would cost \$60 and the service, \$200. The company often sells the phones and services separately. Once delivery is made, the customer cannot return the phone.

For revenue recognition purposes, which one of the following **best** represents how Reany should account for the revenues from this sale?

- a. The company should recognize \$150 when the phone is delivered and nothing over the 2 years as the service fees are non-cancellable.
- b. The company should recognize \$0 when the phone is delivered and the remainder over the 2 years as the service is provided.
- c. The company should recognize \$60 when the phone is delivered and the remainder over the 2 years as the service is provided.
- d. The company should recognize \$35 when the phone is delivered and the remaining over the 2 years as the service is provided.

Question 1 (continued)

(iii) Audit of Accounting Estimates

Which one of the following **best** represents the auditor's objective with respect to auditing accounting estimates?

- a. To obtain sufficient appropriate audit evidence that management's accounting estimates are accurate.
- b. To obtain sufficient appropriate audit evidence that management's accounting estimates are reasonable.
- c. To ensure that management identify in its accounting estimates an appropriate range.
- d. To ensure that management's accounting estimates reflect the mid point of an appropriate range.

(iv) Date of the Auditor's Report

Which one of the following statements is **not** correct 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 additional 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)

Accounting for future income taxes

Taxi Limited (TL) is a public company, which follows Canadian Generally Accepted Accounting Principles (GAAP). The company is completing its journal entries for the current year-end to record income tax expense. As at the beginning of the year, there was a Future Income Tax Asset of \$1 million relating to capital assets. As at the end of the year, the same capital assets have an Undepreciated Capital Cost (UCC) of \$345 million and a net book value of \$454 million. The company just completed its preliminary tax return and is showing taxable income of \$30 million. Tax rates are as follows:

Last year	40%
Current year (enacted)	45%

Required:

Prepare the journal entries to record the income tax expense, income tax payable and any future income tax amounts for the current year. Show all calculations and explain any decisions, choices and assumptions.

Question 3 (8 marks) (14 minutes)

Employee future benefits

Tendeco Inc. (TI) has a defined future benefits plan for its employees. As at the end of the prior year, the plan was in a deficit position. The plan assets equalled \$555,600 and the accrued benefit obligation was \$789,000. All of the difference was recognized on the balance sheet of TI.

The following information relates to the plan:

- Current service cost \$57,000
- Interest on obligation 3%
- Long term expected rate of return 4%
- The plan was renegotiated with the company union and a past service cost of \$120,000 arose at the end of the current year
- Benefit payments \$80,000
- Contribution to the plan by TI \$130,000

The current service cost was incurred evenly over the year; benefits and contribution payments were made midyear. TI calculates interest based on a weighted average method. The past service costs will be amortized in the following year.

Required:

Calculate/show the following:

- Pension expense for the year;
- Accrued benefit asset or liability at year end;
- Pension journal entry for the year; and
- Reconciliation between the deficit or surplus in the plan and the amount recognized on TI's financial statements as Accrued benefit asset or liability at year-end.

Question 4 (14 marks) (26 minutes)

Related Party Transactions

Cindy Chan, a surfing enthusiastic is head of Research & Development (R&D) for Surf Incorporated (SI). Her team is excited about their first completed product, a surfing machine. This machine allows participants to surf on the perfect wave without worrying about bad weather and poor surf.

SI is a wholly owned subsidiary of Theme Park Incorporated (TPI). TPI owns and operates 20 water theme parks across North America. During 2005, SI and TPI had the following transactions.

- SI sold TPI twenty surfing machines for cash at a 20% discount from its listing price. SI provides a discount to other theme parks that purchase the surfing machines in large quantities.
- SI sold TPI a piece of excess land for cash to help fund future R&D on an expert surfing machine to be used after a surfer mastered the basic model. To ensure the transaction was fair three independent appraisals from real estate agents were received for the land.

Required:

Prepare a report to the CEO of TPI discussing the following:

Part A How should the purchase of the surfing machines and the land be recorded in TPI's accounting records and financial statements? (10 marks)

Part B Would there be a change in the accounting for either transaction if TPI owned 40% of SI, instead of 100%? (4 marks)

Question 5 (10 marks) (18 minutes)

Asset Retirement Obligations

Wind Farms Incorporated (WFI) has owned and operated a wind farm in Ontario since 2005 under a 25-year licence granted by the provincial government. The licensing is part of a government initiative to reduce the province's dependence on coal generation. The agreement requires that each operator, such as WFI, dismantle the wind towers at the end of the 25-year period and restore the land to its original condition. An environmental assessment was made and it was estimated that the cost to dismantle the towers and restore the land at the expiry of the licence would amount to \$100 million. The ongoing maintenance of the wind tower generators and treatment of corrosion is estimated to cost between \$1 million and \$5 million annually. The normal borrowing rate for WFI is 10%.

Required:

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

Part A (6 marks)

The appropriate method of accounting for;

1. the \$100 million needed to dismantle the wind towers and to restore the land; and
2. the estimated annual maintenance costs.

Part B (4 marks)

The appropriate method of accounting in subsequent periods for these costs.

Question 6 (8 marks) (14 minutes)

Non-Monetary Transactions

Roofs Incorporated (RI) has developed and patented the “Green Roof,” an eco-friendly roofing system formed of interlocking modules of plants called “Green Grids”. The system is used to cover the rooftops of buildings with vegetation so as to reduce absorbed heat and trap rainwater. Each Green Grid module measures two feet by four, is lightweight and easy to install.

RI, which also does installation, has estimated that it could install an average of five Green Roof systems a year and that each rooftop would measure 2,500 square feet on average.

RI entered into an agreement with Landscaping Incorporated (LI), granting LI the use of the patent for five years for its own business in exchange for the supply of Green Grids modules to RI during this period of time.

RI learned that the module would cost LI between \$10-\$20 a square foot to produce depending on the type of plants.

Required:

Prepare a report to RI’s owner that explains how to account for RI’s agreement with LI.

Question 7 (8 marks) (14 minutes)

Auditor’s responsibility for fraud or error

Riverdance Productions Canada Limited (RPCL) has been in business for 10 years and is preparing for its first public offering (IPO).

Unfortunately, during the current year, revenues and profits have declined. RPCL’s management, being very concerned about this, is currently in the process of finalizing the financial statements. There are a few large transactions awaiting the VP Finance’s approval for recording. The VP Finance told the controller “leave them with me; I’ll provide the appropriate journal entries to best reflect our performance.”

The auditors are pressuring the VP Finance to hand over the draft financial statements so that they can begin the audit. The bank is also pressuring RPCL, to determine whether it should renew or increase the company’s line of credit. For the VP Finance, it is important that the bank renews or increases the line of credit before the IPO.

Required:

- Part A Discuss management’s role as it relates to fraud prevention, supporting your answer with facts related to RPCL. (3 marks)
- Part B In light of the above situation discuss the auditor’s responsibility to consider fraud. (2 marks)
- Part C Misstatements in the financial statements can arise from fraud or error. Define fraud and error as they relate to financial statement misstatements giving examples (3 marks)

Question 8 (8 marks) (14 minutes)

Audit of Fair Values and Disclosures

Real Estate Limited (REL) has numerous investments in properties. During the last two years, there has been a decline in the real estate market and REL is concerned that the properties may be overvalued on the financial statements. The auditors have signalled that they will be focusing on this area as a potential risk area and so REL wants to ensure that they have everything in line before the auditors come. They have done a thorough review of all properties including a valuation of all large properties. An internal analyst, very familiar with the industry, has performed the valuations.

Required:

Assume the role of the auditor preparing the planning file and identify the responsibilities that the auditor has when auditing fair values and disclosures related to the above properties.

Question 9 (7 marks) (13 minutes)

Communication with the Audit Committee / Reservation in the Auditor's Report

The Community Matters (CM) is a registered charity that raises funds on behalf of several smaller agencies in the city of Cedar Springs. Its major fundraising activity is a structured program to solicit corporate donations. Three years ago, a lottery was established with a grand prize of a new home. It was so successful that it is now an annual event. Another fundraising activity is a door-to-door campaign held each October to attract donations from individuals. Receipts are issued when requested by the donor.

You, the auditor of CM, are preparing your plan for the upcoming audit.

Required:

- Part A Describe what you, as auditor of CM, should communicate to the Audit Committee prior to the completion of the audit. Provide a brief explanation of what your communication would include. (4 marks)
- Part B Assume a material scope limitation exists on the completeness of the revenue from the door-to-door campaign. Describe the Audit Report that you will issue. (3 marks)

Question 10 (7 marks) (13 minutes)

Evaluation and Disposition of Misstatements

The auditor's objective is to assess whether the financial statements are misstated by a material amount. The audit is planned with the objective of detecting misstatements that are, individually or in the aggregate, quantitatively material to the financial statements.

Required

:

- Part A In the process of assessing the extent to which the financial statements are or could be misstated, describe the estimates the auditor should make. (3 marks)
- Part B Outline the steps the auditor would take if he or she concludes that the financial statements are materially misstated. (4 marks)

Question 11 (8 marks) (14 minutes)

Review engagement

Yourtown Community College provides a series of lectures to people considering starting a new business. One of the sessions covers the preparation of annual financial statements and it describes the related services of public accountants. Several public accountants have agreed to make presentations. You agreed to help present information on Review Engagements.

Your presentation will cover the following items:

- a brief explanation of a review, the type of procedures used and two examples of each;
- what the accountant does if he or she doubts one of management's representations; and
- the impact on the report if the accountant's doubt persists.

Required:

Prepare a draft of your presentation.

Question 12 (6 marks) (12 minutes)

Use of specialists

ABC Company (ABC) uses the percentage-of-completion method of recognizing revenue. Many of its large, complex, and long-term construction projects, are in progress at year-end. The ABC's auditor wants to use the work and findings of a specialist to determine the degree of completion of ABC's construction projects.

Required:

- Part A Outline the general considerations required in selecting a specialist. (2 marks)
- Part B What considerations are required regarding confidentiality? Use the above situation to illustrate your answer. (3 marks)
- Part C How should the reliance on the work of a specialist be communicated in an audit opinion without reservation? (1 mark)

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	0.92	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	0.86	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	0.79	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	0.74	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	0.68	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	0.63	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	0.58	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	0.54	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	0.50	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	0.46	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	0.43	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	0.40	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	0.37	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	0.34	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	0.32	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	0.29	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	0.27	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	0.25	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	0.23	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	0.21	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	0.20	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	0.18	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	0.17	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	0.16	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	0.15	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 – 2006

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) _____

DO NOT WRITE IN THIS SPACE	

TOTAL	_____
	<u> X 2 </u>

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY TWO – 2006

(100 marks) (3 hours)

NOTES TO CANDIDATES:

1. There are **8 questions and 13 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 (12 marks) (22 minutes)**

Maxwell is employed as a salesman for a coffee distribution company. In 2005 he received a salary of \$120,000 and commissions of \$16,000. In addition, he was awarded a bonus of \$12,000 for being the top salesperson for 2005. The bonus was not paid until 2006.

Maxwell is required to use his car to earn his income and receives a travel allowance of \$2,500 annually for this purpose. He purchased his car in 2004 for \$35,000 plus tax. He claimed the maximum Capital Cost Allowance (CCA) for the car in 2004. In 2005 he incurred operating costs for car insurance, gas and maintenance, totalling \$6,000. In 2005, he also paid \$3,800 in interest on his car loan, and drove the car 28,000 kilometres of which 16,000 kilometres were for employment purposes.

Maxwell incurred the following additional costs in 2005 to earn his commission income:

Advertising	\$5,000
Parking	1,200
Entertaining customers (baseball tickets)	8,000
Meals (dining with prospective customers)	6,000
Golf club membership for entertaining customers	4,000
Salary paid to part-time assistant	9,000

Maxwell principally performs his duties of employment from his office in his home. Maxwell's employment contract requires him to provide his own office and pay for his office expenses. During 2005 he purchased a laptop computer for \$4,500. He also purchased and used \$80 worth of computer paper. His home expenses for 2005 were as follows:

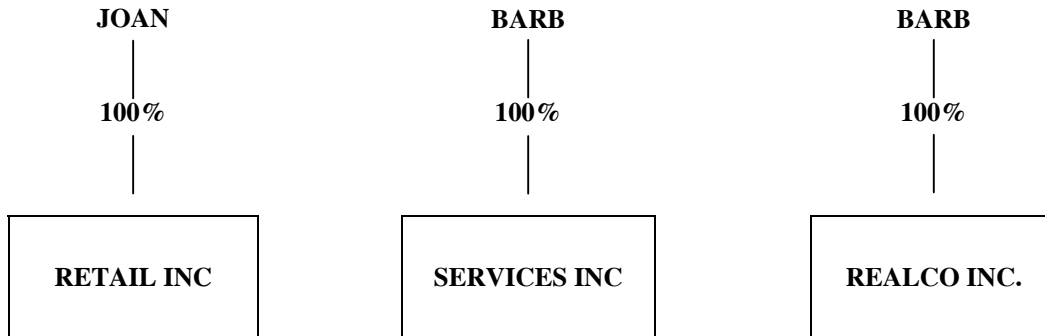
Mortgage interest	\$18,000
Utilities	4,200
Property taxes	5,500
Insurance	900
Telephone	600
Minor repairs and maintenance	<u>1,000</u>
	<u>\$30,200</u>

Maxwell has one telephone line at his home with an extension in his office. His employer reimburses him for long distance calls related to his employment. Maxwell's office occupies 10% of the space in his home.

Required:

From the above information, compute Maxwell's employment income for 2005. Provide an explanation for any items excluded from your calculation.

Question 2 (8 marks) (14 minutes)



Retail Inc. owns and operates a chain of clothing stores across Canada. Its head office is located in a building owned by Realco Inc. for which it pays rent of \$50,000 annually.

Services Inc. provides computer-consulting services to various clients including Realco Inc. For these services, it receives \$30,000 annually from Realco Inc. Barb is the only employee of Services Inc. Services Inc. leases office space from Realco Inc. for which it pays annual rent of \$15,000.

Joan and Barb are sisters. All of the shares issued are common shares.

Required:

Part A Identify the type(s) of income (i.e., active business income, income from property, etc.) being earned by each corporation. In doing so, provide the reasoning for your answer. (5 marks)

Part B Describe how each type of income earned is taxed under the *Income Tax Act*. Address refundable taxes, where applicable. (3 marks)

Question 3 (30 marks) (54 minutes)

This question consists of nine parts with the marks for each part indicated. Each of the nine parts is independent.

Part A (6 marks)

R Ltd., N Ltd., and P Ltd. are Canadian-controlled private corporations.

Rod owns 60% of the shares of R Ltd. and his spouse, Nan, owns 60% of the shares of N Ltd. Their 45-year-old son, Peter, owns 100% of the shares of P Ltd.

P Ltd. owns 40% of the shares of R Ltd. and 8% of the shares of N Ltd.

The remaining shares are owned by strangers. All issued shares are common shares.

Required:

- 1) Which corporations are related? (1 mark)
- 2) Which corporations are affiliated? (1 mark)
- 3) Which corporations are associated? Explain. (2 marks)
- 4) Which corporations are connected? Explain. (2 marks)

Part B (5 marks)

Jessica's only source of income is from a staging business she carries on in Toronto, Ontario. Her combined federal and provincial income tax for the last three years was as follows:

2003	\$20,000
2004	\$40,000
2005	\$60,000

She estimates the amount to be \$80,000 for 2006. Jessica has a cash flow problem and will have to borrow the funds to pay her income taxes.

Required:

Answer the following questions for Jessica:

- 1) Why income tax instalments are required for 2006? (1 mark)
- 2) When the instalments are due? (1 mark)
- 3) The minimum amount of each of the 2006 instalments? (1 mark)
- 4) The deadline for filing her 2006 income tax return? (1 mark)
- 5) The deadline for paying any balance of income tax owing for 2006? (1 mark)

Question 3 (continued)

Part C (4 marks)

Michelle Schecter is the sole shareholder of Koven Corp., a taxable Canadian corporation. Michelle owns equipment that originally cost \$100,000 and has an undepreciated capital cost of \$50,000. Michelle plans to sell the equipment to Koven Corp for \$80,000, its fair market value, in exchange for a combination of shares and debt from Koven Corp.

Required:

- 1) Describe the tax consequences for Michelle and Koven Corp., assuming that no elections are made under the *Income Tax Act*, and (1 mark)
- 2) Assuming that an election is made under Subsection 85(1) of the *Income Tax Act*, describe the income tax consequences for Michelle and Koven Corp., and indicate what should the elected transfer price be? (3 marks)

Part D (4 marks)

Hexbah Inc. is a Canadian-controlled private corporation, which claims the small business deduction. It filed its tax return for the year ended December 31, 2005 on September 16, 2006. The \$20,000 balance of tax owing for 2005 was paid in full on the same date. In 2004, Hexbah Inc. had no taxable income.

Required:

- 1) When was Hexbah Inc.'s 2005 income tax return due? (1 mark)
- 2) Calculate the late-filing penalty for Hexbah Inc. for 2005. (1 mark)
- 3) When was the balance of income tax due for 2005? (2 marks)

Part E (3 marks)

Erma Boyd sold shares of Apotex Inc. for \$7,000, to her 16-year-old son, Eddie, on January 5, 2005. The shares were valued at \$10,000. Erma had purchased these shares in 2000 for \$6,000. Eddie received dividend income of \$200 from the shares in 2005 and each subsequent year until he sold the shares for \$16,000 in 2010.

Required:

Explain the income tax consequences for Erma and Eddie.

Question 3 (continued)

Part F (2 marks)

Chris Wattie’s employer provided him with a car costing \$42,000 (including 7% GST) for 6 months during 2005. During the 6 months Chris drove the car 6,000 kilometres in carrying out his duties of employment and 5,000 kilometres for personal use. His employer paid the operating costs relating to insurance, gas, and maintenance. The operating costs amounted to \$2,000 for the 6 months.

Required:

Calculate the amount to be included in Chris’s 2005 employment income as a taxable benefit for the use of the car.

Part G (2 marks)

TL Ltd. is a Canadian-controlled private corporation operating a mail-order business in several provinces across Canada. During its year ended December 31, 2005 TL Ltd. received \$30,000 in dividends from taxable Canadian corporations.

Dividends from public corporations	\$12,000
Dividends from Nadal Inc.	<u>18,000</u>
	<u>\$30,000</u>

TL Ltd. owns 20% of the voting common shares of Nadal, which declared and paid a total dividend of \$90,000 and received a dividend tax refund of \$21,000 as a result of this payment.

Required:

Calculate the income tax payable by TL Ltd. on the dividend income.

Question 3 (continued)

Part H (2 marks)

On February 1, 2005 Arret Ltd., a corporation with a May 31 year-end, loaned \$40,000 interest-free to a shareholder to fund a personal investment. The loan is to be repaid on August 15, 2007.

Required:

Describe the income tax implications for the shareholder.

Part I (2 marks)

A business with a December 31 year-end purchased new Class 8 equipment for \$20,000 on September 1, 2003. Before that time the business owned no other equipment. No additional purchases were made in the subsequent years. The business claimed maximum CCA each year.

Required:

What are the income tax consequences in 2005 if the business sells the equipment for

- 1) \$13,000?
- 2) \$22,000?

SECTION B - LAW

Question 4 (9 marks) (16 minutes)

Harold Moore, CA, had extensive discussions with Frederick Bookbinder, a representative of Professional Publications Inc. (“PPI”), about Moore writing a textbook, which covered studying for and preparing for professional examinations. After lengthy negotiations, Moore agreed to provide a draft of the text in a format suitable for final editing by December 31, 2007.

Bookbinder agreed that PPI would provide a royalty advance of \$10,000 on October 31, 2006. At the conclusion of the discussions, Moore and Bookbinder shook each other’s hands. Bookbinder told Moore that the lawyers of PPI would prepare a standard written author’s agreement, as this was PPI’s protocol.

In early November 2006, Moore received via courier a written agreement prepared by PPI’s lawyers and signed by Ruddy Vlantino, PPI’s President. A cheque for \$10,000 was also included, along with a note, which read, “As discussed, please sign and return for our records.” At this time, Moore had not been feeling very well and was undergoing medical tests. By mid November 2006, Moore’s physician provided a preliminary diagnosis suggesting that Moore might have cancer. Moore sent a note to Bookbinder, which read, “Very ill, I do not think I can do it after all. Sorry.”

In January 2007, the medical specialist that was treating Moore determined that Moore did not have cancer and treated Moore’s illness with various drugs. Moore, who at that time was feeling well, decided to write the textbook intended for PPI, and to publish and distribute it on his own. By April 2007, the book was ready. Moore promoted it himself and arranged to distribute it through a variety of sources. It was highly successful and Moore made profits from the first printing in excess of \$300,000.

Moore has just received a letter from the law firm representing PPI that states, “we are demanding immediate payment of \$300,000 plus the copyright to your textbook or we will proceed to sue you regarding this contract.”

Required:

Prepare a memorandum that discusses and analyzes the possible contract law issues, claims and possible defences that Moore may have.

Question 5 (6 marks) (11 minutes)

Mercedes Computers Inc. (MCI) manufactures a line of laptop computers powered by a rechargeable battery made by Large Battery Inc. (LBI), and a line of desktop computers.

MCI has recent information from Testers Laboratories, a not-for-profit operated entity, which tests products, that the rechargeable battery on the M500 series laptop computer gets “very hot when recharging and poses a possible fire risk.” Management of MCI has decided not to do anything with respect to this information, although the research and development group at MCI is looking into the redesign of the laptop and the use of a new battery pack.

The employer of Franklin Cough provided him with a M500 laptop computer, which he sometimes uses at home for personal matters. Last Sunday, a fire occurred at Cough’s house. The fire investigator, who appeared in the news, was unable to determine if the cause of the fire was the computer battery overheating or a problem with the electrical wiring in Cough’s home office.

Required:

Identify the basis on which MCI may have a liability. Discuss in detail, what would have to be proven, along with any defences that could be put forward by MCI.

Question 6 (5 marks) (9 minutes)

Smith, Lee & Sandor, Chartered Accountants (SLS) is operating a public accounting practice in a mid-sized town. The firm has five partners and a professional staff of fifteen individuals. Sanjay Sandor, a senior partner, will be meeting shortly with a lawyer who has in the past advised the firm on legal matters. The issue tabled for discussion is whether SLS should become a Limited Liability Partnership (LLP).

You, CA, are employed by SLS. Mr. Sandor has asked that you prepare a memorandum for him that explains what an LLP is, how it differs from a general partnership, what the requirements are for becoming an LLP and what are its advantages. Mr. Sandor notes that SLS has an “excellent system of quality control” and as a result, has reservations about the need for SLS to become a LLP.

Required:

Prepare the memorandum requested by Mr. Sandor.

SECTION C - RULES OF PROFESSIONAL CONDUCT

Question 7 (26 marks) (47 minutes)

The following situations are unrelated.

Required:

In each of the situations below, Rules of Professional Conduct may have been breached or inappropriately applied.

For each of Part A, B and C, identify and discuss the relevant Rules of Professional Conduct and Council Interpretations along with related guidelines, which should have guided the actions of the involved chartered accountants (CA) or CA firm, or both.

Part A (12 marks)

Francis Richards, CA, obtained her chartered accountancy designation in 2005. Francis articulated with Turnbull LLP and just got recruited, as a senior accountant, by Globber & Mailstrom, Chartered Accountants.

On her first day of work, Francis met with Jeffrey Mailstrom who told her: “We work as a close team around here. We are all buddies. Needless to say, buddies do things and overlook things for each other. I will say no more. I would like you to spend the balance of the day writing to all assurance and tax clients you worked on at Turnbull. Tell them that you left because you wanted to be at a firm that provided superior client service. Next Friday, you need to follow up with a telephone call to each of them. Tell them whatever you have to in order to get them to bring their account to us. If fees and money are what they are concerned about, tell them our fee will be the Turnbull fee, less 10%. Now that you are chartered accountant you need to work on your marketing skills. Your compensation and promotion potential to partnership depends on your ability to get clients. Stop taking those courses on technical accounting and assurance matters, and focus on courses dealing with marketing.” Mailstrom then gave Francis a list of clients that she would be in charge of.

On her third day of work, Francis was assigned to the audit of a manufacturing entity, Weld it Boxes Limited (WBL), with an interim scheduled to begin in two weeks. In preparation, Francis reviewed the prior year’s file, and noted the following:

- the working paper file contained no formal audit plan. The front of the file contained the notation, “contact partner in charge for planning memorandum”;
- the financial statements in current assets - accounts receivable - included a five year second mortgage loan to Rudy Globber, senior partner of the firm;

Question 7 (continued)

Part A (continued)

- the working papers that supported the various expenses showed that WBL had paid to build a dock at the cottage of Freddy Flunkster, the majority shareholder of WBL. As well, all the gasoline utilized by Flunkster’s sports utility vehicle and boat were all paid for by WBL. These expense payments were all “approved” by Flunkster. Glover & Mailstrom prepare the corporate tax returns for WBL. No adjustment for these expenses were made in calculating the taxable income;
- WBL has an audit committee, which is made up of Flunkster and three minority shareholders. The audit file included a memo that said, “No communication with committee required as no internal control weaknesses noted.”

When Francis went to talk to Mailstrom about the file, he told her, “In order to save time on a file, we do not do a formal planning memo. I am so closely tied into the client and have such good knowledge that a formal memo is not required. The reason for the note in the file is just in case the file is pulled for practice inspection by the Institute. If that were to happen, we would prepare a memo in a hurry. Mailstrom then went on to say, “I trust that this will go no further, ‘Buddy’. Also, as far as the income tax returns go, these items are immaterial.”

Part B (6 marks)

Buck Nudster, CA, is a chartered accountant in public practice operating as a sole proprietor. Recently, the sole shareholder of Dollar or Less Stores, Inc. (DLS), a review engagement client of Nudster, decided to sell her shares. Nudster located a potential buyer for the shares and acted on the buyer’s behalf in negotiating and finalizing the sale price. Nudster made his working papers available to the buyer and explained the various income items that needed to be adjusted in order to calculate normalized earnings.

Upon signing the purchase agreement, the buyer agreed to pay Nudster a professional fees equal to 5% of the agreed upon value of DLS’s shares and signed a five-year engagement letter for the audit of DLS. Nudster also received a commission of 3% of the agreed upon value of the shares from DLS. Neither the buyer nor DLS was aware of Nudster’s compensation arrangements with one another.

Question 7 (continued)

Part C (8 marks)

In 2004, Sherman Tank, CA, secured for himself a position as VP Finance with Largess Limited (LL), a public company.

Recently, the Provincial Securities Commission (PSC) found Tank guilty of insider trading on the shares of LL. The PSC also concluded that Tank informed a few of his friends of the new developments occurring at LL, which in turn allowed them to take advantage of changes in the market price of LL's shares.

An internal review by the personnel department showed that when Tank applied for the VP Finance position, his resume stated he had been a partner in a national accounting firm. A follow up with that firm showed that Tank had never been a partner; he was as a senior manager, when he left.

Tank in his position as VP Finance was responsible for overseeing the preparation of LL's financial statements. The 2005 and 2006 audited financial statements of LL are now being restated. Apparently, revenue was overstated in both years.

Question 8 (4 marks) (7 minutes)

The Rules of Professional Conduct and related Council Interpretations set out five threats to independence.

Required:

Identify and explain these threats.

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%
Class 45	45%

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	20¢ per kilometre of personal use
Non-taxable car allowance benefit limits	
- first 5,000 km	45¢ per kilometre
- balance	39¢ per kilometre

TABLE II
INDIVIDUAL FEDERAL INCOME TAX RATES

Income Tax Rate Schedule - Individuals

<u>Taxable Income</u>	<u>Tax</u>
\$35,595 or less	16%
\$35,596 to \$71,190	\$ 5,695 + 22% on next \$35,595
\$71,191 to \$115,739	\$13,526 + 26% on next \$44,549
\$115,740 or more	\$25,109 + 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	\$8,149
Married and equivalent to spouse amount	6,920
Net income threshold for married or equivalent amount	692
Age 65 or over in the year	3,979
Disability amount	6,596
Disabled dependents who reach 18 in the year	3,848
Net income threshold for disabled dependents 18 and over	5,460
Basic amount for:	
Age credit and GST credit	29,619
Child tax benefit	35,181
OAS clawback	60,806

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>
2006	5	6	6	-
2005	5	5	5	5
2004	5	5	4	5
2003	5	5	6	5
2002	5	4	5	5
2001	8	8	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. Impairment of Long Lived Assets

The correct answer is (c). HB s. 3063.04 requires the recognition of an impairment loss when the carrying amount is not recoverable and exceeds its fair value.

- (a) is incorrect because there is no indication of a shorter life span.
- (b) is incorrect because amortization should be based on the useful life of the asset.
- (d) is incorrect because the HB does not base its recommendation on whether the decrease in market value is permanent.

ii. Revenue Recognition

The correct answer is (d). EIC 142 provided guidance in determining the relative value of each deliverable: $\$150 \times \$60 / 260 = \$35$ for the phone.

- (a) is incorrect because the contract provides for services over a two-year period; the non-cancellation clause is not an indication of performance.
- (b) is incorrect because the contract features multiple deliverables, which may be divided into units; not recognizing revenue at time of delivery/signature would incorrectly measure the initial revenue component of providing the phone itself.
- (c) is incorrect because the relative fair value of the phone to the entire contract would not be properly measured.

iii. Audit of Accounting Estimates

The correct answer is (b). HB s. 5305.06 requires that the auditor considers a point estimate or zone of reasonableness at or within which he or she will accept management's estimate as being reasonable within the context of the financial statements as a whole.

- (a) is incorrect because estimates cannot be accurate by definition; in addition the auditor's objective is to provide assurance as to the fair, not accurate, presentation of financial statements.
- (c) is incorrect because the HB does not require the identification or the disclosure of a range of estimated amounts.
- (d) is incorrect because the mid point has no greater significance than any other point in 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. However, 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 (HB 5405.02).

- (b) is incorrect per HB 5405.02.
- (c) is incorrect per HB 5405.06.
- (d) is incorrect per HB 5405.07 and 5405.08.

Question 2 (8 marks) (14 minutes)Future Income Taxes (HB 3465)Income Taxes Payable is: $\$30 \text{ M} \times 45\% = \13.5 M *Journal entry*

Current Income Tax Expense	\$13.5 M	
Income Taxes Payable		\$13.5 M

Temporary difference at year-end:

Carrying Value	\$454 M
UCC	<u>345 M</u>
Temporary difference	<u>\$109 M</u>

The temporary difference is **taxable**. In the future, when TL will have no CCA left to claim, it will still add amortization to arrive at its taxable income, hence increase its tax payable in relation to its accounting income.

Value of the Future Income Tax Liability (FITL) $\$109 \text{ M} \times 45\% = \49.05 M

Temporary difference at the beginning:

Future income tax asset	\$ 1 M
Future income tax rate at the time	<u>$\div 40\%$</u>
Temporary difference	<u>\$2.5 M</u>

The temporary difference was **deductible**, because it related to a Future Income Tax Asset (FITA).

The current value of this Deductible Temporary Difference (DTD) is:

$$\$2.5 \text{ M} \times 45\% = \$1.125 \text{ M}$$

A benefit arises as a result of a change (increase) in the income tax rate:

$$\$2.5 \text{ M} \times 5\% = \$0.125 \text{ M}$$

The overall change in temporary differences is:

End of the year	\$109.0 M	taxable
Beginning of the year	<u>2.5 M</u>	deductible
Change	<u>\$111.5 M</u>	taxable

This creates a change in Future Income Tax of: $\$111.5 \text{ M} \times 45\% = \50.175 M

Journal entry

Future Income Tax Expense	\$50.175 M	
Future Income Tax Benefit – adjustment due to income tax rate change		\$ 0.125 M
Future Income Tax Liability		49.050 M
Future Income Tax Asset		1.000 M

Question 3 (8marks) (14 minutes)

Employee Future Benefits (HB 3461)

	Income Statement	Balance Sheet	Computation of Changes in (for notes)		
	Pension Expense	Accrued Liability	ABO	Plan Assets	Past Services Obligation
Balance		\$233,400	\$789,000	\$555,600	
Current Services	\$57,000		57,000		
Interest Cost ¹	23,325		23,325		
Return on Plan Assets ²	- 23,224			23,224	
Contribution/Payment to Plan Assets		- 130,000		130,000	
Benefits paid			- 80,000	- 80,000	
Past Services Cost			120,000		\$120,000
Total	<u>\$57,101</u>	57,101			
Balance at yearend		<u>\$160,501</u>	\$909,325	\$628,824	\$120,000
<i>Compare with HB 3461, Example 1</i>	<i>Exhibit X</i>	<i>Exhibit XI</i>	<i>Exhibit V, up to line 41</i>	<i>Exhibit I, up to line 18</i>	

¹ Interest on Accrued Benefit Obligation (ABO)

$$\text{Average ABO: } 789,000 + (57,000 - 80,000) \div 2 = 777,500$$

$$\text{Interest cost: } 777,500 \times 3\% = 23,325$$

² Return on Plan Assets (PA)

$$\text{Average PA: } 555,600 + (130,000 - 80,000) \div 2 = 580,600$$

$$\text{Return earned: } 580,600 \times 4\% = 23,224$$

Journal Entries

During the year

Pension Expense	\$130,000	
Cash		\$130,000

End of the year

Accrued Benefit Liability	\$72,899	
Pension Expense		\$72,899

Reconciliation

Accrued Benefit Obligation	\$ 909,325
Pension Plan Assets	<u>628,824</u>
<u>Funded status</u> of the plan: Deficit	(280,501)
Unamortized past service costs	<u>120,000</u>
Accrued Benefit Liability	<u>\$ 160,501</u>

Compare with HB 3461, Example 1, Exhibit XII

Question 4 (12 marks) (26 minutes)

Related Party Transactions (HB 3840)

Part A – Accounting for the Purchase of Surfing Machines and Land (SI is wholly owned)

TPI and SI are related parties because TPI has the ability to exercise control over SI (HB 3840.03 (g) & 3840.04 (a)) As a result, a related party transaction (RPT) should be measured at the carrying amount (HB 3840.08) since the presumption of dealing at arm's length (fair value) is absent. However, exceptions are made when evidence exists that the conditions and the terms of RPTs are similar to those of transactions at arm's length.

Surfing Machines

The purchase of surfing machines by TPI from SI appears to be a monetary RPT, since we have no indication to the contrary. In addition, it appears to be in the normal course of operations for SI to sell its surfing machines to theme parks, and for TPI to buy such machines for its own theme parks. (HB 3840.24).

However, the size of the discount TPI received (20%) in relation to the discount granted to unrelated parties might indicate that the transaction is **not** in the normal course of operations. (HB 3840.26 & .28). If this is the case, the RTP should be measured and recorded at the carrying amount (HB 3840.08), and any difference between the carrying and the exchange amount would be charged or credited to equity along with any income tax amount related to the transferred item (HB 3840.09)

If the 20% discount is common practice for the quantities TPI purchased, then the RPT should be measured and recorded at the exchange amount. (HB 3840.18). The gain or loss on a RPT measured at the exchange amount should be recognized in income for the period, unless another section of the HB requires alternative treatment.

Land

The purchase of land by TPI from SI appears to be a monetary RPT since we also have no indication to the contrary. The transaction is, however, not in the normal course of operations because the exchange of capital assets is not the ordinary business of either company (HB 3840.27). In addition, no change in ownership interest occurred as TPI fully owns SI (HB 3840.29 (a) & .33). Note: one may question the reliability of the evaluation made by 3 real estate agents on the basis that they are not professional appraisers.

The transaction must be measured and recorded at the carrying amount since one of the two conditions is not met (HB 3840.08). As a result, any difference between the carrying and the exchange amount would be charged or credited to equity along with any income tax amount related to the transferred item (HB 3840.09)

Question 4 (continued)

Financial Statements

Since TPI's and SI's financial statements will be consolidated, the effect of the RPT's will be eliminated regardless of the basis used to measure and record the RPT (carrying amount or exchange amount) as the HB recommendations on intercompany gains and losses would apply upon consolidation.

A description of the transactions and the relationship between parties should be provided in a note, along with the recognized amounts and the measurement basis used.

Part B – Accounting for the Purchase of Surfing Machines and Land (SI is 40% owned)

One has to examine the ownership structure before recommending an appropriate treatment. If a single shareholder owns all the remaining shares (60%), TPI may not be able to exercise any influence, and, as a result, would not be related to SI. Accordingly, all transactions between the two companies would be recorded at the agreed upon amounts (HB 3840 would not apply).

If a large number of shareholders own all remaining shares, with no single shareholder owning more than 40%, TPI could be in a position to exercise significant influence, and as a result be related to SI (HB 3840.03 (f), (g) and .04 (a)). Accordingly, the purchase of surfing machines would be a RPT that should be recorded in the same manner as in Part A.

For the land transaction, however, there is an indication that a substantive change in ownership interest would occur as a result of the sale/purchase, because more than 20% of the total equity ownership interests has been acquired by TPI (HB 3840.34). If the evaluation/appraisal supports the exchange amount, the RPT for land should be measured and recorded at that amount (HB 3840.29). The gain or loss should then be recognized in income for the period, unless another section of the HB requires an alternative treatment.

If the evaluation/appraisal does not support the exchange amount, a presumption exists that the RPT is not at fair value; as a result, the carrying amount should be used to measure and record the transaction and any difference between the carrying and the exchange amount would be charged or credited to equity along with any income tax amount related to the transferred item (HB 3840.09).

The same disclosure requirements as in Part A apply to the above RPT.

Question 5 (10 marks) (18 minutes)

Asset Retirement Obligations (HB 3110)

Part A

Accounting in 2005

The obligation to dismantle the wind towers is an asset retirement obligation (ARO) because it is required under the licensing contract between WFI and the Provincial Government and requires the permanent removal of a tangible long-lived asset and the restoration of land to its original condition. (HB 3110.03).

The reasonableness of the estimate made during the environmental assessment should be determined because no indication exists as to how it was calculated. The HB requires that the fair value of the ARO be recognized in the period in which the ARO is incurred as long as a reasonable estimate of the fair value can be made. (HB 3110.05). When such a reasonable assessment cannot be made, the recognition should be delayed until such time as a reasonable one becomes available.

Assuming that the estimate is reasonable, WFI must determine the current fair value of the future obligation because the ARO of \$100 M represents a future outlay. The HB suggests using a present value technique to estimate the current fair value (HB 3110.09). WFI could use the expected cash flow approach – the preferred method – in which multiple cash flow scenarios that reflect the range of possible outcomes and a credit-adjusted risk-free rate are used to estimate fair value. WFI could also use a traditional approach, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value.

WFI should recognize the \$100 M in 2005 by discounting the future obligation using its normal borrowing rate (10%).

Calculation of the present value of the ARO: $\$100 \text{ million} \times 0.09 = \9 M

Journal entry (HB 3110.13)

Long-lived Assets – Wind towers	\$9 M	
ARO		\$9 M

The cost of the wind towers, inclusive of the present value of the ARO, should be allocated in a systematic and rational manner over 25 years (HB 3110.13). Normally, an accretion expense should be recognized in 2005 to recognize the increase in liability over that year.

The ongoing maintenance costs would not be recognized as ARO under HB 3110 (A10), unless the disposal of the maintenance supplies falls under a legal obligation in the contract. Maintenance costs, which last more than one year, could be capitalized as a betterment (for example, if the treatment of corrosion lasts 5 years). Maintenance costs, which are recurring every period, would be expensed.

Question 5 (continued)

Reporting

According to HB 3110.21, WFI should disclose the following information about its AROs:

- “(a) a general description of the AROs and the associated long-lived assets;
- “(c) a reconciliation of the beginning and ending aggregate carrying amount of asset retirement obligations showing separately the changes attributable to:
 - (i) liabilities incurred in the current period;
 - (ii) liabilities settled in the current period;
 - (iii) accretion expense; and
 - (iv) revisions in estimated cash flows;whenever one or more of those four components is significant during the reporting period; and
- “(d) the key assumptions on which the carrying amount of the asset retirement obligations is based, including:
 - (i) the total undiscounted amount of the estimated cash flows required to settle the obligations;
 - (ii) the expected timing of payment of the cash flows required to settle the obligations; and
 - (iii) the rates at which the estimated cash flows have been discounted [JAN. 2004]”

Part B

Accounting in Subsequent Periods

WFI should recognize changes in the ARO due to the passage of time – the accretion expense – and due to revisions to timing or amount of AROs cash flows (HB 3110.16).

WFI should measure the change due to the passage of time based on the interest rate used to initially measure the ARO (HB 3110.17)

Calculation of the change due to the passage of time: $\$9 \text{ M} \times 10\% = \0.9 M

Journal entry

Accretion Expense (not interest expense)	\$0.9 M	
ARO		\$0.9 M

Any changes or revisions to the undiscounted cash flows are recognized as an increase or decrease in the carrying amount of the ARO and the long-lived asset using the current credit-adjusted interest rate for upward revisions and the original one, for downward revisions.

Ongoing maintenance cost should be accounted for in the same way as explained above.

Question 6 (8 marks) (14 minutes)

Non-Monetary Transactions (HB 3831)

The agreement between RI and LI is a non-monetary transaction because it involves the exchange of a non-monetary asset – the use of a patent – for another non-monetary asset – the Green Grids (GG) with no monetary consideration involved (HB 3831.05 (f)). However, the contract lacks important parameters that could ease the measurement and the recording of the exchanges between RI and LI over the 5 years of the contract.

The problem before RI is not the measurement of the patent and its recording, but the measurement and recording of revenues from the use of patent, and cost of the supply of GG.

- The transaction seems to have commercial substance because the cash flow of RI will be substantially different as a result of the supply of GG by LI. (HB 3831.06 (a) & .11-.13);
- The transaction is not a mutual exchange of inventory in the same line of business; it involves the supply of merchandise and the use of a capital asset (HB 3831.06 (b)); and
- The transaction is not a non-monetary non-reciprocal transfer to owners (HB 3831.06 (d)).

However, the fair value of the asset given up (use of patent) may not be measurable unless RI has done some market surveys, or similar research or enquiries to determine the value and viability of the patent and right granting. For example, RI could consider the following factors: length of contracts, number of potential landscaping businesses/contracts, limitation of territories, and the like.

The fair value of the asset received (GG) might be easier to determine based on LI's production costs and volume; for example, one could consider standard cost, estimates of the demand for each variety of GG, mix of products, marginal or variable costs, and the like (HB 3831.09). One should also factor in a profit element to LI's estimates. RI should also take into account LI's ability to produce and deliver the GG in sufficient quantity for its estimated capacity – 5 rooftops a year – and additional demand; RI could alternatively assess the possibility to obtain the GG from other suppliers, should the contract with LI allow it. It is important to note that no indication as to exclusivity or territory protection was provided; this could significantly affect the value of the rights granted under the patent.

Recording of revenues from the use of the patent and cost for the supply of GG will occur only upon execution of the contract by RI and LI. (HB3400.09); it is interesting to note that RI cannot build up an inventory of GG because of the perishable nature of the product components; this too could significantly affect the value of the rights granted under the patent and the availability of the GG at times RI needs them.

Should RI be unable to measure the value of the GG, it should consider using the amortization of the cost of the patent as a basis; the process of allocating this cost will involve making assumptions such as the useful life of the patent, and the basis for recognition (e.g., square footage for revenue or cost recognition). However, no information is currently available to arrive at such measurements.

Question 6 (continued)

Sample calculation based on LI's costs:

Average square footage, each rooftop	2,500
Planned rooftops	<u>5</u>
Total square footage needed	<u>12,500</u>

LI's low-end cost	\$10	
Profit component (50% of the cost)	<u>5</u>	
Cost per square foot to RI, if purchased		<u>\$ 15</u>
Measurement of revenue		<u>\$187,500</u>

LI's high-end cost	\$20	
Profit component (50% of the cost)	<u>10</u>	
Cost per square foot to RI, if purchased		<u>\$ 30</u>
Measurement of revenue		<u>\$375,000</u>

Question 7 (8 marks) (14 minutes)

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

Part A

The primary responsibility for the prevention of fraud rests essentially on management and those charged with governance. As a result, management is responsible to put in place measures that reduce the opportunities for fraud, deter, detect and punish fraud. This involves setting a culture of honesty and ethical behaviour, such as:

- setting the proper tone,
- creating a positive workplace environment,
- hiring, training and promoting appropriate employees and
- taking appropriate action in response to actual, suspected or alleged fraud.

The auditor must ensure that the entity has established and maintained internal controls that provide reasonable assurance regarding:

- reliability of financial reporting;
- effectiveness and efficiency of operations; and
- compliance with laws and regulations.

RPCL’s situation illustrates the pressures management is facing with honesty and ethical behaviour; for example the pressure from the IPO and the bank; the issue of the current performance measurement in light of declining profits and the coming IPO. In this case, the Vice-President, or management, may fall to the pressure of reporting better looking financial statements unless it has created controls that would flag attempts at mismanaging earnings.

The creation of an oversight body or an audit committee that would review the financial reporting process could help reduce such risk, but the risk cannot be totally eliminated.

Part B

The auditor must obtain reasonable assurance that the financial statements are free from material misstatement whether through fraud or error, and must follow GAAS. The auditor must maintain an attitude of professional scepticism and should be alert to circumstances under which fraudulent financial reporting might occur. Examples in this situation would be:

- RPCL’s declining profits;
- The bank’s renewal of RPCL’s line of credit;
- RPCL’s initial public offering, and
- the potential for management to override controls.

Question 7 (continued)

Part C

Fraud is an **intentional** misstatement of the financial statements or financial reporting; this may be what RPCL is contemplating for its IPO; the VP may want to massage figures to meet the bank's criteria for renewal of the line of credit, or minimize the decline in revenues and profits for the IPO so as to maintain profitability trends over the years. Fraud can also arise from misappropriation of assets, such as employee theft of physical assets

Error is an **unintentional** misstatement in the financial statements such as data processing errors, incorrect accounting estimates, incorrect application of accounting principles, misinterpretation of facts or circumstances in a transaction.

Question 8 (8 marks) (14 minutes)

Audit of Fair Values and Disclosures (HB 5306)

The auditor should obtain sufficient appropriate audit evidence that fair value (FV) measurements are in accordance with GAAP (HB 5306.04). The fair value is 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.

The auditor should gain an understanding of the entity's processes for determining FV and the relevant control activities (HB 5306.13), that is sufficient to identify and assess the risks of material misstatements at the assertion level, and to design and perform further audit procedures

After gaining such an understanding, the auditor should identify and assess the risks of material misstatement at the assertion level (HB 5306.18) to determine the nature, timing and extent of the further audit procedures, and should design and perform further audit procedures in response to assessed risks of material misstatement.

The auditor should evaluate whether the measurements and disclosures are in accordance with GAAP (HB 5306.22 & .61) and when choices are available (or none exist) whether they are appropriate in the circumstances (under GAAP (HB 5306.28)).

The auditor should obtain audit evidence about management's intent and ability to carry out specific courses of action when intent is relevant to the use of FV measurement (HB 5306.26) and should evaluate whether the method for FV measurements is applied consistently (HB 5306.31).

The auditor should determine whether it is appropriate to use the work of a specialist (HB 5306.33) (as opposed to that of the internal analyst) and whether management's assumptions provide a reasonable basis for the valuations (HB 5306.44).

The auditor should perform audit procedures on data used to develop FV measurements and evaluate whether FV measurements are properly determined from such data (HB 5306.55) and should evaluate the consistency of the evidence with other audit evidence obtained during the audit (HB 5306.66).

The auditor should consider the effect of subsequent events on the FV measurements (HB 5306.58) and should obtain written representations from management regarding the reasonableness of significant assumptions including whether they reflect management's intent and ability to carry out actions (HB 5306.68).

Question 9 (7 marks) (13 minutes)

Communication with the Audit Committee (HB 5751)

Reservation in the Auditor's Report (HB 5510)

Part A

Communication with the Audit Committee (AC)

As CM is a registered charity recommendations related to entities with public accountability apply (HB 5751.07).

The following should be part of the communication to the AC:

- (a) the audit and non-audit services that the auditor is providing to the entity and its related entities (HB 5751.15 (a)). This enables the AC to assess whether the terms of the engagement meet its needs. Should the AC request any additional work over and above the audit, the auditor should confirm in writing what is agreed to.
- (b) the level of responsibility assumed by the auditor under GAAS (HB 5751.15 (b)). Management is responsible for the preparation of the financial statements. The auditor's responsibility is to express an opinion on the financial statements. An audit is performed to obtain reasonable but not absolute assurance as to whether the financial statements are free of material misstatement.
- (c) a summary of the overall audit strategy (HB 5751.15 (c)). This would include the general approach to the audit, areas of the financial statements identified as having a high risk of material misstatement, the materiality and audit risk levels on which the audit is based, and the preliminary assessment of internal control.

Part B

Reservation in the Auditor's Report: Scope Limitation

The auditor should express a qualified opinion in light of the scope limitation on completeness of revenues from the door-to-door campaign/canvassing. However, if the scope limitation is so pervasive or significant that no basis for an opinion exists, the auditor should deny an opinion.

The auditor's standard report should be clearly modified so as to draw attention to the reservation (HB 5510.29) as follows:

- a reservation paragraph should be inserted between the scope and opinion paragraphs of the report, setting out the matters as required by paragraph (HB 5510.34);
- the scope paragraph should contain a reference to the reservation paragraph;
- the opinion paragraph should include wording appropriate for the type of reservation of opinion and a reference to the reservation paragraph;
- the opinion paragraph should use the words "except for", "except that" or "except as" (HB 5510.30); it should **not** use wording that bases the qualification on the scope limitation itself.

Question 9 (continued)

The reservation paragraph should (HB 5510.34)

- include all of the auditor’s reservations;
- provide an adequate explanation of the reasons for each reservation; and
- indicate clearly the extent to which the financial statements may be affected by a departure from GAAP as a result of the scope limitation.

The auditor should provide a statement and explanation as to his or her inability to reasonably determine the effect of the scope limitation on the financial statements.

Question 10 (7 marks) (13 minutes)

Evaluation and disposition of misstatements (HB 5142)

Part A

The auditor should estimate the likely aggregate misstatement (HB 5142.19) by aggregating:

- the misstatements identified as a result of performing specific auditing procedures on other than representative samples;
- the projections of misstatements identified as a result of performing auditing procedures on representative samples;
- the disagreements with accounting estimates; and
- the net effect of uncorrected misstatements in opening equity.

The auditor should aggregate the misstatements so that he or she can ascertain whether, in relation to individual amounts, subtotals or totals in the financial statements, they materially misstate the financial statements as a whole. Furthermore, consideration should be given to further possible misstatements, possible overall bias in accounting estimates and significant changes in bias from one period to the next.

Part B

The auditor should request that management adequately address the misstatement by applying the appropriate accounting principles, by correcting/adjusting the financial statements, or rectifying inadequate disclosure.

If management does not appropriately address the misstatement, the auditor should express a reservation in his or her report.

The auditor would exercise professional judgment when determining the need for a reservation because materiality represents a grey area between what is very likely not material and what is very likely material.

The auditor should also realize that misstatements, although immaterial for the current financial statements, can contribute to material misstatement of future financial statements when aggregated (cumulative effect that resides in opening equity).

The auditor should obtain a written representation from management that it believes the effects of any uncorrected misstatements of the financial statements, as aggregated by the auditor during the audit, are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (HB 5142.24)

This representation is, however, not a substitute for obtaining sufficient appropriate evidence.

Question 11 (8 marks) (14 minutes)

Review engagements (HB 8100 & 8200)

Part 1

A review consists primarily of enquiry, analytical procedures and discussion related to information supplied to the public accountant by the enterprise with the limited objective of assessing whether the information being reported on is plausible within the framework of appropriate criteria.

Enquiries are typically enquiries of management concerning the business activities of the enterprise and the industry of which it is a part and concerning control systems in order to understand how transactions are recorded, classified and summarized. Examples:

- description of the products made or sold, suppliers used, major customers
- who does the bookkeeping, what software is used, who signs cheques, who does and supervises bank reconciliation, payroll preparation

Analytical procedures are typically ratio analyses of representations found in the financial statements, and would include comparing the financial statements with those of the immediately preceding period and with any budgets for the current period, and considering interrelationships of key elements of financial statements that would be expected to conform to a predictable pattern based on the experience of the enterprise. Examples:

- change in sales, cost of sales, budget variances
- profit margin, interest expense

Discussions are typically discussions with appropriate officials of the entity concerning information received or being reported on. Examples:

- discussions on GAAP being used; commitments or obligations and contingencies; subsequent events; RPT's

Part 2

The public accountant should perform sufficient additional or more extensive procedures so as to resolve such doubt or to confirm it. (HB 8100.20 & 8200.27)

Part 3

If the doubt persists and involves a scope limitation, lack of plausibility, a GAAP departure, or an unreasonable interpretation of significant provisions, a reservation should be expressed in the review engagement report (HB 8100.34). The report should draw attention to the reservation by inserting it immediately before the negative assurance paragraph, which should be properly worded and make reference to the reservation (HB 8100.37).

Question 12 (6 marks) (12 minutes)

Use of specialists in assurance engagements (HB 5049)

Part A

Considerations in selecting a specialist or using the work of a specialist include:

- the specialist's expertise and competence in the subject matter and integrity;
- the relevance of the specialist's expertise to the practitioner's objectives in the assurance engagement;
- the objectivity and independence requirements of the practitioner;
- the nature and extent of the anticipated use of the specialist. For example, whether the specialist will be part of the team or used on an arm's length basis.

Part B

The auditor should be satisfied

- that there are no restrictions on what the specialist can communicate to the auditor that would impair the auditor's ability to conduct the assurance engagement;
- the specialist must be able to provide a report on the degree of completion, the assumptions used in determining such a degree, etc.
- that, when the specialist is engaged by the auditor, management has agreed to the exchange of confidential information with the specialist, unless the need for such agreement is obviated by statute or regulation; the specialist should be granted access to construction sites, engineers reports, budgeted costs, construction and materials plans, etc.
- that the specialist agrees to preserve the confidentiality of information the auditor provides to him or her; the specialist should not discuss any instructions from the auditor with ABC's management, except when it involves obtaining information on each project.
- that, when the auditor engages the specialist, he or she obtains the specialist's written agreement that the specialist will carefully and faithfully preserve the confidentiality of any information acquired for the purpose of the assurance engagement, and not make use of such information other than as shall be required in the performance of such services (HB 5049.41); the specialist should not use knowledge acquired – on proprietary technologies or processes, for example – when determining the degree of completion with other clients in the same business (competitors).

The specialist may have his or her own confidentiality requirements that would be discussed with the practitioner. (HB 5049.42)

Part C

The auditor should not refer to the use of a specialist in the auditor's standard report.

Question 1 (12 marks) (22 minutes)

Employment Income Calculation

Salary			\$120,000	
Travel allowance (not reasonable – 6(1)(b)(x))			2,500	
Commission revenue received			\$16,000	
Commission-related expenses				
Sales expenses (8(1)(f))				
Car operating expenses	$\$6,000 \times 16/28 =$	\$ 3,429		
Parking		1,200		
Advertising		5,000		
Entertaining customers	\$ 8,000			
Meals	<u>6,000</u>			
Deductible at 50% (67.1)	<u>\$14,000</u> × 50%	7,000		
Home office expenses (subject to limit):				
Property taxes	\$ 5,500			
Insurance	<u>900</u>			
Business usage 10%	<u>\$ 6,400</u> × 10%	<u>640</u>		
		<u>\$17,269</u>		
<i>Limited to commission revenue</i>			<u>16,000</u>	<u>0</u>
				\$122,500
Deductions				
Interest on car loan:				
Interest paid (8(1)(j))	\$3,800			
Limited to (67.2)	$\$300 \times 365/30$		\$ 3,650	
CCA on car:				
Purchase price	\$35,000+ tax			
Limited to \$30,000+ 7% GST + 8% PST *		<u>\$34,500</u>		
End of 2004 UCC	$\$34,500 \times 85%$	29,325		
2005 CCA		<u>× 30%</u>	<u>8,798</u>	
			\$12,448	
<i>Employment usage</i>			<u>16/28</u>	7,113
Salary paid to part-time assistant (8(1)(i)(ii))			\$ 9,000	
Computer paper (8(1)(i)(iii))			<u>80</u>	9,080
Home office expenses (not subject to limit):				
Utilities		\$4,200		
Repairs & maintenance		<u>1,000</u>		
Business usage 10%		<u>\$5,200</u>	× 10%	<u>520</u>
Employment income				<u>\$105,787</u>

* PST amount is calculated at 8% for Ontario; rate for other provinces will differ, and as a result, the calculated deductions.

Question 1 (continued)

The employer must provide the Form T2200 certifying that the employment contract requires the employee to incur and pay for employment-related expenses (8(10))

The following amounts were not taxable /deductible

- The bonus of \$12,000 is not taxable in 2005 because not it was not received in 2005;
- Golf club membership not deductible for tax purposes (18(1)(l); 8(1)(f)(vi));
- The laptop computer is a capital expenditure. CCA on a computer is not deductible in computing employment income.
- Mortgage interest incurred to purchase a home is not deductible in computing employment income (8(1)(f)(v)).
- The monthly costs for the telephone line are not deductible as it is not a separate telephone line. It is an extension added on to the personal home line.

Question 2 (8 marks) (14 minutes)

Part A Types of Income

- Retail Inc.’s income from operating the chain of clothing stores is Active Business Income (ABI) because its income is derived from a business carried on by a corporation other than a personal services business or a specified investment business.
- Services Inc. and Realco Inc. are associated corporations because same shareholder controls both of them: Barb owns 100% of each corporation (256(1)(b)).
- Services Inc. may carry on a personal services business because Barb, who performs the services on behalf of Services Inc., is a specified shareholder of Services Inc. (125 (7)(a) and 148(1)); however, because the income from services was received from an associated corporation, the income from services qualifies as ABI (125(7)(d)).
- In addition, there is not enough information to conclude whether Barb could reasonably be regarded as an employee of Realco Inc. but for the existence of Services Inc. The income derived from services provided to various other clients is ABI.
- Realco Inc. carries on a specified investment business (SIB), the principal purpose of which is to earn income from property. As a result, income received from Retail Inc. is income from property or SIB. Because income from SIB and property are taxed in the same manner, it is not necessary to differentiate them further.
- However, because Realco Inc. and Services Inc. are associated corporations, income received from Services Inc. is deemed to be ABI.

Part B Taxation of Income

- For Retail Inc., the ABI is taxed at 38% (federal rate); however, the first \$300,000 of ABI earned annually by Retail Inc. qualifies for the Small Business Deduction.
- Since Services Inc. and Realco Inc. are associated corporations they must share the \$300,000 annual business limit.
- For Services Inc., the ABI is taxed at 38% (federal rate) (same as above); however, the ABI earned by Services Inc., to the extent of Services Inc.’s allocated business limit, will qualify for the Small Business Deduction.
- For Realco Inc., the ABI is taxed at 38% (federal rate); however, the ABI earned by Realco Inc., to the extent of Realco Inc.’s allocated business limit, will qualify for the Small Business Deduction.
- Income from property (and SIB) is taxed at 38% and does not qualify for the Small Business Deduction. It is subject to an additional refundable tax of 6 2/3%. However, 26 2/3% of the income is eligible for refundable tax and accumulates in the refundable dividend tax on hand account (RDTOH).
- The refundable dividend tax on hand amount will be refunded to Realco Inc. when Realco Inc. pays dividends to its shareholders: for every \$3 of taxable dividend paid by Realco Inc., it will receive a refund of \$1.

Question 3 (30 marks) (54 minutes)

Part A

- 1) Related corporations: R Ltd., N Ltd. and P Ltd. are related corporations (256(2)(c)(ii)).
- 2) Affiliated corporations: R Ltd. and N Ltd. are affiliated (251.1(1)).
- 3) Associated corporations: R Ltd. and P Ltd. are associated, because R Ltd. is controlled by Rod (60%); P Ltd. is controlled by Peter (100%); Rod and Peter are related; and Peter owns at least 25% of the issued shares of each corporation (40%) (256(1)(c)).
- 4) Connected corporations:
 - R Ltd. is connected with P Ltd., because P Ltd. owns more than 10% of issued shares of R Ltd. having full voting rights and representing more than 10% of fair market value and R Ltd. is controlled by Rod (60%).
 - N Ltd. is connected with P Ltd., because more than 50% of the issued shares of N Ltd. belong to P Ltd. and Nan, a person related to P Ltd (8% + 60% = 68%).

Part B

- 1) Tax instalments are required for 2006 because the balance of tax owing (federal and provincial combined) for 2006 and one of the two prior years exceed \$2,000.
- 2) The 2006 instalments are due quarterly, on the 15th of March, June, September, and December.
- 3) The first two instalments will be \$10,000 each, based on 2004, and the last two instalments will be \$20,000 each, based on 50% of [2005 taxes (\$60,000) minus (2 × \$10,000)] = 50% × \$40,000.¹
- 4) Jessica's 2006 income tax return is due June 15, 2007.
- 5) Jessica's balance of tax owing for 2006 is due April 30, 2007.

Part C

- 1) *Tax consequences when no election is made:* The transfer is deemed to occur at fair market value, \$80,000 for Michelle and Koven Corp. For Michelle, the sale of the equipment will result in taxable income from recapture of \$30,000 (UCC of \$50,000 – proceeds of \$80,000). For Koven Corp., the UCC of the equipment on which to base future CCA will be \$80,000. The capital cost for future recapture purposes will be deemed to be \$100,000 (the original ACB).
- 2) *Tax consequences when election is made:* For Michelle, the elected transfer price must be equal to the UCC of the equipment to defer the recognition of taxable income, and the amount on debt taken back must not exceed \$50,000. For Koven Corp., the UCC of the equipment on which to base future CCA will be \$50,000. The capital cost for future recapture purposes will be deemed to be \$100,000.

¹ The solution version posted prior to July 12, 2007 incorrectly indicated “based on estimate for 2006.”

Question 3 (continued)

Part D

- 1) Hexbah Inc.'s 2005 tax return was due June 30, 2006, six months after its year-end.
- 2) The late-filing penalty is \$1,400: $((5\% + 1\% \text{ for each of complete late month (2 in this case)} = 7\%) \times \text{the unpaid tax balance of } \$20,000)$.
- 3) The balance of tax for 2005 is due March 31, 2006; Hexbah Inc. is a CCPC, which claims the small business deduction, and its taxable income for the prior year did not exceed its business limit.

Part E

Because Erma sold her shares at less than the fair market value (FMV) to a person with whom she is not dealing at arm's length, she is deemed to have sold the shares at their fair market value. Accordingly, she will report a taxable capital gain of \$2,000 in 2005, determined as follows:

Actual proceeds	<u>\$ 7,000</u>
Deemed proceeds (FMV)	\$10,000
Adjusted cost base	<u>(6,000)</u>
Capital gain	<u>\$ 4,000</u>
Taxable capital gain	<u>\$ 2,000</u>

Eddie is deemed to have acquired the shares at the price actually paid (\$7,000) regardless of fact that the transaction was not at arm's length. The consequence is double taxation of a capital gain of \$3000 (\$1,500 being taxable twice).

In 2010, he will report a taxable capital gain of \$4,500, determined as follows:

Actual proceeds	\$16,000
Adjusted cost base (amount paid)	<u>(7,000)</u>
Capital gain	<u>\$ 9,000</u>
Taxable capital gain	<u>\$ 4,500</u>

The dividend income received by Eddie in 2005 and 2006 should be included in Erma's income, under the attribution rules because at that time, Eddie is a minor child.

The dividend income received by Eddie in subsequent years will be included in Eddie's income because the attribution rules no longer apply, Eddie having reached the age of majority for taxation purposes.

Question 3 (continued)

Part F

The taxable benefit for 2005 is \$3,520, as calculated below:

<i>Standby charge:</i>	\$42,000	
	× 0.50	5,000 km/(1,667 km × 6 months)
	× 2%	
	<u>× 6 months</u>	
	2,520	
<i>Operating benefit:</i>	<u>1,000</u>	5,000 personal km × \$0.20/km
	<u>\$ 3,520</u>	

Although not advantageous for him in this case, Chris could make an election that would allow him to determine the Operating Benefit as 50% of the Standby Charge. In other words, the election would allow the taxable benefit to equal 150% of the Standby Charge.

Part G

Part IV tax:

On dividends received from non-connected corporations: \$12,000 × 1/3 =	\$4,000
On dividends received from connected corporation (Nadal Inc.):	
– The amount of the dividend refund \$21,000 × 20% =	<u>4,200</u>
	<u>\$8,200</u>

Part H

Because the shareholder loan remains unpaid at May 31, 2006, one year following the end of the year in which it was made (May 31, 2005), the shareholder must include \$40,000 in his 2005 income for tax purposes.

In 2007, when the loan is repaid, the shareholder can deduct \$40,000 from his income for tax purposes.

Since the loan is included in the shareholder’s income there is no imputed interest benefit.

Part I

The UCC of the Class 8 at the end of 2004 is \$14,400, calculated as follows:

2003	Purchase	\$20,000
	CCA: \$20,000 × 20% × ½	<u>(2,000)</u>
	UCC at the end of 2003	18,000
2004	CCA: \$18,000 × 20%	<u>(3,600)</u>
	UCC at the end of 2004	<u>\$14,400</u>

- 1) Selling for \$13,000 creates a terminal loss of \$1,400 deductible in computing income.
- 2) Selling for \$22,000 creates a taxable CCA recapture of \$5,600, and a taxable capital gain of \$1,000 (((\$22,000 – 20,000)/2).

Question 4 (9 marks) (16 minutes)

Contract Law

Issue: Existence of a contract

- Given that PPI claims, or threatens to sue for what appears to be, a breach of contract by Moore, one should question as to whether a contract existed in the first place. Consider the following:
- Did Moore and Bookbinder have an oral contract at the time they shook hands?
- Considering there was an offer, an acceptance and a consideration, a contract may exist.
- Could the meeting events be interpreted as merely a negotiation with the actual contract being the one prepared by the lawyers?
- As a result, a contract would formally exist at such time it is signed by both parties.
- One could question whether cashing an advance cheque would be interpreted as signing a contract, and in this case whether the royalty advance cheque of \$10,000 has been cashed by Moore.
 - If Moore did not cash the cheque, then there is revocation of the proposal or offer because it was not accepted.
 - If Moore did cash the cheque, there could still be revocation because no formal contract has been signed and the rest was merely an offer.
 - If Moore did cash the cheque, but cannot perform as a result of his circumstances, there could be frustration of the contract.
 - In the latter two situations, Moore owes PPI \$10,000 and would have no additional liability or obligation toward PPI. (*note: a candidate could have arrived at a different, yet valid, conclusion based on a different approach*)

Issue: A contract exists but the cheque did not arrive by the agreed upon date, October 31

One could argue that failure to send the funds by October 31 represents a breach of a condition of the contract and as a result Moore would be discharged from any obligations. However, should the royalty advance of \$10,000 be only a minor clause in the contract, Moore would not then be discharged of his obligations toward PPI.

Issue: Does Moore's illness in November constitute "frustration"?

Frustration occurs when, through no fault of either party, a contract becomes incapable of performance. In this situation, one could question whether Moore's illness would provide for a discharge from the agreement, as it appears that Moore could not perform. One could also question whether the incorrect diagnosis invalidates the "frustration."

Issue: Quantum of damages

In contract law, the purpose of damages is to put the parties in same position as if the contract had proceeded. In this case, PPI would have to pay Moore his royalty, as PPI cannot just get \$300,000 without paying the royalty. However, higher damages may be ordered for lost profit of PPI, and not just the profit Moore realized on his own. One would consider Moore's revenue and publication cost in comparison with PPI's own for the same publication.

Question 5 (6 marks) (11 minutes)

Tort Law – Product Liability

General

One should consider who the possible defendants would be: MCI, LBI, or both MCI and LBI. On the other side, the plaintiffs could be Cough, his insurance company, his employer, or a combination of these.

The plaintiff, having the burden of proof, must prove as a civil matter (tort claim) on “balance of probabilities.”

In this case, the fire investigator could not determine the causation of the fire (it could have been caused by the battery, the wiring in the home office, or any other agent).

This is a tort issue, and not a contractual one (the employer’s computer is used at home).

Duty of Care

One question arises as to whether MCI, LBI, or both owed Cough a duty of care. One may argue that the duty of care is owed to Cough’s employer who purchased the computer for its business. One may argue that the authorization to use the computer at home for a use other than business has changed the duty of care. One may argue that an unauthorized use affects the manufacturer’s obligation towards its products. Certainly manufacturers owe a duty of care to the parties that use their products; as a result, duty is owed to Cough (*note: a candidate could have arrived at a different, yet valid, conclusion based on a different approach*).

Breach of Duty

Another question arises as to whether the use of this particular battery in this computer model represents a design problem or flaw. One should consider

- whether safety tests have been performed, the extent of such tests (i.e., pushed to burning), if any, and their results or conclusions;
- whether MCI was aware of the possible fire risk; Cough may or may not know that Testers Lab’s did such tests and issued a warning;
- whether not informing users of the possible risks despite MCI’s awareness of the risks, could be breach of duty.

One may argue that LBI shares contributory negligence for allowing the use of an “improperly fitted” battery for the computer model. This would clearly be the case if the battery had been designed for this particular model of computer.

One may conclude that a breach of duty likely occurred in this instance (*note: a candidate could have arrived at a different, yet valid, conclusion based on a different approach*).

Damages/Liability

Damages are obvious – the fire – but the extent is unknown.

The causation must be determined; the plaintiff must show that the battery or the combination of battery and computer caused the fire.

Question 5 (continued)

Others

MCI, LBI or both should consider a recall on the battery; without such a recall, MCI is exposed to a higher risk of future legal actions.

MCI, LBI or both should settle out of court, given that such a settlement would avoid public exposure and is usually less costly. MCI could create a fund from which the settlement for each case can be drawn.

It is also possible that the insurance may pay for the damages at Cough's house and in turn sue MCI, LBI or both to recover the amount paid directly to the insured party.

Question 6 (5 marks) (9 minutes)

LLP

What is a LLP

LLP stands for Limited Liability Partnership, not for limited partnership; it is intended for professions governed by an Act (such as chartered accountants), under which such formation is allowed.

Differences with General Partnership

A LLP firm operates like a general partnership. However, the individual partners are not liable for the professional liability of the other partners if certain requirements are met. For example, if a firm were to get sued for professional negligence, all of the assets of the firm would be exposed, but if a shortfall exists, a partner who did not participate in the negligent act would have no further liability.

In a LLP, all of the partners remain jointly and severally liable for the other obligations (e.g., contract) of the LLP and any of them could get sued for their personal assets regardless of their own involvement or participation in the causation for the lawsuit.

Requirements for Creating an LLP

A LLP is created by statute under the Partnerships Act (or similar act in jurisdictions other than Ontario), through a requisite filing (i.e., not common law).

The letters “LLP” (or the spelled out version) must be added to the firm’s name, and that name including the letters LLP must be registered under the Business Names Act (or similar act in jurisdictions other than Ontario), and with the ICAO, or the respective provincial Institute or Ordre (or relevant governing body for other professions).

A LLP must maintain minimum liability insurance as required by the ICAO or the respective provincial Institute or Ordre.

Advantages

The main advantage of creating a LLP is that it provides a lower exposure to its partners than a General Partnership with its unlimited liability.

Other points

Despite the existence of an excellent quality control, the firm could still be exposed to the risk of professional negligence, making the LLP an attractive solution to all partners.

Conclusion

SLS should consider forming a LLP given that most requirements – such as the minimum required liability insurance – are likely in place, except the registration of the name.

Question 7 (26 marks) (47 minutes)

Rules of Professional Conducts

Part A (12 marks)

211.1 Duty to report breach of RPC

- Mailstrom strongly implies not to report any RPC issue by stating: “this will go no further ‘Buddy’ ”)
- Richards would have an obligation to report all non-trivial breaches about the firm.

217.1 Advertising and Promotion

- The statement that Richards would be required to make in the client-soliciting letter about her leaving Turnbull to join a firm providing superior client service may be construed as making unfavourable reflections on the competence of Turnbull.

217.2 Soliciting clients

- The early follow up on each of the client-soliciting letters may be perceived as harassment.

205 False or misleading documents

- The statement “tell them whatever...” could be construed as requesting Richards to make a false or misleading statement in the client-soliciting letter.
- With respect to the long-term loan to the senior partner, the firm is associating itself with false or misleading financial statement.

214 Fee Quotation

- Offering a fee quote at 10% less without having obtained sufficient information to support the quoted fee is a breach of RPC.

203.1 Professional competence

- The suggestion or recommendation to stop taking courses could lead to failure to sustain professional competence in the main areas of expertise.

206 Compliance With Professional Standards

- There seems to be a breach of compliance with professional standards by not planning the audit work as required under the Handbook and by allowing significant misrepresentation in a client’s financial statements (long term loan to the senior partner classified as current asset)

209 Borrowing from Clients

- This RPC specifically precludes a member from borrowing from a client that is not a bank or a financial institution.
- In addition, the borrowing represents a threat to independence (may cloud one’s objectivity) under RPC 204

Question 7 (continued)

Part A (continued)

202 Integrity and due care

- The firm failed to perform audit and tax services with integrity and due care by not correcting material errors in the corporate tax returns.
- Intentional failure to adjust the tax returns for non-deductible expenses could be construed as tax evasion.
- As a result, the firm could be associated with an unlawful activity contrary to RPC 213.

203.2 Co-operate with practice inspection

- Making up an audit planning memo, should a practice inspection occurs, could be construed as a plan to deceive the Institute and failure to co-operate.

201.1 Maintenance of Reputation of Profession

- As a result of the above breaches of RPC, Globber & Mailstrom failed to maintain the good reputation of the profession.

501 Firm’s maintenance of policies and procedures for compliance with professional standards

- Globber & Mailstrom is failing to maintain appropriate policies and procedures designed to ensure its services are performed in accordance with GAAS (e.g., independence; planning).

502 Firm's maintenance of policies and procedures: competence and conduct of firm members

- Globber & Mailstrom is failing to maintain appropriate policies and procedures designed to ensure that its members comply with the RPC (e.g., maintain good reputation of the profession)

Part B (6 marks)

208 Confidentiality of information

- Nudster should not have provided his working papers to the purchaser without the formal approval from the vendor, his client.
- He also should not have suggested adjustments so as to normalize earnings.

210 Conflict of Interest

- There is a possible conflict of interest for acting on behalf of both the purchaser and the vendor at the same time (210.2 (b)).
- Nudster should have declined or not accepted working on behalf of the purchaser unless he had obtained prior consent from the vendor.

204.1 Independence in fact and appearance

- “Getting the audit” could be construed as part of the remuneration for the purchase agreement, which jeopardizes Nudster’s independence.

Question 7 (continued)

Part B (continued)

204.8 Disclosure of Impaired Independence

- Factual or perceived independence no longer exists given the role and the remuneration scheme (audit engagement and fee) that Nudster is receiving.

207 Unauthorized benefits

- The sole shareholder of DSL was not aware that Nudster was receiving compensation from purchaser.

202 Integrity and Due Care

- It is questionable as to whether integrity and due care were considered by Nudster in providing services to DLS and its shareholder, the vendor.

201 Maintenance of Reputation of Profession

- Nudster failed to maintain the reputation of the profession by breaching the many Rules of Professional Conduct listed above.

Part C (8 marks)

General

- The Rules of Professional Conduct apply to members not engaged in public practice (with exceptions) and, as a result, would apply to Tank when acting as VP Finance as an employee of Largess Limited

102.1 Conviction of Criminal or Similar Offences

- Tank should have informed the Institute about having been found guilty of insider trading according to Rule 102.1 (b)
- However, it is possible that Tank's right to appeal has not been exhausted or expired, which may account for the failure to report.

213 Unlawful Activity

- Tank appears to have engaged in unlawful activities by being a party to insider trading.

208 Confidentiality of Information

- Tank appears not to have maintained the confidentiality of the information pertaining to his employer by disclosing confidential information to third parties without the knowledge or consent of LL, the employer.

205 False or Misleading documents

- Tank associated himself with false or misleading financial statements that are now being restated.
- He also associated himself with misrepresentations on his own resume when he stated that he had been a partner in a national accounting firm, while he actually was a senior manager.

Question 7 (continued)

Part C (continued)

206 Compliance With Professional Standards

- Tank failed to comply with professional standards as a Vice President responsible for overseeing the preparation of Financial Statements that later were found to be misleading

202 Integrity and Due Care

- Tanks failed to perform his duties with integrity and due care by associating himself with misleading financial statements, by participating in an insider trading scheme and by misrepresenting his competence and achievements on his resume.

201 Maintenance of Reputation of Profession

- Tank failed to maintain the reputation of the profession by breaching the many Rules of Professional Conduct listed above.

Question 8 (4 marks) (7 minutes)

Threats to Independence

Independence is potentially affected by self-interest, self-review, advocacy, familiarity and intimidation threats:

- 1) A **Self-Interest Threat** occurs when a firm or a person on the engagement team could benefit from a financial interest in, or other self-interest conflict with, an assurance client. Example: a direct financial interest or material indirect financial interest in an assurance client (*other examples could be valid*).
- 2) A **Self-Review Threat** occurs when any product or judgment from a previous engagement needs to be evaluated in reaching conclusions on the particular assurance engagement, or when a person on the engagement team was previously a director or officer of the client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement. Example: a person on the engagement team being, or having recently been, a director or officer of the client (*other examples could be valid*).
- 3) An **Advocacy Threat** occurs when a firm, or a person on the engagement team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may be, or may be perceived to be, impaired. Such would be the case if a person on the engagement team were to subordinate his or her judgment to that of the client, or the firm were to do so. Example: dealing in, or being a promoter of shares or other securities of an assurance client (*other examples could be valid*).
- 4) A **Familiarity Threat** occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a person on the engagement team becomes too sympathetic to the client's interests. Example: a person on the engagement team having an immediate or close family member who is director or officer of the assurance client (*other examples could be valid*).
- 5) An **Intimidation Threat** occurs when a person on the engagement team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client. Example: the threat of being replaced due to a disagreement with the application of an accounting principle (*other examples could be valid*).