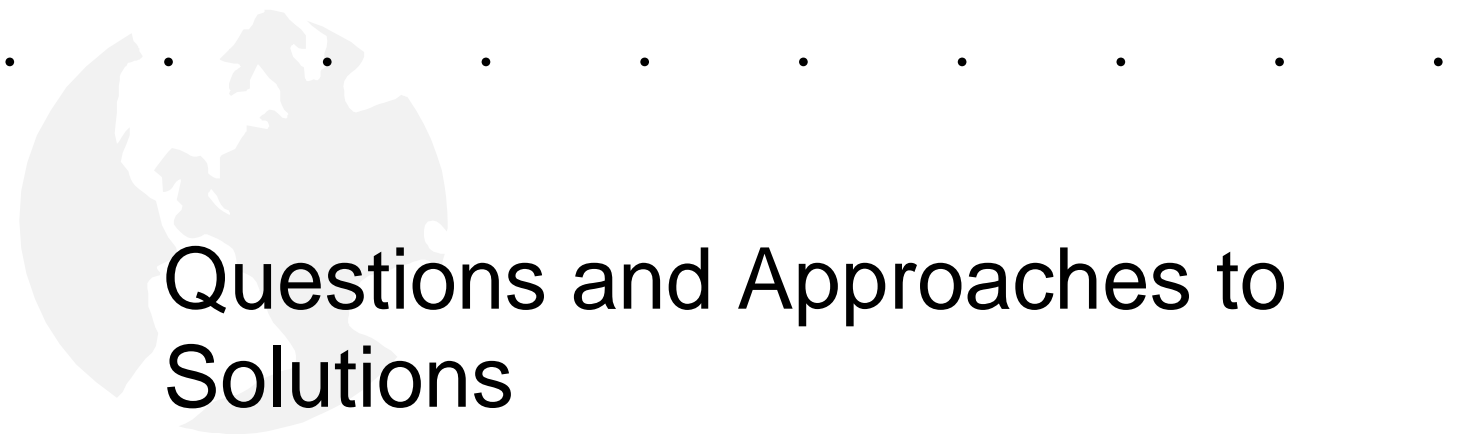




CARE Chartered Accountant Reciprocity Examination 2008

The Institutes of Chartered Accountants in Canada and Bermuda



Questions and Approaches to Solutions

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Chartered Accountant Reciprocity Examination

Institute	Number of Successful Writers		
	2008	2007	2006
British Columbia	15	8	12
Alberta	11	2	3
Saskatchewan		2	
Manitoba		1	
Ontario	35	48	38
Quebec		8	4
Total	<u>61</u>	<u>69</u>	<u>57</u>

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY ONE – 2008

(100 marks) (3 hours)

NOTES TO CANDIDATES:

1. There are **12 questions and 16 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 **FOUR (4) DIGIT 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 or on the back of your answer papers.
5. **Ensure that the answer sheet for question 1** is 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 separately provided for Question 1. 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, submit it along with your other answer papers.**

(i) Financial Instruments, Recognition and Measurement

Krispy Limited entered into a forward contract to buy €100 in 30 days for CA\$150. The contract is outstanding at year end and may be settled net in cash.

Which one of the following **best** represents how the contract should be reported on the year-end financial statements?

- a) As an executory contract that is not recognized until settled.
- b) As an executory contract that is recognized as an account receivable for €100 at the spot rate and an account payable for CA\$150, and that is not subsequently re-measured.
- c) As a derivative that is recognized as an account receivable for €100 at the spot rate and an account payable for CA\$150.
- d) As a derivative that is recognized at the net amount of the account receivable and the account payable.

(ii) Leases

On January 1, 2008 LL Limited purchased a machine for \$100,000 that is being leased to EE Inc. under the following terms:

- o 10 year term.
- o Lease payments of \$12,826 payable at the end of the year.
- o Option to buy the machine after 10 years at \$10,000, which is estimated to be the fair value at that time.

The interest rate implicit in the lease is 6% and is known to EE Inc.

EE Inc. recently borrowed funds from the bank at 4%.

Which one of the following amounts should EE Inc. be recording as an asset at the inception of the lease (rounded to the nearest dollar)?

- a) \$104,019.
- b) \$100,000.
- c) \$ 94,399.
- d) \$ 93,200.

Question 1 (continued)**(iii) Audit of Accounting Estimates**

Fremes Inc. (FI) produces and sells cigarettes. Because the product is harmful, FI is the subject of numerous lawsuits. Management spends a significant amount of resources, time and energy on these lawsuits including legal fees and costs to estimate the value of the potential exposure. FI therefore has numerous policies and procedures in place including controls over how the exposure is estimated. It is now year end and close to the end of the audit. The auditors have not yet been able to establish independently whether the estimates are reasonable.

Which one of the following **best** represents what the auditor should do?

- a) Discuss the estimate further with management.
- b) Discontinue work on the engagement immediately.
- c) Issue a qualified audit opinion.
- d) Issue a denial of opinion.

(iv) Materiality

Which one of the following would most likely result in a material misstatement?

- a) Errors, fraud or consequences of an illegal act.
- b) The inclusion of too much information.
- c) Omission of unnecessary information.
- d) Numerous immaterial errors that are in the aggregate immaterial.

Question 2 (8 marks) (14 minutes)**Financial Instruments, Recognition and Measurement**

Jingle Bells Inc. (JBI) makes bells from copper. It imports its raw materials from the United States. Since the prices and quality of the raw materials vary, JBI often enters into purchase commitments once it finds good suppliers. When it enters into these types of contracts, it always takes delivery of the raw materials and uses them in production. Just before year end in 2008, JBI signed two contracts to buy a fixed amount of copper from a US supplier at a fixed price:

- Contract A is noncancellable and may not be settled net in cash.
- Contract B is noncancellable and may be settled net in cash.

For both contracts, JBI has documented that it plans to take delivery of the raw materials for use in production.

Required:

- a) Part A (2 marks)

How does the CICA Handbook define a derivative?

- b) Part B (6 marks)

Explain how each contract meets or does not meet the Handbook definition of a derivative, and discuss and compare how each of them should be accounted for. Properly support your answer.

Question 3 (8 marks) (14 minutes)

Related Party Transactions

Tranquil Inc. (TI) is in the real estate business. During the year, it sold land to the husband of the president of the company for \$1 million cash. The president owns 10% of the company. A valuation was performed to support the sale price.

Required:

- a) Part A (2 marks)

How does the CICA Handbook define the term “related parties”?

- b) Part B (4 marks)

Discuss whether the transaction meets or does not meet the Handbook definition of a related party transaction, and discuss how TI should be accounting for the sale of the land. Properly support your answer.

- c) Part C (2 marks)

Discuss how your answer to Part B would differ if TI was not in the real estate business? Properly support your answer.

Question 4 (12 marks) (22 minutes)Employee Future Benefits

The following relates to the annual report of Big Steel Inc. (BSI):

Note 1: Summary of Significant Accounting Policies

[...] BSI sponsors defined contribution and defined benefit pension plans, and various other post-employment benefit plans. [...]

Note 12: Pension and Post-Employment Benefits

	(millions of dollars)	<u>2007</u>	<u>2006</u>
Plan assets, at fair value		\$ 545	\$ 495
Accrued benefit obligation, at year end		620	580
Net benefit plan expense			
Current service cost.....		25	20
Interest cost on accrued benefit obligation		34	29
Expected return on plan assets.....		(40)	(58)
Amortization of past service costs		2	2
Amortization of net actuarial gain (loss)		20	15
Amortization of transitional asset		<u>(10)</u>	<u>(10)</u>
Net benefit plan expense		<u>\$ 31</u>	<u>\$(2)</u>

Required:

a) Part A (4 marks)

Explain the differences between defined benefit and defined contribution plans, identify the type of plan illustrated in Note 12, and indicate the type of benefit plan a company would prefer to offer its employees.

Properly support your answer with adequate explanations.

b) Part B (3 marks)

Note 12 reports amounts for the amortization of net actuarial gain (loss). Describe how actuarial gains or losses occur, how they should be recorded and reported, and how the amortization method is applied.

c) Part C (5 marks)

- i. Interest rates are used to determine interest cost on accrued benefit obligation and expected return on plan assets. Describe how BSI should determine the discount rate for the accrued benefit obligation and the rate of return for the plan assets.
- ii. Define and explain how to properly account for each of the following: settlement gain, past service costs and transitional asset.

Question 5 (12 marks) (22 minutes)Foreign Currency Translation, Subsequent Event, and Contingencies

Wedding Gowns Incorporated (WGI) is a private company that manufactures and sells wedding gowns to independent retail stores in Canada and the United States (US). WGI has wholly-owned manufacturing subsidiaries in China and the US. The subsidiaries sell to WGI and to independent stores around the world. WGI imports specific types of fabrics from many foreign suppliers for its Canadian operations.

Gowns are usually made to order but WGI carries gown inventory purchased from its Chinese and US subsidiaries. Model selection is based on samples featured at trade shows. Gowns are delivered by courier to the stores and payments are required 30 days after delivery.

In 2007, WGI reported record profits because two major celebrities wore WGI wedding gowns for their wedding. The two designs sold at record levels and were highly publicized to further boost the sales. In February 2008, prior to the release of the 2007 year-end financial statements, Cross-Stitch Inc (CSI), a major competitor, launched a lawsuit stating that WGI had copied the two popular gown designs from CSI's collection. Lawsuits of this kind are common in the fashion industry but, in many cases, are very difficult to prove.

Required:

a) Part A (4 marks)

Explain how the following transactions should be reported on WGI's non-consolidated financial statements at year end.

- Purchases of fabrics and gowns from foreign suppliers for its Canadian operations
- Sales to US stores
- Balance of accounts payable and receivable in foreign currencies
- Balance of inventory of fabric purchased overseas

b) Part B (6 marks)

Explain how WGI should report its foreign operations in its financial statements, including factors that it needs to consider when determining their classification.

c) Part C (2 marks)

Discuss the effect of the lawsuit from CSI on WGI's December 31, 2007 financial statements. Consider all relevant factors in your discussion.

Question 6 (6 marks) (11 minutes)**Accounting Changes, Inventories, and Property Plant and Equipment**

Pet Lovers Incorporated (PLI) is a private company that sells pet clothing and accessories such as pet purses and pet beds. It also provides a number of services such as pet hotels, doggie spas and dog walkers. PLI is a subsidiary of a US company but reports its separate entity financial statements under Canadian GAAP. To facilitate consolidation for the parent, it has used the last-in, first-out (LIFO) cost formula for its inventory and the straight-line amortization method for its capital assets. Tax authorities in Canada do not allow the use of LIFO for inventories.

PLI has decided to early adopt the Handbook section 3031 for its inventories and to change the cost formula from LIFO to weighted average, in light of the high volume of transactions of interchangeable products. The parent company and PLI are both changing the amortization method from the straight-line to the declining balance for all of their technology-based capital assets to better reflect their decline in value. Both changes will be implemented in the December 31, 2007 year-end financial statements.

Required:

a) Part A (3 marks)

Identify and discuss the choices available to PLI regarding the change in cost formula for inventories in the context of early adoption of Handbook section 3031 – Inventories, and section 1506 – Accounting Changes. Provide a supported recommendation.

b) Part B (3 marks)

Discuss whether the change to the amortization of the technology-based capital assets is a change in accounting policy or a change in accounting estimates. Provide appropriate support to your answer and a recommendation

Question 7 (8 marks) (14 minutes)

Audit of fair values and disclosures

On the advice of its chief accountant, Measureit Limited (ML) invested in the shares of BLT Inc. (BLT) as follows:

- Class A shares that trade on the stock exchange.
- Class B shares that do not trade in an active market.

The Class B shares are classified on ML's financial statements as held for trading; as such, the shares will be measured and re-measured at fair value with gains or losses recognized in net income. These shares are generally felt by the marketplace to be worth about half of the Class A shares. This reflects the price paid by ML when it originally purchased the Class B shares.

The chief accountant will determine subsequent fair values as is normally done for all other assets that require fair value measurement.

Required:

What should the auditors consider when auditing the fair value and the classification of this investment?

Question 8 (8 marks) (14 minutes)

Audit of Accounting Estimates

Management is responsible for the accounting estimates included in financial statements and for establishing policies and procedures for the preparation of accounting estimates.

Required:

- a) Part A (2 marks)

Describe how the CICA Handbook defines accounting estimates, and provide an example.

- b) Part B (6 marks)

Discuss:

- 1) the objectives of the auditor when auditing accounting estimates, and
- 2) the effect that the policies and procedures used by management in establishing accounting estimates may have on the planning of audit procedures.

Question 9 (10 marks) (18 minutes)

Documentation

You, CA, are preparing a brief presentation to new staff in your firm about audit documentation. You have relied on the CICA Handbook in preparing your notes on the nature and purposes of audit documentation.

Required:

a) Part A (5 marks)

Describe the content and the extent of documentation that is required to meet generally accepted auditing standards, and explain what is included, what is excluded, and why.

b) Part B (5 marks)

Describe the standards that apply to changes and the ability to make changes to the audit documentation once the audit is completed. Include an explanation about the report release date and the documentation completion date.

Question 10 (8 marks) (14 minutes)

Review Engagements

You, CA, are the public accountant engaged to review the annual financial statements of Appliance Repair Ltd. (ARL), a privately-held corporation. ARL will provide the financial statements to its bank.

Required:

a) Part A (6 marks)

Assume that your communication is without reservation. Describe the content of your report, including a description of each paragraph in the report and its purpose.

b) Part B (2 marks)

ARL owns a subsidiary that is not consolidated pursuant to an election under differential reporting provisions. Describe the impact on the review engagement and your report.

Question 11 (9 marks) (17 minutes)**Communication with the Audit Committee**

You, CA, have accepted the appointment as auditor of Premier Storage Inc. (PSI), taking over from another firm. PSI is a public company that operates storage facilities in fifteen Canadian cities. You completed your quality control procedures prior to acceptance and signed the engagement letter. After several preliminary discussions with management, you are now preparing to communicate the relevant aspects of your audit strategy to the Audit Committee to help the Committee discharge its responsibilities.

Required:

a) Part A (6 marks)

Explain, with support, six aspects of the overall audit strategy that would arise as a result of your first involvement with this audit and that would be communicated to the Audit Committee.

b) Part B (3 marks)

You will also communicate with the Audit Committee near the completion of the audit. Which matters that arise from the audit should be communicated at that time?

Question 12 (3 marks) (6 minutes)**Reservations in the Auditor's Report**

Your client, Northern Plywood Manufacturing, operates two small plywood plants in remote northern towns. The client has had a history of fluctuating profitability due partly to softwood lumber restrictions on exports and partly to the sudden changes in the demand for new homes. It is now March 15, 2008, and you have substantially completed your audit of the December 31, 2007 financial statements. Yesterday, the larger of the two plants burned to the ground. While the loss is insured, the cost to replace the plant far exceeds the insurance settlement. Your client proposed the following note disclosure:

“The plant in Green Falls suffered a major fire on March 14, 2008. The amount of the insurance claim and benefits to be received are not yet determinable, but management is confident that operations in Green Falls will resume within two years.”

Required:

Provide your supported conclusion on the audit opinion you will issue.

TABLE I

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

<i>Periods Hence</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	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 – 2008

(100 marks) (3 hours)

NOTES TO CANDIDATES:

1. There are **7 questions and 15 pages** in this examination (including the cover page and the appendices).
2. **DO NOT** write your name on your examination envelope or answer papers. Use your **FOUR (4) DIGIT 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 or on the back of your answer papers.
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.

SECTION A – TAXATION**Question 1 (12 marks) (22 minutes)**

Mr. White is considering the incorporation of his currently unincorporated printing business. The business is expected to earn \$600,000 annually, after deducting a salary of \$150,000 for Mr. White to meet his personal needs.

Required:*Part 1 (8 Marks)*

Discuss how Mr. White can save or defer income tax by incorporating his printing business. Take into consideration the ultimate distribution of the after-tax earnings as dividends to Mr. White. Provide detailed calculations to support your conclusion using the following income tax rates:

Corporate tax rate for high-rate business income	33%
Corporate tax rate for low-rate business income	16%
Personal tax rate for eligible dividends	20%
Personal tax rate for non-eligible dividends	30%
Personal tax rate for business income	45%
Personal tax rate for employment income	45%

Part 2 (2 Marks)

If in a particular taxation year Mr. White requires \$100,000 more income than his \$150,000 salary from the incorporated business, would there be a tax preference to taking the additional income as a bonus or as a dividend? Provide clear explanations and supporting calculations.

Part 3 (2 Marks)

Recommend two elective provisions in the Income Tax Act that Mr. White should consider using in order to accomplish the transfer of his printing business to a corporation in the most tax-effective manner. Briefly explain the benefits of using each of these elections.

Question 2 (15 marks) (27 minutes)

Carol Cole died on April 14, 2008 at the age of 67. Her 2007 income tax return had been prepared but was not filed before she died. The tax return has a balance owing of \$10,000. At the time of her death she owned the following assets:

	Fair Market Value	Adjusted Cost Base	Undepreciated Capital Cost
Canada Savings Bonds	\$400,000	\$400,000	
Shares of CDS, a public company	\$12,000	\$72,000	
RRSP	\$120,000	\$80,000	
Rental property			
– land	\$90,000	\$40,000	
– building	\$220,000	\$180,000	\$170,000
Antique furniture	\$12,000	\$2,000	
Home	\$240,000	\$170,000	

In her will, she directed her executors to transfer all of her assets to her husband, with the exception of her shares of CDS. She left the shares to her niece, Anne.

Rental revenue exceeded cash expenses by \$8,000 in 2008 prior to her death. The Canada Savings Bonds pay interest annually on October 31. Interest earned November 1, 2007 to December 31, 2007 was \$2,600. Interest earned January 1, 2008 to April 14, 2008 was \$4,600. Her other sources of income in 2008 were \$4,000 from Canada Pension Plan and \$500 for eligible dividends paid on the CDS shares on April 21, 2008. The dividends were declared payable on April 1, 2008.

Carol had no capital dispositions in 2008 prior to her death. She has never reported any capital gains or losses. Her medical expenses have never been claimed for tax purposes. She paid \$1,000 per month for private nursing care, which commenced January 1, 2006. The nursing fee for April 2008 was only \$600 and was paid by Carol's husband in June 2008.

Required:

Explain the tax implications of the above information in detail. Be specific and provide calculations to support your explanations.

Question 3 (8 marks) (14 minutes)

Michael is employed as a salesperson. In 2008 he earned a salary of \$60,000 and commission income of \$9,000.

He is required by his employment contract to maintain an office in his home. There is only one telephone line in Michael’s home. He estimates that 30% of the usage of his telephone is employment related (all local calls). He purchased a new computer for his office on February 1, 2008. He uses the computer exclusively for employment purposes. The office occupies 20% of the square footage of his home.

His contract of employment also requires him to pay all other expenses he incurs in earning his employment income, including travel and entertainment. The following is a list of the employment related expenses he incurred in 2008.

Household expenses incurred –		
Mortgage interest	\$12,000	
Property taxes	3,400	
House insurance	1,200	
Utilities	3,900	
Maintenance	2,000	
Telephone	800	
Internet service	480	
Office supplies	500	
Cost of the computer *	1,300	\$ 25,580
Car expenses –		
Gasoline	\$ 2,600	
Repairs and maintenance	300	
Parking (100% employment related)	200	
Licence and insurance	1,500	
Interest paid in 2008 on loan to acquire a car	4,200	
Cost of a car purchased on January 10, 2008 *	62,000	70,800
Client entertainment meals		3,000
Advertising and promotion		5,000
		<u>\$104,380</u>

* Includes the GST, and the PST @ 8%.

Michael drove the car 30,000 km in 2008 of which 10,000 were driven in carrying out his duties of employment. Michael does not receive a car allowance.

Required:

Determine the maximum deduction for tax purposes that can be claimed in computing Michael’s employment income for 2008 and indicate which expenses cannot be claimed. Provide supporting calculations and explanations when needed.

Question 4 (15 marks) (27 minutes)

This question consists of five (5) independent unrelated parts; marks are provided for each part.

Part A (4 marks)

Lilico Ltd. is a Canadian-controlled private corporation. For its year ended August 31, 2008 Lilico Ltd. claimed a small business deduction of \$62,900. The taxable income for 2008 has been correctly calculated below.

Retail profits	\$ 370,000
Taxable capital gains	60,000
Taxable dividends from Canadian public corporations *	20,000
Interest on five-year bonds	5,000
Net income for tax purposes	455,000
Dividends	(20,000)
Net capital losses	(30,000)
Non-capital losses	(15,000)
Taxable income	\$ 390,000

* Lilico Ltd. owns less than 1% of the voting shares.

Required:

Determine Lilico Ltd.'s refundable tax on investment income and Part IV tax payable for 2008.

Part B (3 marks)

Differences exist between *inter vivos* trusts and testamentary trusts.

Required:

Describe three differences between an *inter vivos* trust and a testamentary trust.

Question 4 (continued)**Part C** (3 marks)

On March 1, 2008, Alice received a \$40,000 loan from her employer. The loan bears interest at 1% per year. The interest is payable monthly. The principal is repayable at the end of five years. Alice used \$30,000 of the loan toward the purchase of her home. She used the \$10,000 that was left over to purchase investments.

Assume the Canada Revenue Agency prescribed interest rates for employee loans for 2008 were 4% for the first quarter and 6% for the remainder of the year. For this question do **NOT** use the rates posted in the “Prescribed Interest Rates” table on page 34.

Required:

Explain the tax implications to Alice of her employment loan for 2008.

Part D (3 marks)

Susan owns 20% of the shares of a small business corporation called Success Inc. Her shares are worth \$1,000,000 and have a paid-up capital and an adjusted cost base of \$100,000. Susan would like to utilize her full capital gains deduction. To do this she plans to transfer her shares to a holding company of which she owns 100% of the shares. As consideration Susan will receive a note for \$600,000 and preferred shares of the holding company with a fair market value and legal stated capital of \$400,000. Susan and the holding company will make a joint election under Section 85 of the Income Tax Act, electing a transfer price of \$850,000 for tax purposes. This will be Susan’s first capital transaction.

Required:

Determine the tax consequences of this transaction for Susan and her companies.

Part E (2 marks)

Eric owns shares of Atego Ltd., a Canadian-controlled private corporation. All of the income earned by Atego Ltd. since its inception has benefited from the small business deduction. Eric’s shares are worth \$80,000 and have an adjusted cost base and paid-up capital of \$20,000.

Required:

Determine the tax implications for Eric if the shares are redeemed by Atego Ltd.

SECTION B – LAW**Question 5 (6 marks) (11 minutes)**

The Bold Multicultural Centre (BMC) helps newcomers to Canada acquire language and computer skills with its training programs. Earlier in the year, BMC purchased two adjacent warehouses to use as office space (W1) and a training facility (W2). At the time of the purchase, BMC was aware that the roofs of both buildings needed to be replaced due to age and some minor leakage.

The warehouses are located in an area well known for its extreme high winds and for the occasional tornado; one hit the area in the 1980's. BMC signed a contract with Tip Top Roofing (TTR) to re-roof the two buildings because TTR advertises itself as the roofing specialist for such conditions. This contract specified that the roofing shingles would be secured into the plywood underlayment base with screws offering a minimum of $\frac{3}{4}$ inch (19 mm) penetration.

TTR completed the re-roofing on W1 and billed BMC for the work to date, with payment to be received in 30 days, as agreed in the contract. The work on W2 was scheduled to begin within fourteen days of completion of W1.

BMC had begun to move furniture and computers into W1, but before it settled TTR's account, and before work commenced on W2, the area was hit by extremely high winds and heavy rain and large portions of W1's shingles were blown off. W2's original roof was not affected.

Office furniture costing \$15,000 initially stored under a section of the roof torn off was considerably damaged by the rain coming through the leaking roof. Computer equipment costing \$100,000 was stored under another section of W1's new roof that held up, and was not immediately damaged. As the shingles were being blown off, BMC informed TTR of the damage to the roof, but because the storm was continuing there was nothing TTR could do to repair the roof at that time. Two days later, heavier winds and rain hit the area and tore off the remainder of the shingles on W1. The computer equipment was so damaged by the rain that it could no longer be used.

TTR investigated the cause of the failed roof and discovered that the wrong screws had been used resulting in less than $\frac{3}{4}$ inch (19 mm) penetration into the underlying plywood as required by the contract.

Required:

Discuss the causes of action that BMC has against TTR in contract and tort law, alternative courses of action that BMC can take, and any defences that TTR may argue in reply.

Question 6 (14 marks) (25 minutes)

John Jones and Steve Sloan are next door neighbours. John is a CA who runs his own private practice. Steve has a grade twelve education and worked as a tradesman for a few years before a significant inheritance from his father allowed him to retire; he now supplements his income through stock market investments.

During an evening when both neighbours were working in their respective yards, Steve approached John about Shangri-la Results Inc. (SRI), a private company in which he was thinking of buying a minority interest. Steve said it would be nice if they could go out for dinner with their wives – his treat. He said that he wanted to get John’s opinion on this potential investment. John replied that dinner was a great idea, but that he didn’t work in investment valuations.

John, Steve and their wives went for dinner that weekend. Steve raised the topic of SRI and gave John some general information. John said it sounded good but he couldn’t really say without looking at the financial statements. Steve paid for dinner. They then went back to Steve’s home for coffee and dessert.

At Steve’s home, Steve mentioned that he had purchased a weekend getaway package at a local resort for the following weekend that he could not use. He told John that he wanted John and his wife to use it. He said that the package was fully paid for and that he could not get his money back because the cancellation period was past. John asked how much money Steve wanted for it and Steve said nothing, and that he was happy to be able to talk to a CA. Steve showed John a set of unaudited comparative financial statements of SRI, compiled for the year ended 8 months previously. John took a quick look at them. “For a small company, it has pretty high income”, John said, “and its debt-to-equity ratio is certainly good. Look’s like it has potential.”

John thanked Steve for the weekend getaway, which he and his wife very much enjoyed.

Six months later, Steve told John that he had followed his advice and invested in SRI, which had been forced into bankruptcy that week. He said he lost a lot of money and that John could expect to hear from his lawyer soon. Steve told John to also expect to hear from Art, Steve’s brother and his lawyer, because Art had also invested a lot of money in SRI on Steve’s word that he had gotten an opinion from a CA that it was a good investment.

Required:

Discuss the possible legal relationship(s) that may exist between John and Steve, and John and Art, in both contract and tort law, including arguments that would be presented by the potential plaintiffs, and John’s potential reply in defence.

SECTION C – RULES OF PROFESSIONAL CONDUCT**Question 7 (30 marks) (54 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, C, D and E 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 CA(s) or CA firm, or both.

Part A (4 marks) (7 minutes)

Mary Eaves, CA, runs her public accounting practice from home.

i. Ralph Gora Paving

In the summer of 2007, Mary's residence driveway was repaved by Ralph Gora Paving; Ralph was paid cash for the service. In early 2008, Ralph asked Mary if she could get his books up to date and file his personal tax return. Mary agreed and compiled the statements from the records and documents available and filed the return. Mary noted that there was no invoice and no deposit recorded for the repaving of her driveway, and similarly for the repaving of the driveway of three of her friends. Before filing the tax return, Mary got a letter from Ralph wherein he declared that the records provided to her were complete and correct.

ii. Honest Ivan Ltd.

Mary started the audit of the financial statements of Honest Ivan Ltd. (HIL), a used car parts dealer. Mary completed the interim audit and by the time she was completing the year-end audit, she formed a supportable opinion that HIL was selling stolen car parts. She confronted the owner with the problem and was told to keep her nose out of it. Mary immediately resigned from the audit.

Two days later she got a letter from another CA inquiring about the existence of any circumstances he should consider in deciding whether to accept the engagement. Feeling somewhat relieved, Mary sent a letter saying she had withdrawn because the client was limiting the scope of her audit. The CA then notified Mary that he had accepted the engagement and would contact her about information he may need; at this point Mary immediately packed up all of HIL's records that she still had, made copies of her working paper files and sent them to the CA.

Question 7 (continued)**Part B** (7 marks) (13 minutes)

A few months ago, Jeremy Johnson, CA, opened his public practice as a sole practitioner under the name “Jeremy Johnson, Chartered Accountant and Associates”. Robert White, a non-CA, works for Jeremy and is paid an annual salary equal to 50% of his billings to clients.

Robert, who is keen on bringing in new business, has convinced two clients of a national CA firm to come to Jeremy’s, telling them that he would personally serve them better and that if a CA is needed to sign something, he works for one. He guarantees that the fee will be no more than half of that paid in the prior year to the former accountants.

Robert pays his cousin, a CA in public practice, a \$200 referral fee. The cousin is very busy but very selective when accepting new clients. Robert pays his girlfriend a \$500 referral fee; she teaches English to new immigrants, many of whom are starting businesses and require accounting and taxation services. Jeremy reimburses Robert for these payments.

Jeremy’s brother, John, is also a CA with a sole practitioner practice in another city. Jeremy and John have no financial interest in each other’s practices but have agreed to act as each other’s representatives in their respective cities.

Nick, a friend of Jeremy and a CA who is not in public practice, makes his living from a number of commercial real estate properties he owns and operates in another city. Nick has agreed to act as Jeremy’s representative in his town and is paid \$100 for referrals.

Jeremy’s letterhead and promotional material includes the following under his practice name.

Jeremy Johnson – City one – phone and fax numbers

Robert White – City one – phone and fax numbers

John Johnson – City two

Nick Drake – City three.

At the bottom of the letterhead page the phrase “Jeremy Johnson is one of Canada’s Best Chartered Accountants, Recognized by the Canadian Institute of Chartered Accountants’ with National Honours.” Jeremy had placed in the top 10 in Canada on the Uniform Evaluation in the year he wrote.

Question 7 (continued)**Part C (9 marks) (16 minutes)**

Wide & Diggs CAs has been in public practice for a number of years. Two years ago, Wide compiled the financial statements of Perfect Plumbing Ltd. (PPL) and helped negotiate a loan from a private lender. PPL is owned and operated by the common-law spouse of three years of Wide's mother. Wide & Diggs billed PPL \$1,000 for these services. Wide & Diggs, now needing money to renovate its office space, borrowed \$15,000 from PPL under the terms of a contract specifying the loan, interest and repayment terms.

Wanting to increase his firm's revenues, Wide asked his spouse to convince her good friend Agnes Able, a CA working for a public accountants firm, to leave her firm and to bring her clients to Wide & Diggs. Wide's spouse took to the task with considerable zeal and called Agnes Able daily. After about one month, Wide & Diggs received a letter from the provincial institute of CAs asking to reply in writing about a complaint of harassment made by Agnes Able. Wide personally called her and apologized. She accepted his apology and said there were no hard feelings. Wide thought nothing more of the matter.

Jake Overland, a very successful immigration lawyer, approached Diggs about the affairs of his business and more specifically about the annual mandatory audit of a lawyer's trust accounts required by the Law Society and about GST matters. Overland has always charged a flat fee for his services to non-residents, extracted the GST amount and periodically remitted it to the government, not aware that the services were not taxable. Diggs offered to have his firm determine the GST amount that could be reclaimed in exchange for 50% of the recovered amount. From his past experience with other lawyer clients, Diggs believed that the audit of the trust accounts would not take much time, and agreed to perform the work for \$500. Overland and Diggs agreed to the above on a handshake.

The partners at Diggs & Wide agreed to split the work on the Overland engagement with Diggs doing the audit and Wide, the GST claim.

Question 7 (continued)**Part D (6 marks) (11 minutes)**

During its busy season, Blake & Edmonds, Chartered Accountants, offered Jane Carr, CA, a neighbour of Blake, a 4-month contract with his firm to provide professional accounting services. Jane immediately brought in a new client, Electrical Contracting Ltd, (ECL) where she had just completed a 6 month placement she had obtained through Cliff Richards, a CA running a placement agency for CAs.

At ECL, Jane had assumed the responsibility for all accounting functions, including the preparation of year-end adjusting entries, negotiating a credit line increase with the bank, and issuing invoices for services rendered by the business. “Everything was reviewed and approved by the owner/manager” she said, “which was pretty easy on me because he was an electrician who didn’t know a debit from a credit.” Jane suggested that she could complete the audit of ECL for Blake & Edwards in no time.

Blake asked Jane if there were any problems with ECL’s accounts. She replied that everything was in order. She mentioned that she had prepared a proposed adjustment for a fairly large allowance for doubtful accounts but when ECL’s owner reviewed it he complained to Cliff Richards at the placement agency. When asked about the adjustment, Jane explained to Cliff that a number of accounts receivable were doubtful as most of them were builders who were experiencing financial difficulties. Jane was reminded that she was not sent out to jobs to lose business but to give the client what he wanted. The allowance was not made and the financial statements were used to negotiate an increase in the line of credit with the bank.

Jane told Blake that she was fine with no adjustment because she knew ECL would be paid if the economy improved. “Business is always up and down in the construction industry” she said, “some of the accounts might be settled if things pick up. I know those builders and I’ll get them to sign confirmations that they owe the money and that’s good enough.”

Jane was assigned as audit senior on the ECL engagement. Accounts receivable confirmations from each client were obtained, no additional work was performed and no allowance for doubtful accounts was recorded.

Question 7 (continued)**Part E (4 marks)** (7 minutes)

Stan is a CA in public practice. Paul, the grandfather of Stan's wife Susan owns and operates a very successful clothing manufacturing company. During the year, Paul and Mabel, his wife of 50 years, decided to divorce. At a family dinner, with Paul absent, Mabel mentioned to Stan and Susan that she would name Susan as her sole beneficiary in a new will when the divorce is finalized. She intends to cut Susan's brothers out of her will due to their allegiance to Paul, saying that Paul could take care of them. Shortly thereafter, Paul approached Stan to do a valuation of his business for purposes of the pending divorce settlement under the family law requirements. "The lower the value, the less Mabel gets" Paul said. Paul and Mabel are in their 70's, and enjoy good physical and mental health.

At about that time, Mabel also retained Stan to perform a specific audit procedure on sales, as required by the landlord, for an art gallery she owns in a local mall. Mabel is not active in the business but has hired a young artist to manage it. "You'll have to keep it a secret as Paul doesn't know about this business," she told Stan.

TABLE I

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

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

MAXIMUM CAPITAL COST ALLOWANCE RATES FOR SELECTED CLASSES

Class 1	4%
Class 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	24¢ per kilometre of personal use
Non-taxable car allowance benefit limits	
- first 5,000 km	52¢ per kilometre
- balance	46¢ per kilometre

TABLE II

INDIVIDUAL FEDERAL INCOME TAX RATES

<u>Taxable Income</u>	<u>Tax</u>
\$ 37,885 or less	15%
\$ 37,886 to \$ 75,769	\$ 5,683 + 22% on next \$37,884
\$ 75,770 to \$123,185	\$14,017 + 26% on next \$47,415
\$123,185 or more	\$26,345 + 29% on remainder

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

The tax credits are 15% of the following amounts:

Basic personal amount.....	\$ 9,600
Spouse or common-law partner amount.....	9,600
Net income threshold for spouse or common-law partner amount.....	NIL
Child	2,038
Age 65 or over in the year	5,276
Disability amount	7,021
Infirm dependants who reach 18 in the year.....	4,095
Net income threshold for infirm dependants 18 and over	5,811
Basic amount for:	
Age credit and GST credit.....	31,524
Child tax benefit	37,885
OAS clawback.....	64,718
Children’s fitness credit.....	up to 500

CORPORATE FEDERAL INCOME TAX RATE

The tax payable by a corporation on its taxable income under Part I of the *Income Tax Act* 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>
2008	6	6	5	
2007	7	7	7	7
2006	5	6	6	7
2005	5	5	5	5
2004	5	5	4	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.

Candidates are cautioned when using this material that the examinations and the approaches to solutions reflect standards in effect as at March 31, 2008 and are not updated for subsequent changes.

Question 1 (8 marks) (14 minutes)

i. Financial Instruments, Recognition and Measurement (2 marks)

The correct answer is (d). The contract meets the definition of a derivative instrument and therefore is recognized when entered into. It is re-measured at year end at which point, it will either be an asset or liability to the company. It should be measured at the net value (difference between \$150 and the value of the Euros as measured at the year-end spot price).

- (a) & (b) are not correct because the contract meets the definition of a derivative and must be valued and recognized at the fair value of the instrument.
- (c) is not correct because the standard requires measurement at fair value of the instrument.

ii. Leases (2 marks)

The correct answer is (b). The amount that can be recorded as an asset cannot exceed the fair value of the asset under lease (\$100,000).

- (a) is not correct because it exceeds the fair value of the asset under lease.
- (c) is not correct because it uses the interest rate implicit in the lease that, even if known to the lessee, is higher than the lessee's incremental rate of borrowing (4%).
- (d) is not correct because the residual value was discounted at 4% and the result was subtracted from the fair value of the asset under lease; the correct approach would be to discount the actual payments at the incremental rate of borrowing ($\$12,826 \times 8.11 = \$104,018.86$).

iii. Audit of Accounting Estimates (2 marks)

The correct answer is (a) according to HB s. 5305.09. The auditor should consult management and then consider the impact on his/her opinion. There might be some information that the auditor has not yet uncovered.

- (b), (c) & (d) are not correct. They are inappropriate because they do not address the need for the auditor to discuss his/her concerns with management.

iv. Materiality (2 marks)

The correct answer is (a) according to HB s. 5142.04.

- (b) is not correct because information overload does not cause the financial statements to be materially misstated.
- (c) is not correct because the omission of unnecessary information is acceptable.
- (d) is not correct because the misstatements are not material individually or in aggregate.

Question 2 (8 marks) (14 minutes)Financial Instruments, Recognition and Measurement (HB s. 3855)Part A – Definition (2 marks)

The CICA Handbook (HB) defines a derivative as a financial instrument or other contract that has all three of the following characteristics:

1. It derives its value from an underlying instrument, which could be, for example, a commodity, a foreign exchange rate or an interest rate;
2. It requires little or no initial investment; and
3. It is settled at a future date.

A financial instrument is defined as a contract that gives rise to a financial asset of one party and a financial liability or an equity instrument of the other party.

Part B – Recording (6 marks)*Contract A*

Contract A does not meet the definition of a derivative because it cannot be settled net in cash; however, it could meet the definition in certain circumstances, for example, when the entity has a practice of taking delivery of the copper – the underlying commodity – and selling it shortly after to generate a profit from the short-term fluctuations in the copper prices (HB s. 3855.16(b)(ii)).

The Handbook provides other indications to help determine when a contract involving non-financial instruments should be considered as a derivative (HB s. 3855.17).

Contract B

Contract B, a contract to buy a non-financial asset, meets the definition of a derivative because the contract value changes with the fluctuations of the copper price, no initial investment was required and the contract can be settled net in cash (HB s. 3855.14).

To determine whether copper, the underlying commodity, is a financial or a non-financial item (that is, the issue of liquidity), the following should be considered:

- The contract would be for a financial item should the copper be readily convertible into cash;
- An organized market exists;
- An entity needs not take delivery when the contract can be settled net in cash;
- Furthermore, an entity could direct delivery to an ultimate purchaser of the contract when it cannot be settled net in cash.

However, each contract fails to meet the definition of a derivative because JBI has documented that it plans to take delivery for use in production (HB s. 3855.14 & 18). The contracts are executory contracts that will be recorded upon delivery because they are not cancellable; both contracts will give rise to a non financial asset and a financial liability when the copper is received.

If JBI is a non-publicly accountable enterprise, it may choose not to apply HB s. 3855 to its contracts to buy non-financial items (HB s. 3855.07A).

Question 3 (8 marks) (14 minutes)Related Party Transactions (HB s. 3840)Part A – Definition

“**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.”¹

“Immediate family comprises an individual's spouse and those dependent on either the individual or the individual's spouse.”²

Part B – Recording – In Normal Course of Operations

The parties are related because the buyer is the husband of TI’s president; as a result, the sale/purchase of the land is a related party transaction (or the transfer of economic resources between related parties).

The president has the authority and the responsibility for planning, directing and controlling the activities of the reporting enterprise. However, with 10% share ownership, the president does not control the company. Significant influence may exist but requires a review of other factors.

The transaction is monetary and should be measured at the exchange amount because it is in the normal course of operations (HB s. 3840.18); TI normally sells real estate properties such as land. The exchange amount is further supported by a formal valuation.

Part C – Recording – Not in Normal Course of Operations

As a general rule, a related party transaction should be recorded at the carrying amount, except when it is in the normal course of operations (HB s. 3480.08). If TI did not operate in the real estate business, the transaction would not be in the normal course of its operations.

However, the transaction should be recorded at the exchange amount if there is a substantive change in ownership and the exchange amount is supported by an independent valuation (HB s. 3840.29).

In this situation, a valuation to support the sale price of \$1 million exists but the current information does not indicate whether it is independent.

Although the president may be able to exercise control over the buyer as an immediate family member, she does not have the ability to exercise control over the company with a 10% ownership, or significant influence over the operations of TI (even considering her position as president).

Assuming that the valuation is independent, the exchange amount should be used to record the sale of the land.

(Evaluators’ comments: The Evaluators also considered a line of arguments supporting other treatments).

¹ CICA Handbook, 3840.03 (g)

² CICA Handbook, 3840.04 (f)

Question 4 (12 marks) (22 minutes)Employee Future Benefits (HB s. 3461)Part A – Defined Benefit Plan Compared to Defined Contribution Plan (HB s. 3461.010 – 013)

A **defined benefit plan** provides for determinable benefits upon retirement. In this case, the sponsor of the plan is at risk because it has to make up for any deficiencies if the plan is under-performing; however, the sponsor may be able to recapture the excess if the plan is over-performing (for example, through decreased contribution).

A **defined contribution plan** defines the amount of contributions to be made by the specific employees covered under the plan. With this type of plan, the employees are at risk because the amount of benefits received by the employees is dependent on the plan performance and the sponsor has no obligations to make up for any deficiencies; the sponsor also has no right to pick up any surplus in the case the plan over-performs.

Note 12 illustrates a defined benefit plan because it reflects the actuarial obligation and risks inherent to such a plan.

Generally speaking, companies prefer defined contribution plans because the risk of insufficient funding rests with the employees, and because the accounting and costs (actuaries, etc.) related to such a plan are kept to a minimum. However, many other factors must be taken into account, such as the effect a given plan may have on employees' productivity.

Part B – Actuarial Gains and Losses Occurrence and Reporting (HB s. 3461.087 – 093)

Actuarial gains and losses occur because assumptions about the benefit plans differ from the actual experience; an actuarial gain or loss is the difference at the end of the period between the expected value of the plan assets and its actual value, or between the expected value of the accrued benefit obligation and its actual value.

The actuarial gains and losses are not recorded immediately, but are amortized as follows:

◆ *For a defined benefit plan, an entity should recognize amortization of actuarial gains and losses in a period in which, as of the beginning of the period, the unamortized net actuarial gain or loss exceeds 10 percent of the greater of:*

- (a) the accrued benefit obligation at the beginning of the year; and*
- (b) the fair value, or market-related value, of plan assets at the beginning of the year.*

*When amortization is required, the minimum amortization should be that excess divided by the average remaining service period of active employees expected to receive benefits under the plan. However, when all, or almost all, of the employees are no longer active, an entity should base the amortization on the average remaining life expectancy of the former employees. [JAN. 2000]*³

BSI could select a shorter amortization period, but should apply the method consistently to both gains and losses.

³ CICA HB s. 3461.088

Question 4 (continued)Part C (i) – Interest Rates (HB s. 3461.050 & 076)

The discount rate for the accrued benefit obligation should be determined by reference to the market interest rates of high quality debt instruments taking into account the timing of payment of the benefits. The discount rate could also be determined by reference to the interest rate inherent in the amount at which the accrued benefit obligation could be settled (for example, when an annuity contract is purchased).

The expected return on the plan assets should be determined with an expected long term rate of return on the plan assets and the fair value – or a market-related value – of the plan assets. The basis should be applied consistently to each category of plan assets and from year to year. The Handbook suggests the use of fair values for bonds and moving averages for equity assets.

Part C (ii) – Accounting for Various Amounts*Settlement (HB s. 3461.112-116)*

A settlement occurs when an entity substantially discharges or settles all, or part, of an accrued benefit obligation. A settlement eliminates the risks associated with the accrued benefit obligation and the plan assets. When only a portion of a benefit plan is settled, prorated amounts are used to account for the settlement.

A settlement gain represents the net gain from re-measuring the accrued benefit obligation and the plan assets, and the balance of any unamortized transitional amounts and any unamortized actuarial amounts at the date of a settlement.

This net gain should be recognized immediately to income in the period in which the settlement occurs.

Past Service Costs (HB s. 3461.079-086)

Past service costs represent credits granted to employees for services rendered while no benefit plan existed or when a benefit plan is amended. The obligation and related expense are not recognized immediately because the granting of such benefits is deemed to benefit the entity in future periods.

The obligation should be amortized on a straight-line basis over the remaining service period up to the full eligibility date of each employee active at initiation or amendment of the plan. When most of the employees are no longer active, the average remaining life expectancy of the former employees should be used.

Shorter periods could be used especially when the entity is making frequent amendments to the benefit plans which result in granting additional past service benefits.

Question 4 (continued)

Transitional Asset (HB s. 3461.167)

A transitional asset represents the unrecognized amount needed to balance the accrued benefit obligation and the fair value of the plan assets, including any accrued benefit asset or liability, at the time the revised CICA Handbook requirements were adopted by an entity.

When the new standards are applied prospectively, the transitional asset must be amortized over the average remaining service period of active employees expected to receive benefits under the benefit plan. When most of the employees are no longer active at the time the transitional asset is determined, the average remaining life expectancy of the former employees should be used.

When the new standards are applied retrospectively, the restatement of financial statements for prior periods is encouraged but not required.

Question 5 (12 marks) (22 minutes)**Foreign Currency Translation, Subsequent Events, and Contingencies (HB s. 1651, 3820, & 3290)****Part A – Accounting for Foreign Currency Transactions (HB s. 1651)**

All foreign purchases should be translated into Canadian dollars using the rate in effect on the transaction date, unless these purchases were originally invoiced or payable in Canadian dollars (HB s. 1651.14). Depending on the volume of transactions and the stability of the currency, an average yearly rate could be used. The sales to foreign markets will be treated in the same way.

Accounts payable and receivable in foreign currency should be recorded at the spot rate on the date of the transaction; any remaining balance should be adjusted at the balance sheet date using the exchange rate at that date (HB s. 1651.16). Any exchange gain or loss should be recognized in the net income in 2007 (HB s. 1651.20).

The fabric inventory on hand at year end needs no adjustment if carried at cost; however, if carried at market value, it should be adjusted using the exchange rate at the balance sheet date (HB s. 1651.18).

Part B – Accounting for Foreign Operations (HB s. 1651)

WGI should determine whether its subsidiaries are integrated or self-sustaining operations.

A foreign operation is considered integrated when it is financially or operationally interdependent with the reporting entity; the exposure to foreign currency fluctuations is similar to the exposure related to transactions made by the reporting entity.

A foreign operation is considered self-sustaining when it is financially or operationally independent from the reporting entity; the exposure to foreign currency fluctuations is limited to the net investment of the reporting entity in the foreign operation.

Other factors that could affect the exposure of the reporting entity should be considered; for example, the economic environment of the foreign operation, its inflation, local competition, government regulations, sales prices tied to foreign exchange rates or a foreign currency, and market served by the foreign operation.

For a foreign operation classified as integrated, the temporal method should be used; it implies that transactions are recorded at historical exchange rates and that any monetary and fair-valued balances at year end are translated at the year-end exchange rates; amortization should be calculated at the historical rates. Gains and losses should be recognized in the current year's net income.

For a foreign operation classified as self-sustaining, assets and liabilities should be translated using the year-end exchange rates while operations' accounts, amortization included, should use historical or averages rates. The resulting exchange gain or loss should be recognized in a separate component of other comprehensive income for the current year.

Question 5 (continued)

Part C – Accounting for Subsequent Events and Contingencies (HB s. 3820 & 3290)

The lawsuit from CSI is an event subsequent to the 2007 fiscal year, but it relates to events that occurred during 2007. It is also a contingency because it creates uncertainty about the occurrence of a possible loss.

Management should determine the probability of CSI being successful in this particular case given the materiality of the sales (WGI made it public that the allegedly copied designs had sold at record levels).

Additional information is needed at this time to determine the likelihood of the loss. The lawsuit cannot be disregarded just because such lawsuits are difficult to prove. Specific evidence from the law firm representing GWI in this lawsuit would be needed.

If the lawsuit is likely to be successful and if the amount can reasonably be measured, a charge to income should be made for the estimated loss. If the success of the lawsuit is likely and the loss cannot be reasonably measured, or if the success is not determinable, WGI should disclose the contingent loss, its nature and whether the loss can be estimated.

Question 6 (6 marks) (11 minutes)

Accounting Changes, Inventories, and Property Plant and Equipment (HB s. 1506, 3031, & 3061)

Part A – Early Adoption of Accounting Policy Change – Inventories

The revision to the CICA Handbook section on inventories is effective on or after January 1, 2008.

Under the new section (HB s. 3031), LIFO is no longer allowed to determine the cost of inventory, meaning that the change is inevitable whether PLI early adopts the recommendation or not.

The new section provides for prospective and retrospective application of the revised section

Under the prospective choice, the opening inventory and retained earnings should be adjusted to reflect the new measurement. This application is the preferred approach because the values based on the new cost formula can be determined more reliably. However, the financial statements for the prior years may not be comparable, especially if the inventories represent a material asset.

Under the retrospective choice, PLI must restate its prior years' financial statements and disclose that it is applying the new standards earlier than recommended.

The early adoption of the new standards requires PLI to apply the policy as if that policy had always been applied (HB s. 1506.05 (d) and 1506.19(b)). As a result, PLI must be able to determine the value of its past inventories using the new cost formula. This information may not be available given the high volume of transactions of interchangeable products, and, if available, may not be determined in a cost effective manner. In addition, the newly determined average costs may not be sufficiently reliable to warrant a clean audit opinion on the comparative financial statements.

The CICA Handbook recommends making an adjustment to the earliest period for which it is practicable to obtain the needed information.

In light of the high volume of transactions of interchangeable products, it is recommended that the change be applied prospectively.

(Evaluators' comments: The Evaluators also considered a line of arguments supporting a retrospective application)

Part B – Change in Amortization for Capital Assets

Amortization is not meant to measure decline in value but is meant to allocate the cost of using up the service potential of an asset.

A change in accounting estimate would be required if, for example, the economic or useful life of the technology-based capital assets had changed. A shorter useful life due to technological changes might be typical of a change in estimate; however, the pattern under which services are obtained may have remained the same.

A change in method is needed if the pattern of receiving the benefits has changed or if the pattern was initially incorrectly determined.

Question 6 (continued)

Voluntary changes in policies need to provide more reliable and relevant information. In the case of technology-based capital assets, it is likely that the declining balance method would be more appropriate than the straight-line method because the operating efficiency of these assets is declining over time, or simply because the costs needed to maintain the same level of efficiency is increasing over time.

If a change in policy is warranted, it will require a retrospective application with a restatement; however, additional information is needed before a final recommendation can be made.

(Evaluators' comments: The Evaluators also considered a line of arguments supporting the straight-line method (i.e., no change in policy)).

Question 7 (8 marks) (14 minutes)Auditing Fair Value Measurements and Disclosures (HB s. 5306)*Classification of the Investment*

ML is only allowed to treat the investments as held for trading if it can reliably measure its fair value at time of initial recognition.

The ability to assess the fair value of Class B shares will determine whether the shares can be classified as held for trading or as available for sale, given that they do not trade in an active market.

Class B shares may derive their value from Class A shares, given that it is felt in the marketplace that they are worth about half of the Class A shares. If this is verifiable, then the fair value of Class B shares is measurable. However, Class B shares could not be considered real derivatives because they do not meet the definition of a derivative.

In a situation where the fair value of the Class B shares cannot be reliably measured, the shares should be classified as available for sale and carried at cost.

In the case of Class A shares, the stock exchange quotes should be sufficient unless these shares are not actively traded (small volume of transactions).

Auditing the Fair Values

The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with GAAP (HB 5306.04/66).

In addition to understanding how the entity determines the fair value of these shares, the auditor should document the assumptions made by the chief accountant and the controls in place to ensure consistency, timeliness and reliability of the data used in determining the fair value of Class A and B shares (HB s. 5306.16). The auditor could also consider using the assistance of a specialist if the process is complex due to the inactive market of the Class B shares. Other factors to consider are:

- the segregation of duties between purchasing and valuation functions which appear to be assumed by the chief accountant;
- the existence of incentives that could bias the judgment of the chief accountant and the fair value measurements;
- the relevance of the expertise of the chief accountant in valuing other assets;
- the documentation kept by the chief accountant about assumptions related to the valuation process;
- how changes in assumptions are considered, monitored and carried out;
- the integrity of controls and security procedures related to valuation models;
- the use of valuation techniques that should make maximum use of market inputs;
- past similar transactions or subsequent events that could validate or invalidate the fair value measurements; and
- management’s written representation about the reasonableness of the assumptions used in the process.

Question 8 (8 marks) (14 minutes)

Audit of Accounting Estimates (HB s. 5305)

Part A – Definition of Accounting Estimates

An accounting estimate is the amount included in financial statements to approximate the effect of past business transactions/events or the present status of an asset/liability (HB s. 5305.02).

Estimates are common and can have significant or pervasive effects on financial statements individually or in aggregate. Examples include estimating an allowance for doubtful accounts or the useful life of an asset.

Part B – Auditor’s Objectives and Planning

The auditor's objective is to obtain sufficient appropriate evidence to provide reasonable assurance that management’s accounting estimates are reasonable within the context of the financial statements as a whole.

In doing so, the auditor identifies situations where estimates are required, applies his/her knowledge of the entity and its operating environment, takes into account management bias, considers the quality of the data involved in preparing the estimates, the availability and the reliability of data related to the estimates.

The auditor must also gain an understanding of the policies and the procedures involved in preparing the estimates to determine the nature, extent and timing of the necessary audit procedures.

The procedures an auditor should plan include: recalculation of accounting estimates, assessment of key underlying assumptions, materiality of the estimates (individually and in aggregate), estimates’ sensitivity to variations (point estimate, zone of reasonableness), and subsequent events that may affect the estimates.

Question 9 (10 marks) (18 minutes)

Documentation (HB s. 5145)

Part A – Content and Extent of Documentation

The audit documentation demonstrates that the auditor did actually perform audit work, describes the nature of the work performed, and demonstrates that generally accepted auditing standards (GAAS) were met.

The content should be such that an experienced auditor could conduct quality control reviews and inspection. An experienced auditor is one who has a reasonable understanding of audit processes, GAAS, the business environment of the client and its auditing and accounting issues; the experienced auditor should be able to understand the nature, timing and extent of the procedures performed, the results of the procedures, including the significant findings and issues, and the basis for the conclusions reached.

The audit working papers must include the audit procedures performed, the results of those procedures, and the conclusions reached for every relevant financial statement assertion, and must be properly organized to provide clear links to the significant findings.

For example, the auditor should consider the nature of the procedures to be performed, the audit methodology and tools used, the identified risks of material misstatement and the auditor's professional judgment.

Not everything needs to be documented. For example, trivial items and errors that have been corrected will not be included. Any working papers that are incorrect or are superseded should be removed.

Part B – Subsequent Changes to Audit Documentation

Once the audit engagement is complete, changes to the documentation are generally not permitted. This ensures that nothing is added or taken out of the documentation. There are some specific rules governing the timing of changes. The audit documentation must be completed within 45 days of the release date, which is the date the auditor grants the client permission to use the audit report in connection with the financial statements. During that 45-day period, changes of administrative nature may be made. If it is necessary to perform any new audit procedures or add any new conclusions, the documentation must show what was added or amended and why. It should show when and by whom it was added, who (if anyone) reviewed it, and any effect on the auditor's conclusions.

The auditor should document the report release date and the documentation completion date (HB s. 5145.25).

After the documentation completion date, nothing may be deleted or discarded from the file. If it becomes necessary to add any documentation after the completion date, the auditor must document the additions or amendments, regardless of the reason. The documentation requirements are the same as those for additions or amendments made between the report release date and the documentation release date.

Question 10 (8 marks) (14 minutes)

Review Engagement (HB s. 8100)

Part A – Content of Review Engagement Report

The report is addressed to the entity that hired the public accountant (PA) and should be titled “Review Engagement Report”. The report should include three paragraphs:

1. The scope paragraph:

It identifies the subject matter on which the PA is reporting (name of client and financial statements reviewed)

It identifies the standards of performance (Canadian generally accepted standards for review engagements), and the nature of the review work performed and the targeted information (primarily, enquiries, analytical procedures and discussion about the information supplied by the entity).

2. The disclaimer paragraph:

This paragraph should clearly state that a review does not constitute an audit and that an audit opinion is not provided. Review engagements, while adding credibility to the financial statements, only allow the expression of negative assurance on the basis of the work performed. This paragraph makes it clear that no audit was performed.

3. The negative assurance paragraph:

Appliance Repair Limited’s (ARL) financial statements are prepared for general purposes and the communication is without reservation. Accordingly, and based on the nature and extent of the review work performed, the PA should state that nothing has come to his/her attention that causes him/her to believe that the information is not, in all material respect, in accordance with Canadian generally accepted accounting principles (GAAP).

Each page of ARL’s financial statements should be conspicuously marked “Unaudited” to draw the reader’s attention to the fact that no audit work was performed.

The report should be dated as at the date of substantial completion of the review, and signed.

Part B – Impact of Differential Reporting on Engagement and Report (HB s. 8200)

If differential reporting options were used to prepare the financial statements, the scope paragraph should be expanded to indicate that ARL’s financial statements were prepared using the differential reporting options available in Canadian GAAP. The reader’s attention should be drawn to a note in the summary of accounting policies that describes each differential reporting option applied.

Question 11 (8 marks) (14 minutes)

Communication with the Audit Committee (HB s. 5751)

Part A – Six First-Involvement Aspects of Overall Audit Strategy to Communicate to Audit Committee (HB s. 5751.14)

In meeting with the Audit Committee to explain the proposed audit strategy to the Audit Committee, several issues should be discussed that arise wholly or partly as a result of the engagement being new to the auditor.

The preliminary assessment of internal control and planned reliance thereon should be discussed because the previous auditor may have reached different conclusions regarding reliance on controls.

Any areas identified as high risk of material misstatement and the auditor's planned audit response should be discussed, because the application of professional judgment may differ compared to the previous auditor, or new issues may have arisen.

The effects of any new accounting standards on the financial statement should be discussed. If there are changes, the financial statements may differ from the previous year's as a result of applying a new standard, although the method of evidence gathering may not change.

The approach to items such as fixed assets and cut-off may differ from the previous auditor because the operations of Premier are geographically dispersed. The auditor should also discuss the planned reliance on other auditors to provide evidence from geographic locations that cannot be efficiently attended.

It is standard practice to present one's assessment of materiality and audit risk levels in every audit engagement. However, both assessments are likely to differ from those made by the previous auditor, and more work will be required on risk assessment than in an on-going engagement.

Any areas of concern that the Audit Committee or management identifies should be discussed. As the business and environment change, issues change and are not likely to be the same as in the previous year(s), and as a result, the approach to auditing the areas of concern may differ from the previous auditor's.

Management representations and the need to obtain certain representations in writing will be discussed. Although this discussion is standard practice in every audit and might be similar to that in the previous year, changes in client's business and environment will influence its content.

The timing of the audit is always a topic for discussion with the Audit Committee and will certainly change compared to the previous auditor's timing because a first-time engagement requires understanding and documenting the client's business and environment, the assessment of the existing risks and controls in place, and the planned reliance on internal control.

Question 11 (continued)

Part B – Communication Near the Completion of Audit

Certain matters arising from the financial statement audit should be communicated to the Audit Committee. They include fraud, illegal or possibly illegal acts, material weaknesses in internal control, and related party transaction not in the normal course of operations and involving significant management judgments on measurement, disclosure or GAAP selection.

The Audit Committee should also be advised of any errors, whether corrected or not, that based on professional judgment, are non-trivial. These errors need not be material individually or in total to be important to the Audit Committee.

To help the Audit Committee review the financial statements, the auditor should communicate his/her professional judgments on the qualitative aspects of the accounting principles selected by management for financial reporting.

The auditor should also communicate other matters that he/she considers to be important and relevant to the Audit Committee, including any issues that were previously agreed to be part of such a communication. For example, communication with other accountants about auditing matters, the application of accounting principles discussed with management.

Question 12 (3 marks) (6 minutes)

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

The fire at the larger of the two plants is an event subsequent to the financial statement date; it could be indicative of a going concern issue, in light of the insufficient settlement from the insurance company to cover the replacement of the plant, and the history of fluctuating profitability linked to changes in the economy.

The proposed disclosure does not appear to be in accordance with GAAP because it does not adequately warn the readers that the operations may not resume at Green Falls. An assessment of the ability of Northern Plywood Manufacturing to survive with one plant has yet to be done.

In reaching his/her conclusion, the auditor should take into account the size of the remaining operations, the evidence guiding management's confidence about the two-year time frame, and the economic conditions.

If the auditor determines that the note does not adequately disclose the going concern issue in accordance with HB s. 1400, he/she should qualify the audit opinion based on a GAAP departure

If the auditor believes that management is deliberately attempting to mislead the readers or that the effect of the loss is pervasive enough to jeopardize future operations, he/she should issue an adverse opinion.

(Evaluators' comments: The Evaluators also considered a line of arguments supporting the sufficiency of the disclosure).

Question 1 (12 marks) (22 minutes)

Income Tax Savings or Deferral from Incorporating

Part 1

The income tax paid on income earned by a corporation but distributed to Mr. White as dividends should theoretically be the same as the income tax paid by Mr. White on the income of the unincorporated business. However, the integration is not perfect and may give rise to some benefits.

Income Earned Through a Corporation Paid as Dividend

Corporate taxable income \$750,000 – 150,000	600,000	
Corporate tax \$400,000 × 16%	(64,000)	
\$200,000 × 33%	<u>(66,000)</u>	
After tax profits available for distribution to the shareholder	<u>\$ 470,000</u>	
Dividends	470,000	
less: Tax on dividend @ 30% \$334,000 × 30%	(100,200)	
Tax on dividend @ 20% \$136,000 × 20%	<u>(27,200)</u>	
Net cash retained after tax	<u>\$ 342,600</u>	\$342,600
Dividends from GRIP (eligible dividends) \$200,000 × 68%	\$ 136,000	
Ineligible dividends (\$470,000 – 136,000)	334,000	

Income Earned Personally

Personal income (\$750,000 – 150,000)	\$ 600,000	
Personal tax @ 45%	<u>(270,000)</u>	
Net cash retained after tax	<u>\$ 330,000</u>	<u>330,000</u>

Comparison

Tax savings from incorporation		<u>\$ 12,600</u>
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Tax deferral available

Personal tax on dividends (\$100,200 + \$27,200)		<u>\$127,400</u>
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Savings resulting from the incorporation are greater than they should theoretically be (imperfect integration).

(Evaluators' comments: The analysis does not take into account the \$150,000 paid as salary by the corporation because it is not relevant to the decision in this situation).

Question 1 (continued)

Part 2

Dividend

No tax cost/savings because the dividend is not deductible	\$ 0	
Personal tax on dividend $\$100,000 \times 20\%$	<u>20,000</u>	
Additional tax cost	<u>\$ 20,000</u>	\$20,000

Bonus

Corporate tax savings: $\$100,000 \times 33\%$	\$(33,000)	
Personal tax on bonus: $\$100,000 \times 45\%$	<u>45,000</u>	
Additional tax cost	<u>\$ 12,000</u>	<u>12,000</u>

Conclusion: Preference towards a bonus because of tax savings of \$ 8,000

Note that the dividend does not trigger additional payroll taxes.

Part 3

A S.85 election should be filed on those assets that have an accrued gain to allow for the deferral of the capital gains and possible recapture.

A S.22 election should be made on the accounts receivable to enable Mr. White to claim a business loss instead of a capital loss. Without the S.22 election, the corporation could not claim a deduction for bad debts or allowance for doubtful accounts should some accounts prove to be doubtful or uncollectible.

Question 2 (15 marks) (27 minutes)

Due Dates

Because Carol’s death occurred on April 14, 2008, her 2007 tax return is not due until October 14, 2008, that is the later of April 30, 2008 and 6 months after her death. The balance of tax owing for 2007 is also due on October 14, 2008. [S.156.1(4) and definition (b) of balance due day in S.248(1)]

Carol is taxable on all of her income to April 14, 2008 and the executor must file an income tax return. Although her taxation year ends on April 14, 2008, it is not considered to be a return for a short taxation year.

The tax return and any balance of tax owing for 2008 are due on April 30, 2009 unless the rental income can qualify as business income, in which case the filing date is June 15, 2009.

Deemed Disposition

All of Carol’s capital property is deemed to have been disposed of at fair market value (FMV) on the date immediately preceding her death, with the exception of any property transferred to her husband.

There is a rollover provision for the capital properties if they vest indefeasibly to her husband within 36 months of Carol’s death. Her husband is deemed to acquire them at Carol’s adjusted cost base (ACB) and undepreciated capital cost (UCC).

The assets left to Carol’s husband that qualify for the spousal rollover, are the Canada Savings Bonds, the rental property, the antique furniture and the home. The values after the transfer are as follows:

Property Transferred to Spouse

– Canada Savings Bonds	\$400,000	ACB
– Rental property – land	40,000	ACB
– building	170,000	UCC
– Antique furniture	2,000	ACB
– Principal residence	170,000	ACB

If the gain on the home can be exempt from tax by designating the home as Carol’s principal residence, then the executor may want to elect not to use the spousal rollover [S.70(6.2)].

In this case, Carol will be deemed to dispose of the home at its FMV of \$240,000, the gain for tax purposes will be reduced to nil by the principal residence exemption, and Carol’s husband will have an ACB of \$240,000 for the home.

If the spousal rollover is used, Carol’s husband will be entitled to designate the property as a principal residence for each year Carol could have designated it. [S.40(4)]

Question 2 (continued)*Property Transferred to her Niece*

The shares of CDS left to Carol's niece are deemed to have been disposed of at their FMV of \$12,000. This results in a capital loss of \$60,000 or an allowable capital loss of \$30,000. There are no capital gains in Carol's 2008 or prior three year's tax returns against which to apply the net capital loss.

The net capital loss may be used to reduce taxable income from all sources in 2008, the year of death, and in 2007, the year preceding death. Alternatively, the executor could elect to realize the capital gains on the land and the antique furniture by transferring them at their FMV to utilize the capital loss and increase the ACB to Carol's husband.

Registered Retirement Savings Plan (RRSP)

Since the RRSP of \$120,000 is left to Carol's husband, the transfer is considered a "refund of premiums" and is not included in Carol's income. Instead, the amount is taxable in 2007 in the hands of her husband who could, however, defer taxation by transferring the entire amount to his own RRSP in 2007 or within 60 days of 2008.

Income

All income which is earned on a periodic basis must be accrued on a daily basis and included in Carol's income for tax purposes for 2008. This includes the rental income and the bond interest. No capital cost allowance may be claimed on the assets used to earn the rental income in the year of death, since all assets are deemed to be disposed of immediately prior to death.

The bond interest earned from November 1, 2007 through April 14, 2008 (\$2,600 + \$4,600) will be included in Carol's 2008 tax return.

The Canada Pension Plan (CPP) and Old Age Security (OAS) income she received should also be included.

The dividends, which were declared payable but unpaid at April 14, 2008, are considered "rights or things" and must be included in Carol's income in 2008.

An election can be made to include this dividend income in a separate tax return for Carol. This election must be filed by the later of one year after her death and 90 days after the mailing of any Notice of Assessment related to the year of her death.

The benefit of filing a separate tax return is that the graduated personal tax rates and the personal tax credits (basic, spouse (if applicable), age) apply for each tax return. The full tax credit amount can be claimed on Carol's 2008 tax returns, even though she died part way through the year.

Given Carol's level of income in 2008, the "rights or things" election would not be beneficial because the dividend tax credit on eligible dividends could not be used to reduce income tax on other income.

Question 2 (continued)*Income* (continued)

Rental income	\$8,000
Interest on bonds (\$2,600 + \$4,600)	7,200
CPP	4,000
Grossed up eligible dividends ($\$500 \times 1.45$)	725

Carol's medical expenses paid within any 24-month period that includes April 14, 2008 may be claimed. Although the \$600 paid in June 2008 is eligible to be claimed, the maximum credit is obtained by claiming the \$1,000 per month paid April 15, 2006 through April 14, 2008, which totals \$24,000.

The medical expenses are reduced by 3% of net income to a maximum reduction of \$1,962 (2008). The credit for the medical expenses cannot be doubled-up by filing more than one tax return for the year. Since claiming all medical expenses in 2008 leaves some unused amounts, the executor should consider amending the 2006 or the 2007 or both tax returns to maximize the medical expense claims.

The medical expenses for the 24-month period could also be claimed on Carol's husband return, instead of her return.

The age credit applies on all of Carol's tax returns as she was age 67 when she died. A full tax credit can be claimed on her 2008 tax returns, even though she died on April 14, 2008.

Question 3 (8 marks) (14 minutes)

The maximum tax deduction for employment expenses for Michael for 2008 is \$14,098 as calculated below:

ITA 8(1)(f) Sales Expenses

Car expenses –			
Gasoline		\$2,600	
Repairs and maintenance		300	
Licence and insurance		<u>1,500</u>	
		4,400	
Employment usage		<u>× 1/3</u>	
		1,467	
Parking expense		<u>200</u>	\$1,667
Client entertainment meals:	\$3,000 × 50%		1,500
Advertising and promotion			5,000
Home office expenses			
Property taxes	\$3,400 × 20%	\$ 680	
House insurance	1,200 × 20%	<u>240</u>	<u>920</u>
			<u>\$9,087</u>
Limited to commission income			\$ 9,000

ITA 8(1)(i) Dues and Other Expenses of Performing Duties

Home office expenses –			
Utilities	\$3,900 × 20%	\$ 780	
Maintenance	2,000 × 20%	400	
Internet service		480	
Office supplies		<u>500</u>	2,220

ITA 8(1)(j) Motor Vehicle Costs

CCA	\$33,900* × 30% × ½	5,085	
Interest on car loan, the lower of			
•	\$300/30 × 355 days =	\$3,550	
•	Amount actually paid	4,200	
		<u>3,550</u>	
		8,635	
Employment usage		<u>× 1/3</u>	<u>2,878</u>
			<u>\$14,098</u>

*The capital cost is limited to \$30,000 plus Provincial Sales Tax of 8% and Goods and Services Tax of 5%. The rate for the Provincial Sales Tax may be different for other provinces.

No portion of the following expenses can be deducted by an employee:

- Mortgage interest
- Capital cost of a computer
- Monthly charge for the home telephone

Question 4 (15 marks) (27 minutes)

Part A – Refundable Tax on Investment and Part IV Tax Payable

The refundable tax is \$1,333 and calculated on the lesser of

– The aggregate investment income			
Net taxable capital gains		\$ 60,000	
Income from property (interest)		<u>5,000</u>	
Investment income		65,000	
Less: Net capital losses		<u>30,000</u>	
Aggregate investment income			<u>\$35,000</u>
– Taxable income		\$390,000	
Less: Income subject to the Small Business Deduction		<u>370,000</u>	
			\$20,000
Rate			× 6 ⅔%
Refundable tax			<u>\$ 1,333</u>

The Part IV tax payable is \$6,667, calculated on the dividends received from non-connected corporations as follows: $\frac{1}{3} \times \$20,000$.

Part B – Three Differences Between an *Inter vivos* Trust and a Testamentary Trust

1. An *inter vivos* trust is created during the settlor’s lifetime, whereas, a testamentary trust is created on the settlor’s death.
2. Income in an *inter vivos* trust is all subject to tax at the top personal tax rate (federal 29% + provincial) whereas income in a testamentary trust is subject to the graduated personal tax rates.
3. The taxation year of an *inter vivos* trust is the calendar year, whereas a testamentary trust may choose the calendar year or a taxation year that ends within 12 months of the trust’s inception.

Part C – Tax Implication of an Employment Loan

The 5-year loan has different tax implications depending on how the money was used.

	Home Loan	Investment Loan
	<u>\$30,000</u>	<u>\$10,000</u>
Employee loan (\$40,000)		
Prescribed interest		
March 1 to March 31 = 31 days @ 4%	\$ 102	\$ 34
April 1 to December 31 = 275 days @ 4%	904	–
April 1 to December 31 = 275 days @ 6%	–	<u>451</u>
	<u>1,006</u>	485
Less: interest paid for 306 days @ 1% *	<u>(252)</u>	<u>(84)</u>
	<u>\$ 754</u>	<u>\$ 401</u>

* The interest must be paid within 30 days of the calendar year.

Question 4 (continued)

Home Loan

The prescribed interest rate in effect at the time the loan was received will remain in effect for the duration of the loan; however, if the prescribed interest rate declines, the lower rate can be used to calculate the taxable benefit (prescribed rate protection).

The \$40,000 loan was outstanding for 306 days in 2008; 2008 is a leap year with 366 days.

Investment Loan

The prescribed interest rate applicable to the investment loan will change periodically when the rate prescribed by the Canada Revenue Agency changes.

In computing her investment income for tax purposes, Alice is entitled to deduct the interest paid and deemed paid on the investment for a total of \$485 (interest actually paid of \$84 + interest benefit of \$401 deemed to have been paid).

Part D – Tax Implication of S.85

Susan will have a deemed dividend of \$500,000 equal to the non-share consideration she received in excess of the \$100,000 (paid-up capital (PUC) and adjusted cost base (ACB)). She will also have a taxable capital gain of \$125,000 calculated as follows:

Proceeds elected under S.85	\$ 850,000
Less: Amount deemed to be a dividend	<u>(500,000)</u>
Adjusted proceeds	350,000
ACB	<u>(100,000)</u>
Capital gain	<u>\$ 250,000</u>
Taxable capital gain	<u><u>\$ 125,000</u></u>

The preferred shares of the holding company that Susan received will have an ACB of \$250,000 and a PUC of nil.

To avoid the deemed dividend, Susan should reduce the non-share consideration to \$100,000 and increase the preferred shares received to \$900,000.

Part E – Tax Implications of Share Redemption

Eric will have a deemed dividend of \$60,000 if the shares are redeemed by Atego Ltd. He will have to include the grossed-up dividend of \$75,000 in his income ($\$60,000 \times 125\%$) and claim a dividend tax credit of \$10,000 ($\frac{2}{3}$ of the \$15,000 gross-up)

No capital gains will be realized:

Redemption price	\$ 80,000
Paid-up capital	<u>20,000</u>
Deemed dividend	<u>\$ 60,000</u>
Adjusted proceeds ($\$80,000 - \$60,000$)	\$ 20,000
Adjusted cost base	<u>20,000</u>
Capital gain/loss	<u><u>\$ 0</u></u>

Question 5 (6 marks) (11 minutes)

Contract and Tort Laws

The installation and use of proper materials were key terms of the contract; for example, the screws used to secure the shingles were specified as to their length given the weather conditions in the area. Since the use of shorter screws contravened the terms of the contract and caused the roof failure, a fundamental breach of the contract occurred that caused significant financial harm to BMC.

BMC could cancel the contract and sue for damages given that it has no further obligation under the contract; alternatively, BMC could continue with the contract and sue for damages, requiring TTR to continue to perform its obligations.

BMC as the injured party had an obligation to use reasonable efforts to mitigate the damage. However, TTR could argue that, had BMC known that the high winds would continue and that the new roof had problems, BMC could have moved the computer equipment to an area of the building not likely to be affected by the heavy rain. The reasonableness of such an expectation is questionable because BMC could not have known at the time that TTR's work was not meeting the terms of the contract.

BMC can claim only those damages that could not reasonably be mitigated.

TTR owed a duty of care to BMC. The standard of care in this situation is that a reasonable person would expect the builder to ensure it is using proper materials, and as a minimum, the materials specified in the contract.

TTR's conduct directly caused the harm to BMC whether it knowingly or inadvertently used the wrong screws. The harm was foreseeable in that the contract called for materials adapted to the extreme weather conditions in the area to prevent damage to BMC's property and an economic loss.

TTR could invoke the rule of contributory negligence on the basis that BMC could have moved the computers out of the building, or protected them from the rain, once it realized that the damage was spreading to that area of the building.

Question 6 (14 marks) (25 minutes)

Contract, Tort, Professional Responsibility and Negligence

Elements needed for a contract to exist:

1. Offer – An offer must state all of the terms on which an offeror is prepared to deal.
2. Acceptance – The acceptance must be unequivocal and has to be an acceptance of all of the terms of the offer; conditional assent does not represent acceptance.
3. Consideration – The consideration is defined as the price for which the promise or act of the other is bought and is necessary to make a contract binding in law. A gift does not represent a consideration; (for example, if A promises to give B his new car for nothing, there is no consideration and no contract; even if A promises to give B his new car if B fetches it from the garage, there is still no consideration and no contract because fetching the car is simply a condition precedent to A's generosity).
4. Intention to create legal relations – This relates to the inference that an unrelated third party would draw from the conduct of the parties; mere social engagements may not be sufficient to create legal relations.

The Offer

The terms of an offer must be clear and unambiguous.

One could question whether Steve made an offer verbally or by conduct; Steve specifically stated that he wanted John's opinion on buying a minority interest in Shangri-la Results Inc. (SRI) and he made a subsequent offer through his conduct by buying dinner and offering a weekend getaway.

In an offer, the price need not be addressed immediately.

Consideration

The consideration only requires that each party give something up.

Steve may argue that the offer to buy dinner fulfilled the terms of price and consideration. John may argue that the value of the dinner and the weekend getaway were far lower than the value of the fees normally charged for a business valuation.

However, adequacy of the consideration does not require that what is given up be of equivalent value.

Steve arguably has not given anything up; the weekend getaway was lost for all purposes because the refund date was passed, and the dinner was a social outing between friends or acquaintances.

Question 6 (continued)

Acceptance

The acceptance has to be unequivocal.

John somewhat ambiguously declined the offer by stating that he did not work in investment valuations. Arguably, it may be that his conduct was sufficient to constitute acceptance when he accepted the dinner outing and did not object to Steve paying for it.

However, John offered to buy the weekend getaway from Steve, arguably meaning that John did not accept Steve's specific offer on those terms.

Steve could argue that John accepted the offer when he looked at the financial statements after having accepted the dinner and the weekend getaway, when he commented on the income and the debt-to-equity ratio, and when he stated that it looked like the company had potential.

John could counter argue that stating that SRI had potential did not constitute an opinion.

Intention

Intention is determined by the outward conduct of each party.

John's outward conduct shows that he did not intend to contract with Steve while Steve's conduct shows attempts to obtain investment advice in a non-formal way.

Privity to contract

A question arises as to whether Art is privy to the matter.

Art gave no consideration and had no say in the formulation of the terms of a contract that may not exist. As a result, Art should have neither rights nor duties under the yet-to-be-determined legal relationship between John and Steve.

Tort

One must establish that a duty of care existed under contract or tort law, that a breach of that duty occurred, and that causality exists between the breach of duty and the loss to establish the existence of a liability.

The Hedley Byrne Case has established the principle of liability to third parties for negligent misrepresentation; however, the courts have established practical limits to this principle and treat negligent words differently from negligent acts.

The courts have imposed a duty of care only to the class of persons with whom public accountants have a "special relationship," that is to those whom they should have known would have a specific use for the information.

In a general sense, the courts have established that eligible plaintiffs must not only be "foreseeable," but must be specifically "foreseen" in respect to the matter at hand.

The law should reflect the standards of the reasonable man and acknowledge that the care used in social or informal occasions is different than that used in professional ones.

Question 6 (continued)

Tort (continued)

One could argue that John should have foreseen that Steve would rely on any of his statements regardless of the social or professional context in which they were made; Steve had expressly indicated his interest in John's opinion as a CA and is a relatively unsophisticated investor.

John could argue that he did not provide an opinion, that he disclaimed being an expert and that Steve has a certain level of sophistication because he has learned how the stock market works since he is supplementing his income with stock market investments. As a result, Steve must know the difference between audited and unaudited financial statements and should have exercised caution in contemplating his investment.

Art would not be specifically foreseen, but he and Steve can argue that John owed a duty to take reasonable care in expressing what they claim was an opinion.

Connection between breach and damage

Causation is a question of reliance. In law, the plaintiff has the burden to establish that the misrepresentation caused damages.

Steve and Art suffered a loss by investing in the now bankrupt SRI; however they have not clearly established that John owed a duty of care that was breached and that caused them to suffer the loss.

(Evaluators' comments: The Evaluators considered a line of arguments favouring the existence of a contractual relationship between Steve and John).

Question 7 (30 marks) (54 minutes)

Part A – Public Accounting Practice – Client’s Illegal Activities

Ralph Gora Paving

202 Integrity and Due Care

- Mary did not perform her services with integrity and due care by ignoring the illegal activities she had discovered in the course of her work.

205 False or Misleading Documents

- Mary associated herself with a financial statement and tax return she knows are incomplete and misleading; the letter from Ralph does not relieve her from her professional responsibilities.

206 Compliance with Professional Standards

- Mary failed to comply with professional standards for compilation engagements by not requesting additional information about her findings and by not withdrawing from the engagement (HB s. 9200.20).

213 Unlawful Activity

- Mary associated herself with an unlawful activity; she knows that the client is not declaring all of his income, and that tax evasion is illegal.
- The letter provided by the client offers no protection to Mary.

Honest Ivan Ltd.

302 Communication with Predecessor

- Mary failed to inform the successor firm that a suspected illegal activity was a factor in her withdrawal from the engagement (302.3).

303 Co-operation with Successor

- Mary failed to comply with 303.1 by transferring the client’s files and working papers to the successor without proper instruction and authorization from the client.

208 Confidentiality of Information

- Mary may have failed to comply with 208.1 at the same time because the exception in 208.1 (b) that relates to 302 does not justify sending all records and working papers to the successor firm.

201.1 Maintenance of Reputation of Profession

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

Question 7 (continued)

Part B – Public Accounting Practice – Organization and Conduct

406 Member Responsible for a Non-Member in Practice of Public Accounting

- Jeremy is responsible for Robert, a non-member in Jeremy’s public practice, and he failed to make Robert abide by the RPC in various ways:

214 Fee Quotation

- Robert failed to obtain adequate information about the engagement prior to quoting a fee.

217.1 & .2 Advertising and Promotion & Solicitation

- Robert’s client solicitation techniques that are arguably making unfavourable reflection on the competence of another firm are prohibited.

216 Payment or Receipt of Commission

- Robert paid a commission to his girlfriend, a person who is not a public accountant (PA).

216 Payment or Receipt of Commissions

- In addition, Jeremy himself breached 216 by reimbursing Robert for the payment of commissions to his girlfriend.

217.1 Advertising and Promotion

- Although Jeremy’s claim about placing in the top 10 in Canada at the UFE can be substantiated, the claim that he is one of Canada’s best CA, recognized by the CICA with national honours is arguably misleading.
- Claiming skills or attributes superior to those possessed by colleagues with equal qualifications contravenes the fundamental principles governing the conduct of CAs.
- The letterhead is misleading because the firm appears larger than it actually is.

408 Association of Member with Non-Member in Public Practice

- Jeremy contravenes 408 by allowing the following:
 - John and Nick appear as associates of Jeremy while they actually are not.
 - The reference to City two and City three is misleading given that the firm has no office in either cities.
 - Nick appears to be engaged in public practice while he actually is not.
 - The firm name should only make reference to one associate (Robert).
 - John’s name could be included as long as he is clearly identified as a representative.

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 the good reputation of the profession, integrity, etc.).

Question 7 (continued)

Part B – Public Accounting Practice – Organization and Conduct (continued)

201.1 Maintenance of Reputation of Profession

- As a result of the above, Jeremy, John and Nick, and the firm Jeremy Johnson have failed to maintain the good reputation of the profession.

Part C – Public Accounting Practice – Loan, Solicitation, Contingent Fees

104 Requirement to Reply in Writing

- Wide & Diggs (W&D) failed to reply in writing or otherwise to the letter from the Institute that specifically requested a written reply from the firm.

209 Borrowing from Clients

- W&D may have contravened 209 when borrowing \$15,000 from PPL, a client that is not a financial institution or in the business of private lending; however, the following must be determined to establish if 209 has really been breached:

209.2 – it must be determined whether the two-year limit is exceeded and whether PPL relied on W&D's membership in the Institute for the particular service.

209.1 – it must be determined if the common-law spouse for three year of Wide's mother is a family member of Wide for the purpose of 209.

214 Fee Quotation

- Diggs failed to obtain adequate information about the engagement on the trust accounts.
- He may however argue that the experience gained with the other lawyers' trust accounts gave him a sound basis to quote a fee.

206 Compliance with Professional Standards

- Diggs contravened 206 by not obtaining an engagement letter from Overland as required by the CICA Handbook (HB s. 5110, Terms of the engagement).

215.3 Contingent Fees

- Although the contingent fee for the GST engagement is in itself acceptable as per council interpretations, the engagement acceptance is tied to the offering of an audit engagement.
- Arguably, the fee arrangement could be seen as an influence which impairs judgment or objectivity on the audit engagement; the fee on the GST engagement could be substantial given the success of the law firm.
- However, allocating the audit and the GST engagements to two different partners could help mitigate the problem.

217.2 Solicitation

- Wide contravened 217.2 by soliciting professional engagements from Agnes in a manner that is persistent or harassing.

Question 7 (continued)

Part C – Public Accounting Practice – Loan, Solicitation, Contingent Fees (continued)

201.1 Maintenance of Reputation of Profession

- As a result of the above, Wide, Diggs and the firm of W&D failed to maintain the good reputation of the profession.

Part D – Public Accounting Practice – Independence, Integrity & Due Care, Competence

Blake

204.2/501 Identification of Threat and Safeguards/Firm's Maintenance of Policies and Procedures for Compliance with Professional Standards

- Blake and the firm of Blake & Edmonds (B&E) failed to identify threats and safeguards to independence when assigning the audit of ECL to Jane.

206 Compliance with Professional Standards

- Blake failed to comply with professional standards by not supervising Jane properly, in light of what he had learned about Jane and ECL.

211 Duty to Report Breach of Rules of Professional Conduct (RPC)

- Blake failed to report to the Institute Jane's and Cliff's apparent breaches of RPC and doubts as to their competence or integrity.

Jane

204.4(17) Specific Prohibitions: Recent Service with an Assurance Client

- Jane should not be involved in the audit of ECL because during her six-month placement, she worked in a capacity similar to that of an employee and was therefore in a position to exert direct and significant influence over the subject matter of the engagement during that period.
- In addition, Jane negotiated an increase in the credit line, and prepared and recorded journal entries and various source documents for ECL.

205 False or Misleading Documents

- Jane associated herself with a misleading statement on which a bank would rely to increase a line of credit.

206 Compliance with Professional Standards

- Jane contravened professional standards by not complying with Generally Accepted Accounting Principles (GAAP) when preparing interim and year-end general purpose financial statements of ECL.
- Jane failed to comply with professional standards by not applying proper audit procedures following the receipt of accounts-receivable confirmations in the audit of ECL.

Question 7 (continued)

Part D – Public Accounting Practice – Independence, Integrity & Due Care, Competence
(continued)

208 Confidentiality of Information

- Jane contravened 208 by disclosing confidential information about Cliff, her former employer, and about ECL to Blake, for Blake’s and B&E’s advantage.

201.1 Maintenance of Reputation of Profession

- As per council interpretation, Jane appears to criticize Cliff, an Institute member, by sharing her experience on ECL’s contract to Blake.

211 Duty to report breach of RPC

- Jane failed to report Cliff to the Institute regarding doubts about his integrity and due care.

202 Integrity and Due Care

- Jane failed to perform her work with integrity and due care while on contract at ECL.

Cliff

202 Integrity and Due Care

- Cliff failed to perform his services with integrity and due care by instructing Jane to give the client what he wanted.

201.1 Maintenance of Reputation of Profession

- As a result, Blake, Jane, Cliff and the firm B&E failed to maintain the good reputation of the profession.

Part E – Public Accounting Practice – Conflicts

210.2 Conflict of Interest

- Stan should determine if he can provide services to both parties while maintaining an objective state of mind.
- Stan should consider whether there is any interest or family relationship which could cause a reasonable observer to conclude to the existence of a conflict of interest.

Question 7 (continued)

Part E – Public Accounting Practice – Conflicts (continued)

204.8 Disclosure of Impaired Independence

- While grandparents are not defined as close or immediate family in RPC 204, there is a potential conflict of interest between Stan and Paul if Stan’s wife were to become the sole beneficiary of Mabel’s estate and Stan were to do Paul’s business valuation.
- Stan may be influenced to overvalue the business, thus increasing the property distribution to Mabel and then potentially increasing the size of Stan’s wife inheritance.
- Mitigating factors however exist: Mabel has not yet changed her will; the inheritance is many years away, and may be subject to other future variables such as changes in her health, mishandling of her estate, a remarriage, and change of mind.

208 Confidentiality of Information

- Stan is bound to keep Mabel’s affairs confidential.

Conclusion

Stan should adopt a mitigating approach where Paul and Mable, the clients, should be involved in the resolution of the conflict of interest or the appearance of such a conflict.