

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY ONE – 2007

(100 marks) (3 hours)

NOTES TO CANDIDATES:

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

Question 1 (8 marks) (14 minutes)

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

(i) Impairment of Long-lived Assets

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

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

(ii) Revenue Recognition

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

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

Question 1 (continued)

(iii) Date of the Auditor's Report

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

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

(iv) Fraud

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

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

Question 2 (6 marks) (11 minutes)

Financial Instruments, Recognition and Measurement

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

Required:

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

Question 3 (10 marks) (18 minutes)

Hedging

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

Required:

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

Question 4 (12 marks) (22 minutes)

Goodwill and Other Intangible Assets, and Differential Reporting

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

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

Required:

Prepare a report to Joe Rucker that addresses the following:

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

Question 5 (12 marks) (22 minutes)

Non-monetary Transactions and Related Party Transactions

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

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

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

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

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

Required:

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

Question 6 (6 marks) (11 minutes)

Not-for-Profit Organizations – Contributions

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

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

Required:

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

Question 7 (6 marks) (11 minutes)

Audit of fair values and disclosures

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

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

Required:

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

Question 8 (5 marks) (9 minutes)

Responsibilities of those Charged with Governance and of Management

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

Required:

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

Question 9 (12 marks) (22 minutes)

Communications with Those Having Oversight Responsibility for the Financial Reporting Process

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

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

Required:

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

Question 10 (9 marks) (15 minutes)

Date of the Auditor's Report

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

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

Required:

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

Question 11 (6 marks) (11 minutes)

Reservations in the Auditor's Report

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

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

Required:

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

Question 12 (8 marks) (14 minutes)

Audit of Accounting Estimates

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

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

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

Required:

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

TABLE I

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

<i>Periods</i> Hence	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%
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
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
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
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
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
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
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
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
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
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
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
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
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
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
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

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%
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
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
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
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
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
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
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
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
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
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
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
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
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
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
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

ANSWER SHEET

Question 1

CANDIDATE NUMBER: _____

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY ONE - 2007

NOTE:

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

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

- i.** a) ____ b) ____ c) ____ d) ____
- ii.** a) ____ b) ____ c) ____ d) ____
- iii.** a) ____ b) ____ c) ____ d) ____
- iv.** b) ____ c) ____ d) ____ e) ____

DO NOT WRITE IN THIS SPACE	

Total	_____
×	2

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY TWO – 2007

(100 marks) (3 hours)

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SECTION A - TAXATION

Question 1 (10 marks) (18 minutes)

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

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

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

Required:

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

Question 2 (15 marks) (27 minutes)

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

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

Question 2 (continued)

7. Stinson had the following additional receipts in 2006:

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

8. Stinson paid the following amounts in 2006:

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

Required:

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

Question 3 (25 marks) (45 minutes)

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

Part A (5 marks)

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

Required:

Describe the federal income tax implications for Paul

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

Part B (4 marks)

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

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

Required:

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

Question 3 (continued)

Part C (3 marks)

You read the following statement in a newspaper:

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

Required:

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

Part D (3 marks)

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

Required:

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

Part E (2 marks)

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

Required:

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

Question 3 (continued)

Part F (2 marks)

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

Required:

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

Part G (2 marks)

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

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

Required:

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

Part H (2 marks)

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

Required:

Determine the Part IV tax payable by OL for 2006.

Question 3 (continued)

Part I (2 marks)

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

Required:

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

SECTION B - LAW

Question 4 (8 marks) (14 minutes)

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

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

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

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

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

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

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

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

Required:

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

Question 5 (8 marks) (14 minutes)

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

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

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

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

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

Required:

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

Question 6 (4 marks) (8 minutes)

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

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

Required:

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

SECTION C - RULES OF PROFESSIONAL CONDUCT

Question 7 (26 marks) (47 minutes)

Required:

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

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

Part A (6 marks)

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

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

Question 7 (continued)

Part B (12 marks)

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

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

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

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

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

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

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

Question 7 (continued)

Part C (8 marks)

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

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

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

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

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

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

Question 8 (4 marks) (7 minutes)

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

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

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

Required:

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

TABLE III

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

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

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

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

Class 1	4%
Class 3	5%
Class 8	20%
Class 10	30%
Class 10.1	30%
Class 12	100%
Class 13	original lease period plus one renewal period (Minimum 5 years and Maximum 40 years)
Class 14	Length of life of property
Class 17	8%
Class 39	25%
Class 43	30%
Class 44	25%
Class 45	45%

SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

Maximum depreciable cost - Class 10.1	\$30,000 + GST
Maximum monthly deductible lease cost	\$800 + GST
Maximum monthly deductible interest cost	\$300
Operating cost benefit - employee	22¢ per kilometre of personal use
Non-taxable car allowance benefit limits	
- first 5,000 km	50¢ per kilometre
- balance	44¢ per kilometer

TABLE IV

INDIVIDUAL FEDERAL INCOME TAX RATES

2006 Income Tax Rate Schedule - Individuals

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

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

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

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

CORPORATE FEDERAL INCOME TAX RATE

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

PRESCRIBED INTEREST RATES

<u>Year</u>	<u>Jan. 1 - Mar. 31</u>	<u>Apr. 1 - June 30</u>	<u>July 1 - Sept. 30</u>	<u>Oct. 1 - Dec. 31</u>
2007	7			
2006	5	6	6	7
2005	5	5	5	5
2004	5	5	4	5
2003	5	5	6	5
2002	5	4	5	5

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

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