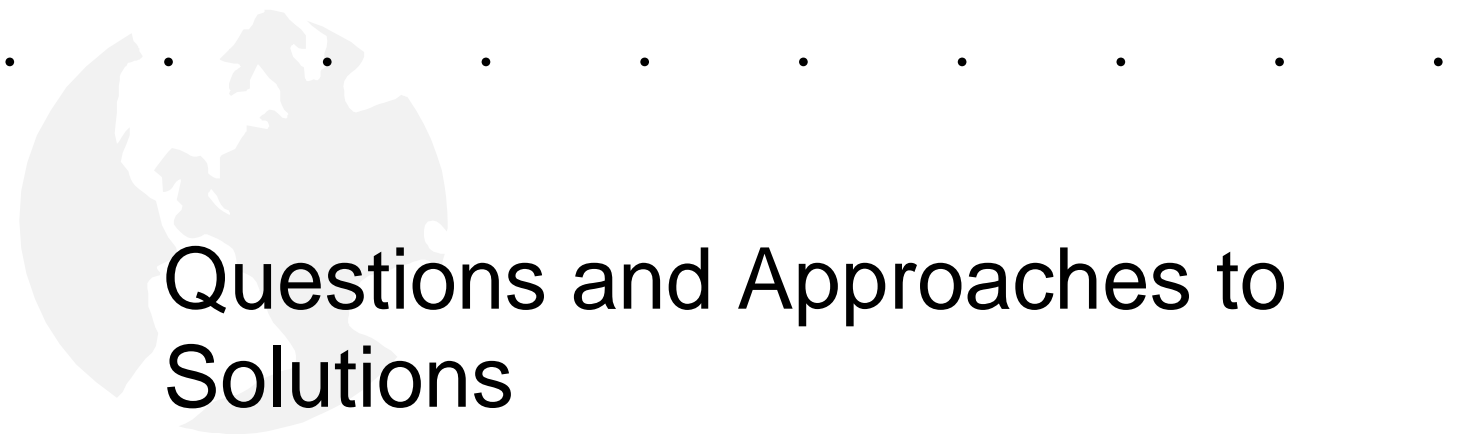




CARE Chartered Accountant Reciprocity Examination 2008

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

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

TABLE II

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

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

THE INSTITUTES/ORDRE OF CHARTERED ACCOUNTANTS IN CANADA

CA RECIPROCITY EXAMINATION

DAY TWO – 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 *	<u>1,300</u>	\$ 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 *	<u>62,000</u>	70,800
Client entertainment meals		3,000
Advertising and promotion		<u>5,000</u>
		<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.
