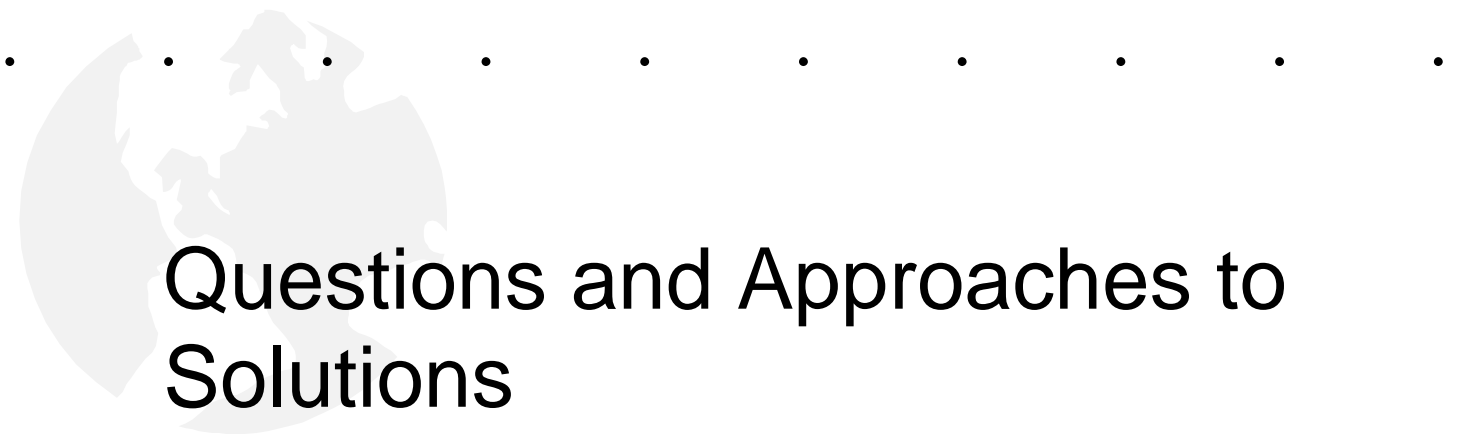




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# CARE Chartered Accountant Reciprocity Examination 2007

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	2007		2006		2005	
	Number of Writers	% Pass	Number of Writers	% Pass	Number of Writers	% Pass
British Columbia	15	53	14	86	19	89
Alberta	5	40	6	50	5	40
Saskatchewan	2	100	–	–	–	–
Manitoba	1	100				
Ontario	78	62	57	67	55	60
Quebec	9	89	6	67	2	0
New Brunswick	–	–	–	–	–	–
Nova Scotia	–	–	–	–	–	–
Newfoundland	–	–	–	–	–	–
<b>Total</b>	<b>* 110</b>	<b>63</b>	<b>* 83</b>	<b>69</b>	<b>* 81</b>	<b>64</b>

\* excludes re-admission candidates

**ANSWER SHEET**

**Question 1**

**CANDIDATE NUMBER:** \_\_\_\_\_

**THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA**

**CA RECIPROCITY EXAMINATION**

**DAY ONE - 2007**

**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	
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Total	_____
×	2
	_____

**THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA**

**CA RECIPROCITY EXAMINATION**

**DAY ONE – 2007**

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**(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 front 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

When determining impairment of assets, a company looks at asset groups. Which one of the following **best** describes the assets/liabilities that should be included/excluded from the asset group for impairment assessment purposes?

- a. A mortgage liability on a building that is included in an asset group and that represents the only source of cash flow to pay the liability.
- b. Goodwill that relates to a larger asset group.
- c. Inventory and accounts receivables should never be included.
- d. Goodwill is never included.

(ii) Revenue Recognition

Ginger Limited (GL) sells annual memberships to its gym facilities. The membership fees are payable upfront in January but members may cancel at any time before June 30 and receive a full refund of the membership fees. Assuming that GL must follow generally accepted accounting principles, which one of the following **best** describes how and when to recognize revenues?

- a. GL may not recognize revenues until the cancellation period is over.
- b. GL may recognize revenues over the year as long as it can estimate cancellations based on history.
- c. GL may recognize revenues up front as long as it can estimate cancellations based on history.
- d. GL may recognize revenues over the year and recognize the impact of any cancellations as they occur.

**Question 1 (continued)**

(iii) Date of the Auditor's Report

Heinrich and Heinrich, LLP, is planning to sign the audit report of one of its clients. The senior and manager on the job are discussing the date of the audit report. Which one of the following statements is **not correct** as it relates to the date of the auditor's report?

- a. The auditor has no continuing responsibilities to seek further audit evidence after the date.
- b. Management must continue to monitor events after the date that might affect the financial statements.
- c. If an event comes to the attention of the auditor after the date, the auditor would consider this in the next year's audit only.
- d. Management must keep the auditors informed of significant events after the date that might affect the financial statements.

(iv) Fraud

Auditors are concerned with fraud that results in misstatement of financial statements. Which one of the following situations is **not** considered to be fraud?

- a. Misapplication of accounting principles to maximize revenues.
- b. Omission of material information due to concern regarding shareholder negative reaction.
- c. Unreasonable accounting estimate based on a competitor's policy for a similar product.
- d. Cheque signature forgery.

**Question 2 (6 marks) (11 minutes)**

**Financial Instruments, Recognition and Measurement**

Farzan Limited (FL) manufactures PVC pipes; it has a positive cash flow and has been building up an excess of cash in hopes of making a strategic acquisition of a competitor sometime in the next two years. In the meantime, FL has decided to invest the excess cash by purchasing common shares of Nearzan Limited (NL). The purchase represents 20% of the total outstanding common shares of NL. Assume that FL must follow generally accepted accounting principles.

**Required:**

- a) Identify the alternatives available to FL for the classification of the investment in its financial statements. (3 marks)
  
- b) For each alternative, identify how the investment would be measured now and in the future, and how any income, gains and losses would be recognized or reported in its financial statements. (3 marks)

**Question 3 (10 marks) (18 minutes)**

Hedging

Howard Inc. (HI) is a public company with shares traded on a stock exchange in Canada. HI buys raw materials in a foreign country and has concerns about the strengthening of the foreign currency unit (FCU) against the Canadian dollar. Recently, a major purchase of raw materials in FCU was recorded as accounts payable in the financial statements. This account payable is due in sixty days. To protect itself against the foreign currency exposure, HI has entered into a forward contract to purchase FCU at a fixed price in sixty days.

**Required:**

- a) Explain how the forward contract acts as a hedge from an economic perspective. (2 marks)
- b) Discuss how the forward contract should be accounted for without hedge accounting. (3 marks)
- c) Provide a general description of hedge accounting. (2 marks)
- d) Determine whether HI should use hedge accounting and explain your choice. (3 marks)

**Question 4 (12 marks) (22 minutes)**

**Goodwill and Other Intangible Assets, and Differential Reporting**

Big Bang Inc. (BBI) is a private corporation wholly owned by Joe Rucker. BBI designs and stages special effects, such as explosions and laser lighting, at major rock concerts and theatrical productions. In 2006, BBI decided to expand its business by purchasing the fireworks side of Entertainment Incorporated (EI). Based on a report prepared by a business valuator, BBI paid EI \$650,000 on July 1, 2006 for the following assets, the estimated value of which represents the present value of expected future cash flows:

- a ten-year patent for a propane gun that sends balls of flames 50 feet into the air (\$300,000 based on renewal license);
- a fifteen-year patent pending approval for a process that creates special water effects (\$250,000 over ten years);
- a customer list consisting of existing rock bands that have used EI for concerts in the past five years (\$50,000 over next two years); and
- a license to detonate fireworks that is required under fire regulations and that is renewable indefinitely at a nominal cost (\$25,000).

**Required:**

Prepare a report to Joe Rucker that addresses the following:

- a) The recording of the assets acquired from EI on July 1, 2006. (2 marks)
- b) The appropriate accounting treatment for each of these assets at the end of BBI's year (June 30, 2007), explaining how the values reported in the financial statements are determined. (7 marks)
- c) The criteria that BBI must meet to qualify for differential reporting (1 mark)
- d) Identify the exceptions to regular reporting standards available to BBI under differential reporting? (2 marks)

**Question 5 (12 marks) (22 minutes)**

**Non-monetary Transactions and Related Party Transactions**

Wendy Lee owns Apiaries Inc. (AI), a company that produces honey. Jason Lee, Wendy's brother, owns Jars Inc. (Jars), a company that processes honey and other foods.

Bees store honey in honeycombs that they seal when full. Each hive produces 75-100 kilograms of honey per year. The honeycombs are harvested – that is, cut out from the hive's frame – when sealed by the bees, and sold to processing companies for packaging. The honeycombs cost about \$1.50 per kilogram to produce and are normally sold to processing companies for \$3 a kilogram. Processing companies spend about \$1.60 per kilogram to transform and package the honey and sell it to market for \$5.50 a kilogram.

In addition to producing honey, AI rents out over 700 hives to orchardists and farmers for pollination purposes. Rental rate per hive is normally \$40 a month. However, a recent shortage of bees has driven up the rental rate to \$60 a month.

In May 2006, a group of cranberry farmers approached AI to trade 1,500 kilograms of fresh cranberries in the coming fall in exchange for the use of 200 hives for pollination in July and August. AI agreed to the trade but does not anticipate entering into such transactions in the future. The market price of cranberries swings widely depending on the abundance or the scarcity of cranberries in a given year. On May 1, the market price for the cranberries was \$10 per kilogram.

During 2006, AI sold Jars 50,000 kilograms of honeycomb for \$2.70 a kilogram, and the cranberries received from the farmer for \$7 a kilogram, the going price for cranberries in the fall of 2006.

**Required:**

- a) Describe how the exchange of hives rental for cranberries should be accounted for, providing adequate support to your answer. (4 marks)
- b) Describe how the sale of the honeycomb and cranberries to Jars should be accounted for, providing adequate support to your answer. (8 marks)

**Question 6 (6 marks) (11 minutes)**

Not-for-Profit Organizations – Contributions

Health Information (HI) was created as a not-for-profit organization to assist in developing and implementing a web-based patient medical record system that can be securely accessed by the medical profession across Canada when treating patients. During 2006, HI received the following initial contributions towards fulfilling its objectives:

- Fifty (50) computers on wheels with software to be used at bedside by the medical professionals to record the medical information being acquired while treating patients. The manufacturer donated the computers as part of a pilot project in which some hospitals agreed to participate and provide feedback. HI is responsible for loaning the computers to these hospitals and for gathering the feedback. Each computer normally sells for \$10,000.
- Five hundred (500) hours of programmers' time to adapt the computer software to the information needs of the hospitals.
- Fifteen (15) million dollars in cash from corporate donors. HI can only use the interest on the \$15 million to provide grants to the hospitals. The principal amount must remain untouched.
- Two (2) million dollars from individuals for future purchases of any type.

**Required:**

- a) Discuss the appropriate method of accounting for the initial contributions listed above assuming that HI uses the restricted fund method of accounting with a restricted fund for the pilot project. Provide explanations. (4 marks)
- b) Discuss the appropriate method of accounting for the initial contributions listed above assuming that HI uses the deferral method of accounting (without funds). Provide explanations. (2 marks)

**Question 7 (6 marks) (11 minutes)**

Audit of fair values and disclosures

Robinson and Jones, LLP, is planning the audit of one of its clients, a biopharmaceutical company that owns a significant number of intangible assets, and is involved in lawsuits as both a plaintiff defending its patents and a defendant against customer lawsuits. A significant audit risk related to a number of balance sheet items exists, as a result of the soft values assigned to many of the client's assets and liabilities and the significant measurement uncertainty.

In gathering sufficient appropriate audit evidence, generally accepted auditing standards requires that the auditors obtain an understanding of the entity's financial reporting framework. This includes obtaining an understanding of the entity's process for determining fair value measurements and disclosures, and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level.

**Required:**

Identify and explain the factors that the auditor must consider when obtaining an understanding of the entity's process for determining fair value measurements and disclosures, and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level.

**Question 8 (5 marks) (9 minutes)**

**Responsibilities of those Charged with Governance and of Management**

During the past year, Durando Limited (DL) has been subjected to numerous shareholder lawsuits. The lawsuits allege that DL and its management misled shareholders, creditors and investors. As a result of the lawsuits, DL has realigned its management team and created a new governance structure. Of paramount importance to this realignment is creating a culture of honesty and ethical behaviour. DL is also interested in setting up proper internal controls.

**Required:**

- a) Discuss what is involved in creating a culture of honesty and ethical behaviour. (3 marks)
- b) Identify the objectives of internal controls. (2 marks)

**Question 9 (12 marks) (22 minutes)**

**Communications with Those Having Oversight Responsibility for the Financial Reporting Process**

You, CA, are the auditor of Southern Computer Technologies (SCT), a publicly traded retailer of computer hardware and software. You met with the Audit Committee of SCT at the beginning of the 2007 audit to discuss your responsibilities, planning issues and your audit strategy. The audit is now substantially completed and you are considering the issues that should be discussed in your second meeting with the Committee.

This year, SCT adopted the CICA Handbook requirements for comprehensive income, financial instruments and derivatives.

**Required:**

Describe the matters arising from an audit that should be communicated to the Audit Committee.

**Question 10 (9 marks) (15 minutes)**

Date of the Auditor's Report

Peterson and Davies, LLP, (PD) audits White Pine Furniture Ltd. (WPF), a private company with a December 31 year end. PD substantially completed the fieldwork for the fiscal 2006 audit on March 15.

- On March 21, PD received a letter confirming the accounts receivable balance of Country Furniture Store, the largest customer of WPF.
- On April 4, PD finished assembling and reviewing working papers, reviewing drafts of financial statements and obtaining final management approval of the financial statements.
- On April 8, WPF suffered an uninsured fire in a storage shed on its property. The loss of inventory was significant but not material in amount.
- On April 10, WPF agreed to disclose the loss from the fire in the notes to the financial statements.
- On April 15, PD released its standard audit report on the revised financial statements.
- On May 5, the local newspaper revealed that Country Furniture Store had declared bankruptcy, leaving several suppliers including WPF with uncollectible accounts.

**Required:**

- a) Explain the impact on the audit report of each of the events that occurred after March 15 until April 15, and conclude on the date PD should have used on the audit report released on April 15. (4 marks)
- b) Explain what PD should have done when it became aware of the bankruptcy of Country Furniture Store. (5 marks)

**Question 11 (6 marks) (11 minutes)**

**Reservations in the Auditor's Report**

For the **following independent situations**, assume you are the audit partner on the engagement.

1. Your firm has audited Meghan's Pet World Inc. (MPWI) for ten years. In the past three years, MPWI's financial condition has steadily declined. In the current year, for the first time, the current ratio is below 2:1, which is the minimum requirement specified in MPWI's major loan agreement. The violation of the covenant permits the lender to demand payment. MPWI refuses to classify the loan as a current liability.
2. Angus Manufacturing Limited has been your client for the past five years. During this period, the client limited the scope of your examination of its inventory. You were not able to express an unqualified opinion on the financial statements in each of the past five years because you consider inventory to be a material amount. The client's banker will no longer accept the qualified auditor's reports. As a result, for the December 31, 2006 audit, you were allowed to attend the physical inventory counts.
3. Your client, a national furniture retailer, has stores in many cities across Canada. You were not able to count the cash on hand at the close of business on the last day of the fiscal year at all stores. As an alternative procedure, you observed that deposits in transit, as shown on the year-end bank reconciliation, appeared as credits on the bank statement on the first business day of the new fiscal year. You were satisfied about the cut-off of cash receipts by the use of this procedure.

**Required:**

For each of the above independent situations, provide your supported conclusion on the appropriate audit opinion.

**Question 12 (8 marks) (14 minutes)**

Audit of Accounting Estimates

The following quote is from a note to the financial statements of your audit client, Commercial Lender Corporation (CLC).

“The most significant estimates that the Corporation is required to make relate to the recoverability of its investments in long-term receivables.”

You know from previous audits that the management of CLC has established policies and procedures for the preparation of accounting estimates. CLC gathers the necessary data on which to base bad debt estimates from statistical analysis of historic information and from evaluation of the current economy. Controls over preparation of estimates exist, although you have not relied on them in past audits.

**Required:**

Explain the audit procedures you would undertake to develop sufficient appropriate audit evidence to evaluate management's estimates on the recoverability of its investments in long-term receivables.

**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

**THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA**

**CA RECIPROCITY EXAMINATION**

**DAY TWO – 2007**

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**(100 marks) (3 hours)**

**NOTES TO CANDIDATES:**

1. There are **8 questions and 17 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.

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## SECTION A - TAXATION

### **Question 1 (10 marks) (18 minutes)**

Little Ltd. (Little) has sustained net capital losses of \$20,000 in its taxation year ended December 31, 2004 and non-capital losses of \$80,000 from business operations in its taxation year ended December 31, 2005. On October 1, 2006, 95% of the shares of Little were acquired by Big Inc. (Big), an arm's length Canadian private corporation. Details of the assets owned by Little on October 1, 2006 are summarized below.

Asset	Cost	Fair market value
Short term investment	\$ 20,000	\$ 12,000
Inventory	45,000	60,000
Land	80,000	140,000
Building [undepreciated capital cost (UCC) \$80,000]	100,000	150,000
Equipment – Class 8 [UCC \$36,000]	40,000	30,000
Small tools – Class 12 [UCC \$0]	15,000	2,000
Eligible capital property [cumulative eligible capital (CEC) \$10,000]	18,000	12,000

From January 1, 2006 to October 1, 2006, Little had net income of \$3,000, all of which was business income.

### **Required:**

- How does the purchase of the shares of Little by Big affect the utilization of the non-capital and net capital losses of Little? (2 marks)
- For each asset owned by Little, determine the adjustments required to the tax values of the assets. (5 marks)
- Little has the ability to make an election under S.111(4)(e) of the *Income Tax Act* to recognize income (capital gains and recapture) for tax purposes. Recommend the asset or assets on which the election should be made and the amount of income that should be created for tax purposes by the election. Assume that Little will be able to use all available losses within two years. (3 marks)

**Question 2 (15 marks) (27 minutes)**

Stinson is an architect, employed by Marshall Ltd. (ML), an Ontario-based public corporation. He has income from a number of sources in addition to his employment income. A description of his financial activities for 2006 is given below.

1. Stinson received a salary of \$65,000. He was awarded a bonus of \$20,000 for the work he performed in 2006. However, the bonus was not paid until March 2007. In addition, ML provided the following items of remuneration:
  - a) A car allowance of \$300 a month to cover costs of travel in the performance of his duties. Stinson is required to use his own car to travel on company business. During 2006, 60% of the kilometres traveled were for company business.
  - b) A contribution of \$10,000 to a registered pension plan.
  - c) Group term life insurance – coverage equals three times his salary and the insurance premium cost \$600.
2. In 2006, ML granted Stinson an option to purchase up to 5,000 of its shares for a price of \$5 per share. At the time the option was granted, the shares were valued at \$7 per share. During 2006, Stinson purchased 1,000 shares. At the date of purchase, ML's shares were trading at \$16 per share. Later in the year, Stinson sold the shares for \$20 per share.
3. In 2005, Stinson purchased 100 shares of AZ Ltd., a public corporation, for \$20 per share. In 2006, Stinson received eligible dividends of \$100 on these shares before selling them for \$30 per share.
4. During the year, Stinson gifted shares of BY Ltd. a public corporation, to his 14-year-old daughter. The shares had cost him \$200 and had a value at the time of the gift of \$1,800. In 2006, his daughter received eligible dividends of \$80 and then sold the shares for \$2,600.
5. Stinson's mother died in 2006 and left Stinson shares of CX Ltd. a public corporation in her will. His mother had purchased the shares several years earlier for \$25,000. The shares were worth \$75,000 at the time of her death. Stinson sold the shares later in the year for \$100,000. As named beneficiary on his mother's life insurance policy, Stinson received proceeds of \$18,000.
6. Stinson owns a small farming operation as well as a rental property. In 2006, the farm generated a loss of \$10,000 and the rental property generated a loss of \$2,000 before capital cost allowance (CCA). The rental building had an undepreciated capital cost (UCC) of \$35,000 at December 31, 2005.

**Question 2 (continued)**

7. Stinson had the following additional receipts in 2006:

- |                      |        |
|----------------------|--------|
| a) Interest on bonds | \$ 800 |
| b) Lottery winnings  | 5,000  |

8. Stinson paid the following amounts in 2006:

- |  |          |
|--|----------|
| - Car expenses for gas, repairs and insurance  | \$ 6,900 |
| - 12 monthly car lease payments of \$900 plus 6% GST and 8% PST  | 12,312   |
| - 12 monthly alimony payments of \$1,000 (agreement signed in 2000)  | 12,000   |
| - 12 monthly child support payments of \$1,200 (agreement signed in 2000)  | 14,400   |
| - Charitable donations   | 5,000    |
| - Interest on house mortgage (mortgage funds of \$40,000 were used for the purchase of the house and \$10,000 were used for the purchase of public company shares) | 3,000    |
| - Interest on bank loan to purchase shares of public corporations  | 1,500    |

**Required:**

Calculate Stinson's net income for tax purposes for 2006 in accordance with the aggregating formula of section 3 of the *Income Tax Act*. List items that should not be included in net income for tax purposes. Show all of your calculations.

**Question 3 (25 marks) (45 minutes)**

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

**Part A (5 marks)**

On March 1, 2006, Paul received a loan from Yee Ltd., a corporation that is owned by Paul's mother and that employs Paul. Paul used the loan to purchase a condominium in which to live. A loan agreement was signed wherein Paul agreed to pay interest at 2% below prime and repay the loan in full after three years. Yee Ltd. has a December 31 year-end.

**Required:**

Describe the federal income tax implications for Paul

- a) if he received the loan because of his employment, and
- b) if he received the loan because of his mother's shareholding.

**Part B (4 marks)**

In the current year, Susan sold the following assets to a Canadian-controlled private corporation, which she controls. The purchase-sales agreement stated that an election under Section 85(1) of the *Income Tax Act* would be made for each asset.

Asset	FMV	Cost	Selling Price	Payment received	
				Demand Note	Shares (FMV)
Land	\$60,000	\$40,000	\$60,000	\$50,000	\$10,000
Investment (long-term)	8,000	13,000	8,000	2,000	6,000
Depreciable asset [undepreciated capital cost (UCC) \$50,000]	90,000	70,000	90,000	40,000	50,000
Goodwill [cumulative eligible capital (CEC) \$30,000]	80,000	50,000	80,000	Nil	80,000

**Required:**

For each of the four assets, determine the minimum elected transfer price under Section 85(1) of the *Income Tax Act*.

**Question 3** (continued)

**Part C** (3 marks)

You read the following statement in a newspaper:

“A business that derives its income from selling personal services (computer consulting services, for example) cannot be viewed as earning active business income.”

**Required:**

Describe the differences that exist between a personal services business and an active business, and conclude whether the above statement is true.

**Part D** (3 marks)

David contributed \$9,000 to his registered retirement savings plan (RRSP) in October 2006 and \$5,000 to a spousal RRSP in January 2007. David had earned income of \$60,000 in 2005 and \$70,000 in 2006. David’s notice of assessment showed unused RRSP deduction room at the end of 2005 of \$1,000. His T4 slip for 2005 showed a pension adjustment (PA) of \$4,000.

**Required:**

Determine the maximum RRSP contribution David could deduct in 2006. Show all calculations.

**Part E** (2 marks)

In the current year, Parsley Ltd. purchased new office equipment costing \$24,000. The vendor gave Parsley Ltd. \$4,000 for the old office equipment, which had been purchased five years earlier for \$10,000. At the beginning of the current year, the Class 8 undepreciated capital cost (UCC) balance was \$4,600.

**Required:**

Calculate the maximum CCA deduction for Class 8 for the current year.

**Question 3** (continued)

**Part F** (2 marks)

At the end of last year, the Class 1 UCC balance was \$60,000. During the current year, the office building (Class 1) with an original cost of \$80,000 was sold for \$110,000. There were no other Class 1 transactions in the current year.

**Required:**

Calculate the effect of the disposal on net income for tax purposes for the current year.

**Part G** (2 marks)

In 2000, Sharon purchased land for \$200,000 with the intention of building a rental property. She built an apartment building and earned rental income from it until 2006 when she sold the rental property for a substantial profit.

In 2000, John purchased land for \$200,000 with the intention of holding it until the land increased in value and could be sold at a gain. In 2006 he sold the land for a substantial profit.

**Required:**

Which one of the above individuals (Sharon or John) is most likely to have the profit on the sale treated as business income for tax purposes? Give a brief explanation for your answer.

**Part H** (2 marks)

Olympia Ltd. (OL) is a Canadian private corporation. During its year ended December 31, 2006, OL received a dividend of \$10,000 from Salt Ltd. (Salt) and a dividend of \$12,000 from Pepper Ltd. (Pepper). OL owns 15% of the issued common shares of Salt and 4% of the issued common shares of Pepper. Both Salt and Pepper only had common shares issued. Salt received a dividend refund of \$2,000 and Pepper received a dividend refund of \$4,000.

**Required:**

Determine the Part IV tax payable by OL for 2006.

**Question 3** (continued)

**Part I** (2 marks)

Peter received a notice of reassessment for his 2002 tax return from the Canada Revenue Agency (CRA). The mailing date on the notice of reassessment was August 14, 2007. The mailing date on the original notice of assessment for his 2002 tax return was May 20, 2003.

**Required:**

- a) Explain whether the CRA has the right to reassess the 2002 tax return on August 14, 2007?  
(1 mark)
- b) If Peter wishes to dispute the reassessment, by what date must the notice of objection be filed? (1 mark)

## **SECTION B - LAW**

### **Question 4 (8 marks) (14 minutes)**

A provincial government agency (Agency) with the mandate to protect individuals in need of protection as a result of mental capacity issues learned in July 2006, from an anonymous source, that Betty Rubbler was being abused by Daniel, her eldest son, and his family. An investigator from the Agency was dispatched to review the situation and found out that:

- Betty Rubbler was living on her own in a one bedroom apartment, but under very poor living conditions: the apartment and Betty were very unclean. Betty's body showed several bruises, which she said were caused by her son;
- It appeared that Betty was suffering from dementia as she seemed very confused and disoriented;
- Betty appeared at risk of harm.

As a result of the findings, the investigator did the following:

- Obtained a court restraining order, dated July 15, 2006, requiring that Daniel and his family must come no closer than 500 metres to Betty;
- Moved Betty to a nursing home; and
- Took control of all of Betty's assets.

Daniel denied having abused his mother. He hired a lawyer to appeal the restraining order. However, before the appeal was heard in court, Betty died. Her death occurred in the nursing home on December 3, 2006.

In February 2007, the landlord of the apartment building in which Betty lived was arrested and charged with assaulting one of the elderly tenants in the building. The police suspected that the landlord may have assaulted other elderly tenants, including Betty.

Daniel and his family are upset that they did not get to see Betty in the months preceding her death and would like to make a claim for their suffering from being away from her for this period of time.

The Agency returned Betty's remaining assets to her estate, the executor of which is Daniel. Approximately \$40,000 was missing and "unaccounted for" by the Agency. In response to further enquiries by the executor of the estate, the Agency has responded "We are not responsible for any missing assets. We handle many assets and lost assets are just one of the costs associated with such a massive operation. We are sorry for your loss."

### **Required:**

Prepare a memorandum that discusses in detail the basis of any claim that Daniel and the Estate of Betty Rubbler or both could make against the various parties. Your memorandum should include an assessment of the legal issues, what would have to be proven, and any possible defences.

**Question 5 (8 marks) (14 minutes)**

Charles Brown called Ricky Rich of “Painting Service – Top Quality At Low Prices”, an unincorporated sole proprietorship, to paint all of the rooms in his house. To Ricky’s question “What is the total area of the rooms in the house?” Charles replied that the rooms had a combined area of 4,500 square feet. Ricky quoted Charles \$9,000 to paint the house, on the basis of \$2.00 per square foot for paint and labour. Charles told Ricky that he could start painting on the weekend of October 20, 2007.

On the morning of October 20, 2007, Ricky came to Charles’s house with painting supplies, and a contract that he had prepared and that stated the following: “Ricky Rich agrees to paint the house of Charles Brown for \$9,000, a non-refundable deposit of \$1,000 is required prior to commencement of the work and the balance of \$8,000 is due upon completion. After reading the contract, Charles and Ricky signed it and Charles gave Ricky the \$1,000 deposit in cash.

Ricky was then shown over to the rooms to paint. Puzzled by their sizes, Ricky measured the walls, and angrily he turned to Charles and said: “You lied! These rooms have walls of more than 4,500 square feet, with their 10-foot ceiling, not to mention the intricate details of all of these crown mouldings!”

Charles explained that he thought Ricky meant floor square footage when asked for the total area of the rooms in the house, since most people provide floor space measure when referring to the size of rooms. Ricky replied, “Any normal person would realize that I was talking about wall area, and not floor area when I asked you for the area of the house, since I am painting your walls, not your floors. You just plain lied to me!”

Charles became quite upset at Ricky and responded, “I did not lie to you and you should have measured the room to satisfy yourself before signing the contract! In any event, we have a signed contract and I expect you to complete the job for \$9,000, as promised.” Ricky replied that he was not going to paint the rooms and stormed out of the house. When Charles asked for his \$1,000 deposit back, Ricky replied, “it is a non-refundable deposit and you don't deserve to get it back since you lied to me and wasted my time!”

**Required:**

Prepare a memorandum to Charles that discusses and analyzes the possible contract law issues, claims and possible defences.

**Question 6 (4 marks) (8 minutes)**

Mary Puppins has invented a new baby bottle, made of a type of silicone that she claims is superior to existing baby bottles because its operation is more natural.

Mary's friend has told her that as long as she places a warning on the bottle that states, "Use solely at your own risk", she will not have any personal liability. For this reason, Mary is considering bringing the bottle to market, initially operating as a sole proprietor.

**Required:**

Mary would like to know if her friend is correct and accordingly has asked that you prepare a memorandum that discusses product liability in Canada. Your memorandum should include who can make a claim and the nature of what would have to be proven to make such a claim.

## SECTION C - RULES OF PROFESSIONAL CONDUCT

### Question 7 (26 marks) (47 minutes)

#### Required:

In each of the **following unrelated situations**, 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 (6 marks)

Tamara Sutton, CA, is a sole practitioner. Tamara was retained in 2001 to complete the audit of a condominium corporation and has completed the audit for all years commencing December 31, 2002 to December 31, 2006. In July 2007, Tamara had a friend of hers, who is also a chartered accountant, review some of her files. The findings of her friend, as well as certain comments by Tamara are set out below:

<u>Findings</u>	<u>Tamara's Comments</u>
1. No engagement letter was included in the working paper file.	1. It is not necessary because all parties know that I have been retained to do an audit and that is what I provide each year.
2. Documentation in the files does not make reference to a risk assessment nor to materiality	2. Everything is material and so an assessment is not necessary.
3. In 2006, 25 adjusting journal entries were made by Tamara. The file does not indicate any review of the entries with the condominium corporation staff.	3. The accounting staff at the client is not sophisticated and these adjustments are a necessary value-added service.
4. The financial statements did not contain certain note disclosures required by the Provincial Condominium Act.	4. I can only audit what I am provided with. Completeness of disclosure rests with management.
5. There is no indication that Tamara communicated with the Board of the Condominium Corporation.	5. I am on a fixed fee of \$3,500 for my services and accordingly must budget my time and cannot provide any services not required by generally accepted auditing standards.

**Question 7** (continued)

**Part B** (12 marks)

While attending university, Sarah Franklin was employed as the part-time bookkeeper-accountant by Lucknow Furniture Inc. (LFI), a private small furniture store located in a rural community. During that period, LFI provided loans to Sarah totalling \$25,000. After graduation in May 2005, Sarah started articling with Elgin & Partners, LLP (EP) but continued to provide bookkeeping services to LFI.

George Elgin, CA, the senior partner at EP, puts significant pressure on all staff to bring in new clients. In October 2005, Sarah introduced LFI to EP, which was appointed to complete a review of LFI's financial statements for the year ending November 30, 2005. George placed Sarah in charge of the engagement. Sarah completed the review on January 14, 2006, with minimal supervision. George noted on Sarah's performance evaluation form that she demonstrated excellent judgment as she was able to complete the engagement without formal planning and direct partner involvement.

In January 2007, Sarah became ill during her fieldwork on the review of LFI for the year ended November 30, 2006. Jane Sampson, CA, another EP staff, took over the completion of the fieldwork. In the course of her work, Jane discovered and documented the following:

- Sarah is continuing to act as part-time bookkeeper at LFI. As at November 30, 2006, she still has a loan of \$18,000;
- No engagement letter or planning memorandum for the work could be located;
- George's wife has loaned \$50,000 at 9% to Elmira Furniture Limited (EFL), a wholly owned subsidiary of LFI. The investment in EFL is accounted for on the cost basis because EFL is privately owned and would meet the requirement for the use of differential reporting;

When Jane presented the file to George for review, he thanked her for her efforts and ordered her not to mention this to any of the other partners. He explained that he would "handle it."

George spoke to Sarah and explained to her that he was disappointed that she had signed the firm's independence representation showing that she had no conflicts or independence issues. He told her that she could no longer be a member of the professional staff on the review of LFI. He suggested that if she wanted to keep her bookkeeping work at LFI, she should request that LFI pay her salary to her mother because her work there was raising too many issues.

In March 2007, EP was selected for practice inspection by the Provincial Institute. George removed the working paper file from the file room and omitted LFI from the list of firm clients given to the practice inspector.

**Question 7** (continued)

**Part C** (8 marks)

Frank Plummer, CA, is a chartered accountant in public practice operating as a sole proprietor. Frank previously worked at a national accounting firm in the assurance group. Frank's tax knowledge was acquired through his university courses and from regular readings of tax advice or tips in the newspaper.

In January 2007, Frank was appointed to review the 2006 financial statements of Tri Lawncare Inc. (TLI) and Elliott Imports Inc. (EII) and to prepare their federal and provincial corporate tax returns.

TLI is a corporation, the shares of which are held by three brothers: Richard Elliott (80%), James (10%), and Thomas (10%). Richard moved to Arizona in 2006 for health reasons. Cheryl Elliott, Richard's wife is the sole shareholder of EII that was incorporated in 2005 with the objective of importing and distributing electronic devices from China.

Preliminary income for TLI was \$370,000 and for EII, nil. In 2005 and 2006, EII had a tax loss of \$123,000. Frank advised Richard and Cheryl that income needed to be transferred from TLI to EII to utilize the tax losses. He recommended that EII invoice TLI for \$123,000 for consulting services in 2006. Frank also indicated that he would invoice TLI for all of his time for both companies. Richard and Cheryl were pleased with the tax planning strategy and Frank booked the adjusting entries for both corporations. He also prepared the invoice for EII's consulting services to TLI and all supporting documents.

In 2007, the Canada Revenue Agency (CRA) requested additional information from EII as EII reported revenues, yet had filed a "nil" Goods and Services Tax (GST) return. Cheryl had filed the "nil" GST return on the advice of Frank.

Cheryl left many messages for Frank asking him to address the CRA request, but Frank did not respond. Frustrated and concerned that a tax audit could occur, Cheryl appointed David Patel, CA, as the public accountant for EII. Frank did not reply to David's written request for information and access to working papers.

**Question 8 (4 marks) (7 minutes)**

Dianne Lee, who is 68 years old and the sole shareholder of Lee Manufacturing Limited (LML) has expressed an interest in selling her business and has discussed this with her family at a recent family gathering. Marissa, one of Dianne's three children, expressed an interest in acquiring the business from Dianne at that meeting. This surprised everyone because Marissa had never shown any interest in the business and lives far away from Dianne.

Dianne has contacted you, CA, the partner on LML's account, to advise both Dianne and Marissa regarding this transaction. Dianne feels that you are the best source of advice because you have been LML's auditor for the past ten years.

A senior partner at your firm has cautioned that this situation is fraught with ethical issues and considerations.

**Required:**

Identify and discuss the major ethical issues that you CA must consider before proceeding.

**TABLE III**

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

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


---

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

**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	22¢ per kilometre of personal use
Non-taxable car allowance benefit limits	
- first 5,000 km	50¢ per kilometre
- balance	44¢ per kilometer

**TABLE IV**

**INDIVIDUAL FEDERAL INCOME TAX RATES**

**2006 Income Tax Rate Schedule - Individuals**

<u>Taxable Income</u>	<u>Tax</u>
\$ 36,378 or less	15.25%
\$ 36,379 to \$ 72,756	\$ 5,548 + 22% on next \$36,378
\$ 72,757 to \$118,285	\$13,551 + 26% on next \$45,529
\$118,286 or more	\$25,388 + 29% on remainder

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

The 2006 tax credits are 15.25% of the following amounts:

Basic personal amount .....	\$ 8,839
Married and equivalent to spouse amount .....	7,505
Net income threshold for married or equivalent amount .....	751
Age 65 or over in the year .....	5,066
Disability amount .....	6,741
Disabled dependents who reach 18 in the year .....	3,933
Net income threshold for disabled dependents 18 and over.....	5,580
Basic amount for:	
Age credit and GST credit .....	30,270
Child tax benefit .....	36,378
OAS clawback .....	62,144

**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>
2007	7			
2006	5	6	6	7
2005	5	5	5	5
2004	5	5	4	5
2003	5	5	6	5
2002	5	4	5	5

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 (a)** according to HB s. 3063.14.

(b) & (d) are not correct because goodwill is included in the carrying amount of an asset group to be tested for impairment when the asset group is or includes a reporting unit (HB s. 3063.15.)

(c) is not correct because inventory and accounts receivable may be included (HB s. 3063.16.)

**ii. Revenue Recognition**

**The correct answer is (b).** According to EIC 141, revenue should be recognized over the period during which the space and facilities are made available to subscribers (in this case, access is granted uniformly over the year), provided one can estimate the returns.

(a) is not correct because the revenue should be recognized over the period unless cancellations cannot be reasonably estimated.

(c) is not correct because the revenue is not earned upfront. The company must provide the facilities to earn its revenues.

(d) is not correct because EIC requires a reasonable estimate of the cancellations made.

**iii. Date of the Auditor's Report**

**The correct answer is (c).** According to HB s. 5405.02, the auditor must consider the effect of an event that comes to his or her attention following the date of the auditor's report that may affect the financial statements and auditor's opinion. Accordingly, answer (c) is incorrect, hence the correct choice.

Choices (a), (b) and (d) are incorrect choices because these statements are correct. (a) The auditor signs off after having gathered all evidence needed; there is no need to seek further audit evidence. (b) Management must always monitor its communications to financial statements users, hence has a responsibility to monitor events both within and outside the enterprise and to consider their effect on the financial statements. (d) Management need not inform the auditors of everything that happens after the date – only the material events that might affect the financial statements.

**iv. Fraud**

**The correct answer is (c).** Fraud by definition represents intent to deceive (HB s. 5135.006)

(a) Purposeful manipulation of revenues represents fraud because the intent is to deceive.

(b) Purposeful omission of material information also represents fraud because the intent is to deceive.

(d) The forgery of a signature is a deceitful act, the purpose of which is to mislead others into believing that the cheque was authorized.

**Question 2 (6 marks) (11 minutes)**

**Financial Instruments, Recognition and Measurement (HB s. 3855)**

a) Classification Alternatives (3 marks)

The alternatives available to Farzan Limited for the classification of the investment in its financial statements are (1) available for sale (AFS); (2) held for trading (HFT); and (3) significant influence (SI) – long term investment, if significant influence exists. The AFS or HFT investments could be presented as current or non-current based on professional judgment.

The AFS or HFT financial instruments need not be labelled in this way. The Handbook indicates that “in presenting and disclosing information, an entity uses those labels that are most informative to users of financial statements. Accordingly, an entity may appropriately use labels other than held for trading, held to maturity, loans and receivables and available for sale.”

b) Initial and Subsequent Measurements and Recognition (3 marks)

The investment would be measured and gains or losses recognized as follows:

AFS or HFT financial instruments are initially and subsequently measured at fair value.

- The gains or losses for AFS are recognized in other comprehensive income.
- The gains or losses for HFT are recognized in net income.

SI financial instruments are accounted for by the equity method of accounting.

- The investment in Nearzan should initially be recorded at cost and the carrying value, adjusted thereafter to include Farzan’s share in Nearzan’s net income or loss. Dividends received by the investor are deducted from this carrying value.
- Under the equity method, gains or losses on disposition of the SI investment or on certain reductions of the ownership percentage are recognized in net income.

**Question 3 (10 marks) (18 minutes)**

**Hedging (HB s. 3855 and 3865)**

a) **Economic Perspective of Hedging** (2 marks)

Howard Inc. (HI) is exposed to a foreign exchange risk because it owes foreign currency units (FCU) and normally only has Canadian dollar cash inflows.

The forward contract allows HI to purchase FCU at a fixed rate to actually settle the accounts payable now, even if the actual payment to the supplier will be done at a later date. It removes the uncertainty as to the amount of FCU HI will have to buy in the future. The hedging transaction therefore offers protection against fluctuations in the exchange rate.

b) **Accounting for a Forward Contract without Hedge Accounting** (3 marks)

If the forward contract is not accounted for as a hedge, it should be accounted for as a derivative because the transaction meets the following three Handbook criteria (HB s. 3855.19 (e)):

1. The value of the forward contract changes in relation to the value of the underlying asset;
2. Little or no initial investment is needed; and
3. The settlement will occur at a future date.

According to HB s. 3855.39, all derivatives should be recognized as financial instruments, even if the initial value is zero.

Subsequently, these derivatives should be measured at their fair value (HB s. 3855.66) and the gains or losses should be recognized in the net income of the period during which the changes in fair value occurred (HB s. 3855.76 (a)).

c) **General Description of Hedge Accounting** (2 marks)

According to HB s. 3865.07 (a), “hedge accounting is a method for recognizing the gains, losses, revenues and expenses associated with the items in a hedging relationship such that those gains, losses, revenues and expenses are recognized in net income in the same period when they would otherwise be recognized in different periods.”

It requires that HI identify a hedging relationship between hedged and hedging items and assess the effectiveness of the hedge on an ongoing basis.

d) **Suitability of Hedge Accounting for HI** (3 marks)

HI could use either method because both the hedged item (the account payable in FCU) and the hedging item (the forward contract) are recognized on the balance sheet. The liability is initially converted at the spot rate on the date of the transaction and restated using the spot rate on each subsequent reporting date; the forward contract is revalued at fair value. The gains and losses related to both items roughly offset each other and are recorded in the net income in the same period. There might however be a mismatch because only the account payable is re-measured at the spot rate, which may not exactly match the value that would have been obtained had the account payable been measured at fair value.

**Question 4 (12 marks) (26 minutes)**

**Goodwill and Other Intangible Assets (HB s. 3062) and Differential Reporting (HB s. 1300)**

a) Initial Recognition on July 1, 2006 (2 marks)

Before proceeding with the recording of the assets, one must determine the nature of the transaction between EI and BBI. Is it the purchase of a series of assets or a business? The distinction is necessary because a difference of \$25,000 exists between the fair value of the individual assets purchased (\$625,000) and the price paid to EI (\$650,000).

The purchase of a customer list *per se* does not necessarily indicate that a business unit is acquired; however, when the purchase of a customer list is combined with the acquisition of a majority of the productive assets from the selling company, support exists for considering the transaction as a business combination.

For this transaction, the purchase discrepancy should be recorded as goodwill and the other assets acquired should be recorded under the following categories:

Intangible asset with a finite life

- Patent for propane gun
- Patent pending on water effect process
- Customer list

Intangible asset with indefinite life

- License to detonate fireworks

b) Appropriate Treatment at Year End (7 marks)

***Goodwill***

Goodwill is a residual amount: the purchase discrepancy resulting from allocating the purchase price of a business entity (generally speaking, the reporting unit), and the fair value of the identifiable net assets acquired. Goodwill is not amortized but tested annually for impairment at the reporting unit level.

To test for impairment, one must use a methodology that approximates the fair value of the reporting unit – in a way similar to a business combination – so as to extract the fair value of goodwill. This is done in a two-step process:

Step 1: The fair value (FV) of the reporting unit is compared to its carrying value (CV). If the FV of the reporting unit is greater than its CV, no impairment exists.

Step 2: If the CV of the reporting unit exceeds its FV, impairment may exist. In this case, the FV of goodwill must be compared to its CV. If the FV is lower than the CV, impairment of goodwill exists, and a loss equal to the difference between FV and CV must be recognized.

When certain conditions are met, goodwill need not be tested for impairment in a given year. However, earlier test might be warranted when certain events occur that may affect goodwill, for example, the loss of key personnel, adverse action by a regulatory body, or unanticipated competition.

**Question 4** (continued)

***General Intangible Assets***

*With finite life*

An intangible asset with finite life is subject to amortization over its useful life; usually no residual value is assumed unless the asset can be sold for a price to another entity before the end of its economic life.

The amortization method should parallel the pattern of benefits to the entity, and a charge to income should be made accordingly. The amortization method and useful life should be reviewed annually.

A test for impairment is not required annually for intangible assets with a finite life. However, a test for impairment should be made when certain events indicate impairment (e.g., when circumstances indicate that the CV may not be recoverable). An impairment loss exists when the CV of an intangible asset with a finite life, usually the unamortized balance, exceeds the FV.

*With indefinite life*

An intangible asset with indefinite life is not subject to amortization, except when it is determined that its useful life is no longer indefinite. An intangible asset with indefinite life should be tested for impairment annually, or more frequently when circumstances indicate that impairment may have occurred. The test is a comparison of the asset's CV with its FV. An impairment loss exists when the CV exceeds the FV.

The impairment losses should not be reversed when the FV of the intangible assets subsequently increases.

***Specific Intangible Assets***

- The patent on propane guns should be amortized over its legal life of 10 years; however, this period could be shorter if there are changes in the technology or if the licence is not renewed.
- The patent pending on the water effect process should be amortized over the expected cash flows of its 10 years life. However, an inability to secure the patent may indicate impairment. In this case, the FV should be determined on the reduced ability of the process to generate cash flow (taking into account factors such as competitors with similar and different processes). Should there be impairment, a write down or a write-off may be needed.
- The customer list should be amortized over 2 years; the amortization only applies to the names on the list at the date of acquisition.
- The licence to detonate fireworks should not be amortized because it can be renewed indefinitely. The nominal cost of renewing the licence should be expensed as a cost of maintaining the service potential.

**Question 4** (continued)

c) Differential Reporting (1 mark)

An enterprise is a qualifying enterprise when and only when

- It is a non-publicly accountable enterprise, and
- Its owners unanimously consent to the application of differential reporting options.

The consent must be in writing.

d) Differential Reporting Options Available to BBI (2 marks)

Under the differential reporting options, BBI may elect to test goodwill and intangible assets with indefinite life for impairment occasionally rather than annually, when events or circumstances indicate that impairment may exist.

**Question 5 (12 marks) (22 minutes)**

**Non-Monetary Transactions (HB s. 3831) and Related Party Transactions (HB s. 3840)**

a) Accounting for Exchange of Bee Hives for Cranberries

The exchange of bee hives rental service for cranberries is a non-monetary transaction because no cash was involved. The selection of a measurement basis between the fair value and the carrying value will depend on whether the transaction had commercial substance.

Commercial substance exists when the configuration of the risk, timing, and amount of cash flows from the asset given up differs from those of the asset received.

In BI's situation, the risk, timing and amount of the rental services differ from those of marketing cranberries (e.g., market, amount, uncertainty, harvest time, etc.).

As a result, the exchange should be measured at the fair value of the rental services or cranberries sale, whichever is the more reliable value, taking into consideration the following factors in determining the amount:

- A better measurement would be obtained at the time of sale when the actual price is known;
- The fair value based on the May 1 market price would be \$15,000 ( $\$10 / \text{kg} \times 1,500 \text{ kg}$ );
- The cranberry market price varies widely depending on production;
- The bee hive rental might also be affected by uncontrollable factors, as it was this year;
- The fair value based on going rates is \$24,000 ( $\$60 \times 200 \text{ hives} \times 2 \text{ months}$ );
- The fair value based on regular rates is \$16,000 ( $\$40 \times 200 \text{ hives} \times 2 \text{ months}$ ).

*(Evaluators' comments: The Evaluators also considered a line of supported arguments favouring the carrying value).*

b) Accounting for Transactions Between AI and Jars

Related Party Issue

Because Wendy and Jason are sister and brother, a question arises as to whether the transactions between AI and Jars should be considered related party transactions (RPT).

The CICA Handbook defines related parties as follows: "Related parties exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. Related parties also include management and immediate family members (HB s. 3840.03 (g)).

The CICA Handbook further indicates that "[i]mmediate family comprises an individual's spouse and those dependent on either the individual or the individual's spouse."

**Question 5** (continued)

Although it seems that Jason and Wendy would not be related according to the CICA Handbook definition, it is important to consider other factors such as:

- The ability of Wendy or Jason to influence each other's decisions;
- Whether AI can only sell its production to Jars (economic dependence);
- AI's minimum production in 2006 is about 52,500 kg (75 kg × 700 hives) versus sales of 50,000 kg;
- A discount of 10% on sales price (\$2.70 vs. \$3.00);
- The current year production is under stress due to a shortage of bees.

If Jason and Wendy are related, the financial statements should describe the relationship and transactions between the two parties, the recognized amount, and the measurement basis.

*(Evaluators' comments: The Evaluators also considered a line of supported arguments favouring the absence of related parties).*

Sale of Honeycombs to Jars

The transaction is monetary and could be measured at \$2.70, the agreed upon exchange amount; it is a transaction done in the normal course of operations given the nature of AI's business (produces and sells honeycombs to processing plants).

However, the presence of a discount might be indicative of conditions other than normal. Additional information is needed to determine if the discount is due to market condition, despite a shortage of bees, or to the relationship existing between AI and Jars. Additional information on the total production of honeycomb and the sales to processing plants other than Jars is also needed.

Most likely, given the information currently available, the sales of honeycombs to Jars should be recorded at the exchange amount of \$2.70 given that the discount is not material.

*(Evaluators' comments: The Evaluators also considered a line of supported arguments favouring the carrying amount of \$1.50).*

Sale of Cranberries to Jars

AI does not normally sell cranberries and AI does not anticipate exchanging cranberries for bee hive rentals in the future. The transaction does not appear to be in the normal course of operations, but the change in ownership interest is substantive enough to support recording the transaction at the exchange amount.

*(Evaluators' comments: The Evaluators also considered a line of supported arguments favouring other values).*

**Question 6 (6 marks) (11 minutes)**

**Non-for-Profit Organizations – Contributions (HB s. 4410)**

a) Accounting for Donations – Restricted Fund Method of Accounting

The donation of the computers on wheels is a contribution (i.e., a non-reciprocal transfer) that should be recognized at fair value since it can reasonably be estimated (\$500,000).

HI may choose to recognize the 500 hours of programming time if this time would normally have been purchased and used in the normal course of HI's operations, and be capable of fair value assessment. HI should obtain an estimate of the fair value of this programming time given that it is more likely than not that it would have needed to purchase the time to adapt the software to its objectives.

The contributed computer and time – or computer only – should be recognized as revenue in the current period in the restricted fund, in compliance with the restricted fund method of accounting.

The \$15 million contribution represents an endowment contribution because the principal amount must be maintained and only the interest can be used towards HI's objectives.

Under the restricted fund method, endowment contributions must be recognized as revenue in the current period in an endowment fund.

The \$2 million unrestricted contribution should be recognized as revenue in the general fund in the current period.

b) Accounting for Donations – Deferral Method of Accounting

The donation of the computers on wheels and the programming time should be measured at fair value similarly to the above treatment. However, under the deferral method of accounting, deferral of restricted contributions is needed when the related restrictions remain unfulfilled.

The purpose of pilot project is unlikely to be achieved within one year; and the assets will be providing services in the future, and be subject to amortization over the period benefits are received.

The endowment contribution of \$15 million should be recognized as a direct increase in net assets in the current period, rather than as revenue, and the unrestricted contributions should be recognized as revenue in the general fund, as indicated in a) above.

**Question 7 (6 marks) (11 minutes)**

**Audit of Fair Values and Disclosures (HB s.5306)**

While it is management's responsibility to establish processes and controls for determining fair value measurements and disclosures, it is the auditor's responsibility to identify and assess risks of material misstatements and to design and perform audit procedures when auditing fair values.

The processes for determining fair value may be as simple as using stock market prices and as complex as estimating future cash flows in the presence of uncertainty about the occurrence and timing of certain future events.

The auditor would consider factors such as:

*Internal control over the process*

The auditor should consider whether proper segregation of duties exists between those who initiate the transactions and those in charge of performing the valuation.

*Reliability of the valuation process*

The auditor should review information related to the expertise and experience of the staff and the role of the information technology used for the purpose of determining the fair value measurements. The more complex the model, the more experienced and knowledgeable the staff must be. When information technology is involved, the auditor should review the approval process for changes over control and procedures over security related to valuation models, including controls over consistency, timeliness and reliability of the data.

*Types of accounts*

The accounts that capture routine and recurring transactions benefit from well established and tested systems of recording and valuation and are less prone to errors than accounts that capture non-routine or unusual transactions; these are often unique transactions whose measurement requires gathering new information and making new assumptions more subject to misstatement.

*Use of specialists*

An entity may not have the in-house expertise to develop its own models and processes for determining fair value measurements, and must rely on a service organization or an independent valuator to perform the fair value measurement. If the auditor plans on using the work of the specialist, the auditor should consider, for example, whether the specialist has an understanding of the valuation process for financial reporting purposes.

*Documentation*

Management would normally document its process and assumptions in arriving at fair value measurements. This documentation provides the auditor with a valuable source of evidence on the process and the changes made from time to time to the models and the assumptions used. For example, the documentation could include whether management uses available market information to develop its assumptions.

**Question 8 (5 marks) (9 minutes)**

**Responsibilities of Those Charged with Governance and of Management (HB s. 5135)**

a) *Creating a culture of honesty and ethical behaviour*

According to the CICA Handbook s. 5135.014, creating a culture of honesty and ethical behaviour implies

- “(a) setting the proper tone;
- (b) creating a positive workplace environment;
- (c) hiring, training and promoting appropriate employees;
- (d) requiring periodic confirmation by employees of their responsibilities; and
- (e) taking appropriate action in response to actual, suspected or alleged fraud.”<sup>1</sup>

Responsibilities may vary from jurisdiction or entities, informal in some, more structured in others.

Management, under the oversight of those charged with governance, should focus on fraud prevention and deterrence. The objectives are to reduce the opportunities for fraud to take place and to convince employees not to engage in fraudulent activities because the controls in place increase the likelihood of being caught.

The existence of strong core values that are clearly communicated to employees and adopted by management in conducting business contributes immensely to developing a similar culture of honesty and ethical behaviour among the employees because the employees tend to follow the behaviour model adopted by management.

b) *Objectives of Internal Controls* (HB s. 5135.015)

The objectives of the internal controls are threefold as follows:

- Reliability of financial reporting;
- Effectiveness and efficiency of operations; and
- Compliance with laws and regulations

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<sup>1</sup> CICA Handbook s. 5135.014

**Question 9 (12 marks) (22 minutes)**

**Communications with Those Having Oversight Responsibility for the Financial Reporting Process (HB s. 5751)**

1) Communications with the audit committee (HB s. 5751.16)

- fraud;
- illegal or possibly illegal acts;
- material weaknesses in internal control; and
- related party transactions not in the normal course of operations that involved significant judgments.

2) Communication of misstatements (HB s. 5751.17)

Using his/her professional judgment to determine the need to report any non-trivial errors, the auditor may include the following:

- “(a) questions regarding management competence;
- (b) non-trivial misstatements arising from error, whether or not corrected;
- (c) errors that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process; and
- (d) errors that may cause future financial statements to be materially misstated.”<sup>2</sup>

The auditor should also consider informing the audit committee of any non-trivial uncorrected misstatements that are immaterial, according to management, both individually and in the aggregate.

3) Matters having a significant effect on qualitative aspects of GAAP (HB s. 5751.20)

Best accomplished by discussing frankly and openly with management and the audit committee, the auditor could raise the following concerns about GAAP:

- Initial selection of, changes in, adoption and effect of new GAAP (such as the adoption of the HB requirements for comprehensive income, financial instruments and derivatives);
- Potential impact of any proposed standards, controversial or emerging issues;
- Existence of any alternatives used in the industry and the impact of adoption;
- Effect, including risk and rewards, on the financial statements and the entity of significant unusual transactions;
- Issues and related judgments made by management, in formulating particularly sensitive accounting estimates and disclosures;
- Basis for the auditor's conclusions regarding the reasonableness of those estimates;
- Factors affecting the carrying values of assets and liabilities, including the bases for determining the economic and useful lives of tangible and intangible assets; and
- Revenues and expense recognition timing issues.

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<sup>2</sup> CICA Handbook s. 5751.17

**Question 9** (continued)

- 4) Other audit matters relevant to the audit committee (HB s. 5751.21 to .26)
- The auditor’s responsibility relating to information that management prepared for inclusion in the annual or interim report, but other than the annual and interim financial statements;
  - Significant matters related to component entities (subsidiaries, joint ventures, etc.);
  - Any disagreements with management, resolved or not, about matters that could be significant to the entity's financial statements or the auditor's report;
  - Auditor’s awareness that management has consulted with other accountants about accounting or auditing issues;
  - Any major issues related to the appointment or re-appointment of the auditor, including, discussions about GAAP, GAAS, and fees;
  - Any serious difficulties encountered in the course of the audit, such as significant delays in obtaining requested information or unnecessary restriction on the audit timetable.

**Question 10 (9 marks) (15 minutes)**

a) Date of the Auditor's Report (HB s. 5405)

March 21 – No effect. Awaiting receipt of specific corroborating evidence or documentation before signing and releasing its report would not normally cause PD to change the date of its report. PD is no longer seeking new evidence but is merely ensuring the receipt of all evidence previously sought but not obtained as at March 15; after this date, PD does not have a continuing responsibility to seek further audit evidence.

April 4 – No effect. Assembling and reviewing working papers, reviewing drafts of the financial statements and obtaining management's final approval of the financial statements does not constitute seeking new audit evidence.

April 8 – Consider double-dating. Retain the original date of the report and amend it with respect to the subsequent event only. For example, "March 15, 2007, except as to Note X, which is as at April 8, 2007." Note that it is possible to argue that no effect should be reflected on the financial statements because the event – a significant but not material inventory loss – is not materially misstating.

PD's responsibility beyond the original date is limited to examining evidence related to the specific subsequent event; it has no responsibility to search for other events or to update its evaluation of other financial statements' items that are not related to the specific subsequent event.

April 10 – No effect. The subsequent event happened April 8.

April 15 – No effect. PD will date its report as at the date of substantial completion of examination, March 15 in this case. The date of signature or release of the auditor's report is normally after the fieldwork completion and after the date of the report.

As a result, the report should be dated March 15. By this date, PD has identified and examined the evidence available and has considered and examined such evidence to the extent necessary to support its opinion.

b) Expected Action upon Learning about the Bankruptcy

On or about May 5, when PD became aware of a possible misstatement in Accounts Receivable, PD should have considered the evidence available about the valuation of Country Furniture, the adequacy of the Allowance for Doubtful Accounts and whether the financial statements are materially misstated.

**Question 10** (continued)

Soon after, PD should have discussed the matter with management and the audit committee or the Board of Directors, if deemed appropriate, to determine whether a misstatement had occurred that required prompt disclosure. If this was the case, management may have decided to:

- “(a) notify persons known to be relying, or likely to rely, on the financial statements that a misstatement has been discovered;
- (b) issue, as soon as practicable, revised financial statements or disclose the revision in financial statements of a subsequent period when issuance of such statements is imminent;”<sup>3</sup>

If the misstatement was an isolated event and a revised version of the financial statements was about to be issued, PD may have double dated its report.

However, if the effects of the misstatement were so pervasive that little reliance could be placed on the previously obtained evidence, PD should have re-opened the audit, sought new evidence to validate the previously obtained evidence, and issued a new report with a new date.

PD should have differentiated its report on the revised financial statements from the original one by adding a separate paragraph to provide explanations clearly stating that the March 15, 2007 audit report has been withdrawn and that the financial statements have been revised.

If PD believed that such matters “had not been dealt with appropriately, [it] would consider seeking legal advice as to the action it should take to discharge its responsibilities.”<sup>4</sup>

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<sup>3</sup> CICA Handbook, s. 5405.14

<sup>4</sup> CICA Handbook, s.5405.18

**Question 11 (6 marks) (11 minutes)**

**Reservations in the Auditor's Report (HB s. 5510)**

**Situation 1**

A departure from GAAP exists because the disclosure does not draw attention to the lender's right to demand payment. It is unlikely that WPMI will be able to continue to satisfy its current liabilities and continue as a going concern. An adverse opinion is necessary to inform and protect the users of the financial statements.

**Situation 2**

A scope limitation continues to exist because you, as the auditor, are unable to verify the opening inventory, even though the ending balances can be audited. The inventory represents a material amount that directly affects income. Your report requires modification of the scope and the opinion paragraphs. A qualification of the opinion is needed for the effects of any adjustments to the cost of sales, the income taxes, the net income for the year, the opening retained earnings and cash provided from operations.

**Situation 3**

No scope limitation exists; the potential scope limitation was overcome with alternative procedures. There is no departure from GAAP. You will issue the standard three-paragraph opinion.

**Question 12 (8 marks) (14 minutes)**

**Audit of Accounting Estimates (HB s. 5305)**

The audit objective is to determine if management's accounting estimates are reasonable within the context of the financial statements as a whole. As the auditor, you need to apply your understanding of the entity, of its environment and of the industry in which it operates to evaluate the reasonableness of accounting estimates.

You would consider both subjective factors, such as management bias, and the quality of data involved in the preparation of the estimates. You would need to gain an understanding of the policies and procedures involved in preparing the accounting estimates to determine the nature, timing and extent of the audit procedures necessary.

There is little doubt that the estimate of uncollectable accounts would be material in this industry. There are a number of key factors that should be examined, including management assumptions, the estimate's sensitivity to variation, and deviations from historical patterns. Other factors would include materiality of estimates, both individually and in the aggregate, in relation to the financial statements as a whole, and the estimate's consistency with the evaluation of the current economy.

Certainly, you would verify the calculation of accounting estimates and examine the collections occurring between the balance sheet date and the date of your report. If complex estimation processes were used or involved specialized techniques, it may be necessary for you to rely on the work of specialists.

The risk of misstatement due to accounting estimates varies with factors such as the complexity and subjectivity involved in preparing estimates, the nature and extent of assumptions required, and the degree of uncertainty of future events. The availability and reliability of information within CLC is likely good, but external information may not be easily available.

However before concluding that a misstatement exists, you may want to consider an acceptable threshold, range or point estimate within the context of the financial statements as a whole, and the cumulative effect of bias in the preparation of management's accounting estimates. "This may be important when, for example, the estimates consistently lie at one boundary of the zone of reasonableness or move from one boundary to the other in successive periods. In these circumstances, the auditor would reconsider the estimates and, as a result, may conclude that a misstatement has occurred."<sup>5</sup>

If you were unable to obtain sufficient appropriate evidence or had obtained evidence that refutes management's estimates, you would have to discuss the findings with management and consider the effect on your opinion and report.

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<sup>5</sup> CICA Handbook, s. 5305.07

**Question 1 (10 marks) (18 minutes)**

Acquisition of control and utilization of losses

a) Utilization of the Non-Capital and Net Capital Losses

The non-capital losses are deductible against income from the business that incurred the loss or similar business, and as a result, that business must be carried on at a profit or with reasonable expectation of profit to benefit from the non-capital loss carry-forward.

The net capital losses are deemed to have expired on September 30, 2006 as a result of the acquisition of control. As a result, all accrued losses are deemed to have materialized.

b) Adjustments to the Tax Values of the Assets

All assets are deemed to have been sold at their fair market value (FMV) and a year end is deemed to have occurred immediately before the acquisition of control (i.e., on September 30, 2006).

The following adjustments are needed:

- Short term investments: the adjusted cost basis (ACB) is reduced by \$8,000 to \$12,000; The \$8,000 write down is deemed a capital loss as at September 30, 2006.
- Equipment Class 8: the undepreciated capital cost (UCC) is reduced by \$6,000 to \$30,000.
- Eligible capital property: the cumulative eligible capital (CEC) is reduced by \$1,000 to \$9,000 (FMV of \$12,000  $\times$   $\frac{3}{4}$  = \$9,000 – current balance of \$10,000).

c) Recommendation about the Election under s. 111 (4)(e)

Little should not make an election that could trigger a recapture of capital cost allowance because the non-capital losses are not expiring within the timeframe provided (2 years).

However, sufficient taxable capital gains should be triggered to absorb the net capital loss that will be expiring as a result of the election and the acquisition of control.

Expiring Net Capital Losses:

- December 2004 net capital losses	20,000
- September 2006 allowable capital loss on short term investments: \$8,000 $\times$ 50%	<u>4,000</u>
	<u>\$24,000</u>

The election under s. 111(4)(e) should be made on the land because no recapture will be triggered.

A capital gain of \$48,000, \$24,000 of which is taxable, should be elected.

**Question 2 (15 marks) (27 minutes)**

Taxation of Different Sources of Income

3 (a) Income from office, employment, business and property			
- Salary			\$65,000
- The car allowance must be included because it is not reasonable given that it is not based on kilometres			3,600
- Life insurance premium [6 (4)]			600
- Stock option benefit $(\$16 - \$5) \times 1,000$			11,000
- Car lease payments – 12 months (see <i>Evaluators' comments</i> ) (maximum \$800 per month plus GST and PST: $\$800 \times 1.14$ )	(10,944)		
- Other car expenses	( 6,900)		
-	(17,844)		
- 60% prorating for business use	<u>60%</u>		<u>(10,706)</u>
			69,494
3 (b) Capital gains			
- Shares of ML $(\$20 - \$16) \times 1,000$	4,000		
- Shares of AZ shares $(\$30 - \$20) \times 100$	1,000		
- Shares of BY gifted to his daughter $(\$1,800 - \$200)$	1,600		
- Shares of CX inherited from his mother $(\$100,000 - \$75,000)$	<u>25,000</u>		
	31,600		
- Taxable Capital Gains (50%)	<u><math>\times 50\%</math></u>		15,800
3 (c) Deductions permitted			
- Spousal support payments (alimony) pursuant to a written agreement			( 12,000)
3 (d) Loss from office, employment, business and property			
- Farm loss is deductible provided that a reasonable expectation of profit exists. However, it is restricted to a maximum deduction of \$8,750, calculated as follows:			
- Restricted farm loss is:			
First \$2,500 of the loss	(2,500)		
- Plus 50 % of remaining loss up to 6,250 $[(10,000 - 2,500) \times 50\%]$	<u>(3,750)</u>	(6,250)	
- Interest income		800	
- Dividend – from AZ $(\$100 \text{ received} \times 145\% \text{ gross-up factor})$		145	
- Dividend – from BY $(\$80 \text{ received by his daughter but attributed to him} \times 145\%)$		116	
- Mortgage interest $(\$3,000 \times 10/50)$		(600)	
- Bank interest related to the investment in shares		(1,500)	
- Rental loss		<u>(2,000)</u>	<u>( 9,289)</u>
Net income			<u>\$64,005</u>

**Question 2** (continued)

**Taxation of Different Sources of Income**

The following items should **not** be included in the calculation of Stinson’s net income:

- 50% of the difference between the fair market value (\$75,000) and the cost (\$25,000) of the shares of CX at time of his mother’s death; this amount was taxable in the hands of his mother;
- The bonus of \$20,000 will be taxable in the year Stinson receives the amount (2007);
- The capital cost allowance (CCA) cannot be used to create or increase a loss on rental property;
- The contribution of \$10,000 to the registered pension plan was made by the employere and is not taxable in the employee’s hand in the year of the contribution (nor is it deductible by the employee);
- The life insurance proceeds of \$18,000 are not taxable;
- The lottery winnings of \$5,000 are not taxable;
- The child support payments of \$14,400 are not deductible (nor taxable in the hands of the receiver);
- The charitable donations of \$5,000 are not deductible, but are eligible for a non-refundable tax credit.

*(Evaluators’ comments: the Evaluators considered the often used quick solution that consists of multiplying the maximum amount allowable (\$800) plus GST and PST by 12 months, as illustrated in the response.*

*However, s. 67.3 requires to select the lower of two calculated amounts that limits the amount deductible for car lease payments; in the absence of information on the manufacturer’s list price and the refundable deposits made by the lessee, the formulas can be simplified as follows.*

$$\frac{(A \times B)}{30} - C$$

*Where A = the prescribed amount, B = the days since the inception of the lease until the earlier of the end of the year and the end of the lease, and C = the amount deducted in prior years.*

*A*

*Where A = the amounts actually paid during the year.*

*In circumstances where all relevant information is available, the calculations required under s. 67.3 should be performed)*

**Question 3 (25 marks) (45 minutes)**

**Taxation – Short Answer Questions**

**Part A – Shareholder Loans vs Employee Loans (5 marks):**

a) If the loan is received because of Paul’s employment

- The loan should not be included in his income, because the loan was used by Paul to buy a home in which he lives. In addition, the loan is made with *bona fide* arrangements for repayment
- However, Paul will be taxable on an imputed interest benefit based on the prescribed rate in effect when the loan was received and reduced by any interest paid if paid by 30 days after the end of the year.

b) If the loan is received because of the shareholding of Paul’s mother

- The loan must be included in Paul’s income for 2006.
- However, Paul may deduct the amount of loan repaid in the year of the payment is made.
- No imputed interest benefit will be included in Paul’s income because the loan has been included in Paul’s income.

**Part B - Section 85 – Minimum Elected Amounts (4 marks):**

The minimum elected transfer price under s. 85(1) should be as follows:

Land	\$50,000	the non-share consideration
Investments	\$ 8,000	the fair market value
Depreciable asset	\$50,000	the undepreciated capital cost
Goodwill	\$40,000	$4/3 \times$ CEC of \$30,000

**Part C - Active Business Income (3 marks):**

The statement is not true.

Active business corresponds to any business other than a personal services business or a specified investment business and includes an adventure or concern in the nature of trade (s. 125(7)).

**Question 3** (continued)

A personal services business is “a business of providing services where

- a) an individual who performs services on behalf of the corporation (in this definition and paragraph 18(1)(p) referred to as an "incorporated employee"), or
- b) any person related to the incorporated employee

is a specified shareholder of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation, unless

- c) the corporation employs in the business throughout the year more than five full-time employees, or
- d) the amount paid or payable to the corporation in the year for the services is received or receivable by it from a corporation with which it was associated in the year;” (s. 125(7)).

A specified shareholder is one who owns 10% or more of the shares of the corporation providing the services (s. 248(1)).

As a result, the income derived from selling services such as computer consulting services would normally be considered active business income.

**Part D – Contribution to Registered Retirement Savings Plan (RRSP) (3 marks)**

Maximum contribution for 2006

18% × \$60,000, the earned income for 2005, maximum \$18,000	\$10,800
Deduct: pension adjustment	<u>4,000</u>
	6,800
Add: unused RRSP deduction room from the 2005 notice of assessment	<u>1,000</u>
Maximum RRSP deduction for 2006	<u>\$ 7,800</u>

**Part E – CCA Calculation (2 marks)**

Because Parsley acquired new office equipment during the year, a two step calculation is required to determine CCA for the year:

a) On the balance of Class 8 at the beginning of the year:		
UCC at the beginning	\$4,600	
	<u>× 20%</u>	\$ 920
b) On the addition to Class 8:		
Cost	\$24,000	
Trade in	<u>4,000</u>	
	\$20,000	
Half year rule rate on the net addition	<u>× 20% × ½</u>	<u>2,000</u>
		<u>\$2,920</u>

**Question 3** (continued)

**Part F – Capital Gains and Recapture (2 marks)**

Because the sale's proceeds exceed the UCC at the beginning of the year, the recapture of CCA must be included in income, as follows:

Proceeds, not exceeding ACB	\$ 80,000
UCC at the beginning of the year	<u>60,000</u>
CCA recapture	<u>\$ 20,000</u>

Because the sale's proceeds exceed the ACB of the asset, the taxable portion of the capital gain must be included in income, as follows:

Sales proceeds	\$110,000
ACB	<u>80,000</u>
Capital gain	\$ 30,000
Exempt portion	<u>50%</u>
Taxable capital gain	<u>\$ 15,000</u>

**Part G – Capital vs Income (2 marks)**

The intended use of the property at the time of acquisition is the principal factor in deciding its tax treatment at the time of a subsequent sale.

John's transaction will most likely be treated as business income because of the nature of the asset and the purpose of the transaction. Buying and selling land would be considered as a business of trading, where land would be the inventory.

Sharon's transaction on the other hand will most likely be treated as a capital gain and recapture of CCA (if any CCA has been claimed in the past). The purpose of her rental property was to generate income from property, not to sell properties.

**Part H – Part IV Tax (2 marks)**

OL is a Canadian-controlled private corporation (CCPC) and connected to Salt because it owns more than 10% of Salt's common/voting shares (s. 186(4)).

As a result, Part IV tax payable corresponds to a proportion of dividend refund Salt received, as follows:

$$15\% \times \$2,000 \text{ (the dividend refund Salt received)} \qquad \qquad \qquad \$ 300$$

OL is not connected to Pepper because it does not own more than 10% of Pepper's common/voting shares.

As a result, Part IV tax payable corresponds to a third of the dividend OL received, as follows:

$$33 \frac{1}{3}\% \times \$12,000 \text{ (the dividend received by OL)} \qquad \qquad \qquad \underline{4,000}$$

$$\qquad \qquad \qquad \underline{\underline{\$4,300}}$$

**Question 3** (continued)

**Part I – Reassessment Period and Notice of Objection Deadlines(2 marks)**

- a) The normal reassessment period ended on May 20, 2006, which is 3 years after the date of the original notice of assessment for the year 2002.

CRA cannot reassess Peter unless there is misrepresentation in the income tax return, whether careless or intentional.

- b) A notice of objection must be filed by November 12, 2007, which is 90 days after the date of the notice of reassessment.

**Question 4 (8 marks) (14 minutes)**

Tort Law – Negligence

**Introduction**

The situation at hand requires identification and review of the factors that could indicate negligence because no contractual or legal relationship existed between the parties. It should be noted that a claim made by each family member would be made on the same basis.

**Claim for the Loss of Enjoyment of Betty and of Companionship**

A claim could be made against the investigator, and as a result, against the employer, or the government agency, or both, on the basis of vicarious liability (a liability of an employer to compensate for tort or harm done to someone by an employee in the course of his or her employment).

*Three Elements Need to Be Proven*

1. The Agency (as defendant) owed a duty of care to Daniel and his family (the Daniel Family).

The Agency is the investigator's employer and as such, it would be liable on the basis of vicarious liability as indicated above. A duty of care to the Daniel Family existed because it was reasonably foreseeable that the Daniel Family could be injured by the Agency's carelessness in making its assessment and by the actions it took.

By statute, the Agency owes a duty of care to the disabled person under its care. As a result, it could be argued that it cannot be acting for a disabled person and for others at the same time; to owe a duty to others would put the disabled person at risk.

One should also consider Public Policy and the criteria or factors affecting fault versus strict liability.

2. The Agency breached its duty by falling below a standard of care

In establishing what constitutes reasonable standard of care, one must examine what standard would be demanded from an ordinary reasonable person.

In this instance, did the investigator do enough to determine the causes of the bruises to Betty, or consider persons other than the members of the Daniel Family? Did the investigator consider the fact that Betty appeared to be suffering from dementia, which caused her to be confused about facts and events, and maybe people? Did the investigator consider the fact that the tip was from an anonymous source, which might be questionable as to its reliability and motive?

One should examine whether the actions taken (e.g., injunction) were excessive under the circumstances.

It is arguable or defensible that harm to the Daniel Family was reasonably foreseeable, as a result of the investigator's actions.

**Question 4** (continued)

3. The breach of duty of care caused damages to the Daniel Family

Undisputedly, the Daniel Family suffered damages in the form of mental/emotional damage in the period during which they were prevented from visiting Betty and at the time of her death: anguish, anger, upset, and additional grief, all this as a direct result of the actions taken by the investigator.

One difficult issue is that of quantifying the damages given the nature of pain and suffering; however, the loss or damage was not remote.

*Possible Defence*

As indicated above, the Agency could possibly claim that it acted reasonably and in the best interest of Betty by removing her from the degraded environment in which she lived and by obtaining the restraining order to keep a source of harm away from her.

The investigator could argue that the evidence before him at the time was sufficient to lead to the course of action taken, that he acted reasonably, within the statutory requirements, and in the best interest of Betty.

The Agency could also argue that the Daniel Family contributed to the situation by letting Betty live in an unclean apartment (contributory negligence) and that a similar reasoning could apply to the landlord's situation.

As defence, one should also consider the "but-for" test and the resulting chain of events, without however, extending this cause to the death of Betty.

**Claim for the Loss of Assets**

A claim could be made on the basis of vicarious liability against the investigator (as the person who took control of Betty's assets), and against the Agency (as the custodian of her assets until her death). The claim could also include as defendant the specific employees who oversaw the assets management and who may be responsible for the missing funds.

Similarly to the first claim, three elements need to be proven:

1. That a duty of care existed. The Agency owes a duty of care to those parties on the behalf of which it is acting (concept of proximity), regardless of its statement to Betty's Estate that it does not owe such a duty of care, or that the duty of care does not included this specific aspect.
2. That a breach of the duty of care occurred. The loss of some of Betty's assets may be due to a lack of proper safeguard policies and procedures, an inefficient internal control system, the ability to override the existing controls, or the lack of reporting obligation (breach in the standard of care).
3. That the loss was caused by the breach of the standard of care. The Agency admits that "lost assets are just one of the costs associated with such a massive operations" and implies that it does not have in place the proper policies and procedures that could prevent such losses from happening in the first place.

**Question 4** (continued)

The quantification of the loss or damages should not be very difficult:

- it should be based on the difference between the value of the assets that were taken over and the value of the assets returned to the Estate; the possible difficulty resides in the fact that a proper inventory of the assets was not done;
- it could also include the income that would have normally been earned; and
- it could include a provision for the legal and other costs needed to recover the missing funds.

*Possible Defence*

The defence that the Agency could possibly use is that it acted reasonably, within statutory requirements, and in best interest of Betty.

**Question 5 (8 marks) (14 minutes)**

Contract Law

**Introduction**

The dispute between Charles and Ricky comes from the way each party interprets the terms of the agreement (contract) based on what each understood when entering into this contractual relationship. Charles, being the plaintiff, has the burden of proof; he must prove as civil matter (tort claim) on “balance of probabilities.”

**Contract between Ricky and Charles**

*Existence of a contract*

Both parties appear capable of contracting: none of the parties appear to have diminished contractual capacity (such as being a minor, being of unsound mind or diminished mental capacity, or being incapacitated by alcohol or drugs).

There seems to be all necessary elements to form a contract: Ricky made a verbal offer and Charles accepted the offer by providing a start date; on the set date, both parties signed a written agreement, and exchanged a money consideration of \$1,000 as a deposit.

*Deficiencies*

It is possible that mutual mistake exists in the contract because one party interpreted “total area of the rooms” as meaning floor area while the other party was thinking wall area. The effect could be to void the contract because there was no meeting of the minds at the time, or the terms were too vague for a contract to really form.

Possible misrepresentation exists, however, in that Charles could have provided floor area intentionally knowing that wall area was requested, which would constitute a fraudulent representation. If Charles provided floor area unintentionally, it could be viewed as an innocent mistake or at most as negligence.

Ricky on the other hand could have checked the rooms and negotiated changes to the contract prior to signing it because he would have realized that the understanding of area was different for each party. Ricky is the specialist and could have asked more directed question and been more specific about the square footage to be painted in writing up the contract.

*Interpretation*

There are a few approaches to interpreting the words used by both parties, ranging from a strict interpretation of the words (their ordinary or plain meaning) to a more liberal interpretation of the intent of Charles and Ricky in drafting their contract. A court would certainly look at a reasonable interpretation of the parties’ intent when agreeing on the terms of the contract.

**Question 5** (continued)

**Parol evidence rule**

A question arises as to whether Ricky is bound to perform.

An agreement in writing exists as both parties read and signed a contract in the presence of one another. Terms that may have been discussed during the negotiation of the contract will not affect the evidence related to any of the circumstances surrounding the agreement, e.g., the fact that the written contract does not make reference to a cost of \$2 per square foot or to the 4,500 square foot surface/area to paint which could have been discussed over the phone; the inadequate consideration in itself would not be a determining factor in enforcing the contract.

Failure to perform by Ricky would result in a breach of contract.

**Others**

By repudiating the contract, Ricky stated that he does not intend to perform as originally promised. Charles could consider the contract terminated and contemplate suing for damages. Charles could also insist on performance of the contract by Ricky, given that Charles already performed a condition of the contract by providing the deposit.

The parties could also agree to terminate the contract as if no contract ever existed; however, Ricky would have to return the deposit.

**Question 6 (4 marks) (8 minutes)**

**Tort Law – Product Liability**

**Duty of Care**

Mary owes a duty of care to the parties using the product. The British leading case of *Donoghue v. Stephenson* adopted by Canadian courts was instrumental in rejecting the requirement for a contractual relationship between the parties and in providing some protection to consumers of products that could harm them. It allowed third parties to sue for negligence (tort law). As a result, Mary would owe a duty of care to the baby as a user of the product and not the purchaser.

**Breach of Duty**

Breach of duty of care can result from many factors, such as a design problem with the baby bottle, or a production problem. The labelling itself does not provide protection to the manufacturer, even with a disclaimer on it. Courts have shifted the burden of proof to manufacturers, requiring them to demonstrate that they were not negligent. In addition, the warning label would not apply to the baby, and likely not to the parent who purchased the baby bottle.

The question is really whether a defect in the product that caused injury was foreseeable; for example, the use of silicone could prove to be harmful to the baby and the manufacturer would have to prove that it took every reasonable precaution to determine the safety of silicone in this application.

**Damages/Liability**

Should the product prove to be harmful to the baby, the parents as legal guardians can make a claim for damages caused by the breach of duty of care; however, depending on the nature of the harm, damages may be difficult to determine, but not impossible.

**Others**

It is not advisable that Mary operate her business as a sole proprietorship because she would have unlimited liability in the event that the product is defective and causes substantial damages beyond the value of her own assets. It is advisable for Mary to carry product liability insurance.

**Question 7 (26 marks) (47 minutes)**

**Part A – Tamara Sutton (6 marks)**

**206 Compliance with Professional Standards**

There seems to be breaches of professional standards as evidenced by:

- Not having obtained an engagement letter or failing to document the assessment of risk and materiality.
- Failing to qualify the report based on incomplete disclosure in the financial statements or seemingly lacking the knowledge of the client, etc. for the audit.
- Failing to comply with GAAS in performing the audit work (such as communicating with Board of the Condominium Corporation).

**204 Independence**

- Tamara has contravened 204.1 & 204.4 (23) that specifically prohibits her from preparing journal entries without seeking approval of the management (i.e., the Board)..
- She may also have contravened 204.4 (24) – Preparation of financial statements. Although it is not clearly stated in the situation, it may be implied by the comment that client is not sophisticated, and accordingly management may not have prepared the financial statements.

**203.1 Professional Competence**

- Tamara failed to display professional competence by ignoring the requirements of the Provincial Condominium Act.

**204.2 Identification of Threats and Safeguards**

- Tamara created a threat to independence by performing journal entries and possibly preparing financial statements.
- However, a mitigating factor could be that she has requested that her CA friend review the files.

**208 Confidentiality of Information**

- By passing on the client’s file to her CA friend, Tamara may have breached confidentiality, unless she obtained prior approval from the client.

**214 Fee Quotations**

- One should consider whether the fixed fee is the result of an adequate assessment of the work involved on the engagement.

**202 Integrity and Due Care**

- Performing the audit work for a fixed fee may impair Tamara’s due care, for example, failure to communicate with the Board, and shifting the responsibility for completeness of disclosure of the financial statements to management.

**Question 7** (continued)

**211 Duty to report breach of RPC**

- Tamara’s CA friend has an obligation to report the above breaches of professional conduct to the Institute.

**201 Maintenance of Reputation of Profession**

- As a result of the above breaches, Tamara failed to maintain the good reputation of the profession.

**Part B – Elgin & Partners, LLP (12 marks)**

**Sarah Franklin**

**205 False or Misleading Documents**

- Sarah as a CA student knowingly signed the firm independence statement while not independent from LFI.

**204 Independence**

- Sarah has contravened the rule of independence by participating in the review of LFI’s financial statements as the person in charge of the engagement,
  - while still owing money (loan) to LFI (204.4 (12a)), and
  - while still working as a bookkeeper (204.4 (23)).
- Sarah has contravened 204.5 by failing to disclose a prohibited relationship with LFI to the partner.

**210 Conflict of Interest**

- The duty Sarah owes to Elgin & Partners creates a professional conflict with the duty she owes to LFI.

**201.1 Maintenance of Reputation of Profession**

- As a result of the above breaches, Sarah failed to maintain the good reputation of the profession.

**Question 7** (continued)

**George Elgin, CA**

**206 Compliance With Professional Standards**

- Various examples of failure to comply with professional standards exist:
  - Lack of engagement letter;
  - Lack of planning;
  - Lack of supervision;
  - Lack of competent staff;
  - Failure to properly respond to independence issue;
  - Failure to follow GAAP for LFI’s wholly-owned subsidiary;
  - Failure to apply the professional competence standard (203.1).

**203.2 Cooperation with Practice Inspections**

- George failed to co-operate with the Institute by hiding a problem file and by falsifying its client list.

**204 Independence**

- 204.2 – George has failed to identify and mitigate the threats and safeguards (self interest and self review)
- 204.4 – George contravened a specific prohibition related to independence because his wife has lent money to LFI’s wholly-owned subsidiary, while LFI is a review engagement client.
- 204.5 – George also failed to report the prohibited financial interest to the other partners in firm.
- 204.6 – From the above, it is not clear whether the firm has in place the necessary measures or policies to ensure compliance with independence rules, or whether such measures, if in place, are effective or enforced.

**202 Integrity and Due Care**

- George’s advice to report Sarah’s employment income as her mother’s could be construed as tax evasion.
- George’s removal of LFI’s file from the file room and LFI’s name from the list of clients demonstrate a lack of integrity, as is keeping matters related to LFI secret from the other partners.

**205 False or Misleading Documents**

- George has associated himself and the firm with false and misleading documents by advising Sarah to have her mother report Sarah’s employment income and by modifying the list of clients in light of the coming practice inspection.

**213 Unlawful Activity**

- George has knowingly associated himself with an unlawful activity by recommending Sarah have LFI pay Sarah’s mother for Sarah’s work.

**Question 7** (continued)

**211 Duty to report breach of RPC**

- The firm should report Sarah to the Institute for breaching the rules of professional conduct.
- Jane should report Sarah, George and Elgin & Partners on the same grounds.

**201.1 Maintenance of Reputation of Profession**

As a result of the above breaches, George and Elgin & Partners failed to maintain the good reputation of the profession.

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

- The firm has failed to ensure compliance with GAAS (independence, planning, etc.).

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

- The firm has failed to ensure compliance with the rules of professional conduct (maintain good reputation of the profession, maintain integrity, etc.).

**Part C – Frank Plummer (8 marks)**

**202 Integrity and Due Care**

- Frank has breached the standard of integrity and due care by various actions such as backdating documents, providing improper advice (e.g., EII and TLI invoicing each other); favouring the majority shareholders; failing to reply to Cheryl's and David's requests.

**204 Independence**

- Frank breached specifically prohibited rules of independence (204.4 (22) & (23)) by performing management functions and preparing source documents.

**203.1 Competence**

- One could question whether Frank has the tax competence to provide the advice he gave Richard and Cheryl in light of his assurance background and his approach to professional development in taxation.
- His knowledge is dated and tax advice or tips found in newspapers may not constitute an adequate and reliable source or resource for professional development.

**205 False or Misleading Documents**

- Frank associated himself with false documents, for example,
  - by creating documents for services that were never rendered by EII to TLI;
  - by backdating some documents; and
  - by invoicing TLI for his services to EII because TLI is profitable and EII is losing money.

**Question 7** (continued)

**206 Compliance With Professional Standards**

- Frank failed to comply with the general reporting standards because
  - the financial statement of TLI and EII may not be plausible as a result of the advice provided;
  - Frank did not act on behalf of all shareholders; and
  - Frank failed to complete the engagement.

**213 Unlawful Activity**

- The invoicing for services never rendered by EII may be construed as an attempt by EII and TLI to evade tax.
- Frank's participation in this transaction is detrimental to TLI's minority shareholders.

**208 Confidentiality of Information**

- Frank may not be authorized to use the knowledge gained about TLI to EII's benefits. If he is not, then he has contravened 208.

**210 Conflict of Interest**

- Frank has placed himself in a conflict of interest situation by acting for TLI and EII at the same time. The duty of care is owed to each client, that is the corporations and the shareholders, including the minority interests.

**303 Co-operation with successor**

- Frank failed to reply to David's requests for information about the working papers and to provide access to them.

**201.1 Maintenance of Reputation of Profession**

- As a result of the above breaches, Frank failed to maintain the good reputation of the profession.

**Question 8 (4 marks) (7 minutes)**

**Ethical Issues to Consider Prior to Accepting Advisory Services Engagement**

**204 Independence**

- By virtue of being the auditor of LML, the firm may appear to have less objectivity; threats to independence may exist:
  - Advocacy threat where the firm may appear to promote Dianne’s interest at the expense of Marissa’s.
  - Self-interest threat where the firm may appear to fear losing LML as a client if Marissa buys LML.
  - Familiarity threat where the firm may appear too sympathetic to one party over the others.

**Adequate safeguards are needed such as:**

- The involvement of other partners not familiar with the audit (CI 128)
- The involvement of all parties to the decision, including the children who have not expressed an interest.
- Other valid safeguards would include avoiding recommending a decision that could be construed as making a management decision (CI 130); obtaining the client’s acknowledgement of responsibilities for the decision made as a result of the advice provided (CI 128).

**208 Confidentiality of Information**

- Dianne should provide her written consent before disclosing any information about LML to Marissa.

**210 Conflict of Interest (CI 210)**

- By being a partner on LML’s audit and advising both buying and selling parties, CA is placed in a situation of conflict of interest at three levels:
  - Professional level: the advice may run contrary to Dianne’s interest.
  - Legal level: the firm cannot represent parties whose interests may be conflicting.
  - Business level: the engagement may affect the firm’s ability to continue providing assurance services to LML.
- The firm must develop ways to manage the conflicts on the above three levels before accepting the engagement.
  - Examples: engagement letter specifically addressing issues related to the conflicts; requiring Marissa to obtain advice from another firm; involving an independent business valuator; and Dianne signing an agreement to disclose relevant information.
- Otherwise the firm should not accept the engagement.
- From time to time, the firm should review its process for identifying new conflicts and for dealing with existing ones, and determine its effectiveness. If need be, the firm may have to take proper action, which could lead to terminating a previously accepted engagement.