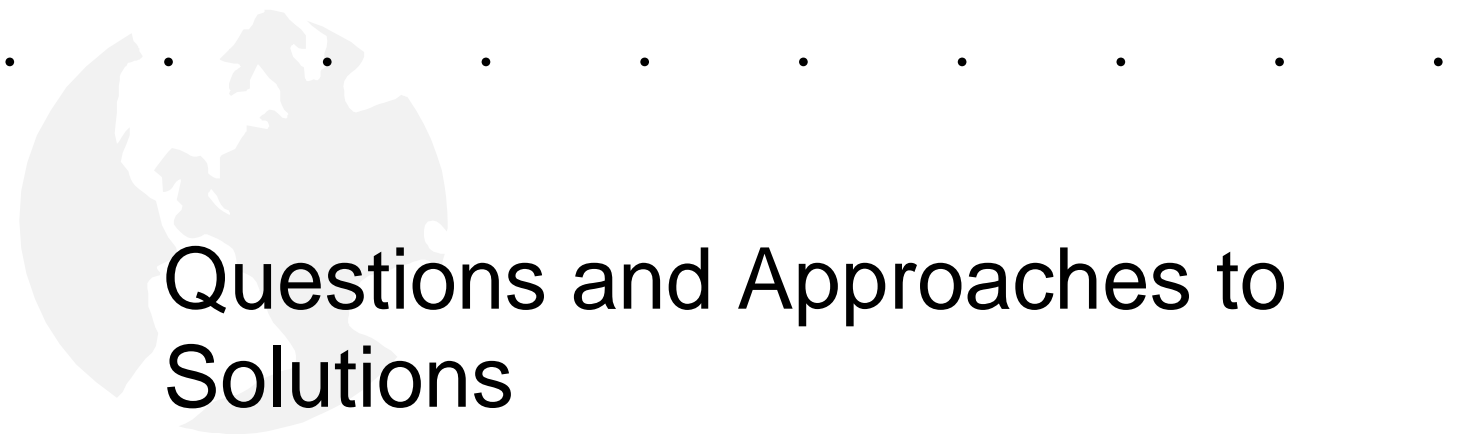




CARE Chartered Accountant Reciprocity Examination 2008

The Institutes of Chartered Accountants in Canada and Bermuda



Questions and Approaches to Solutions

Introduction

The solutions outlined in the following material represent comprehensive approaches to questions and are based on the full range of available marks. They do not represent responses that candidates could realistically expect to produce in the prescribed time limits. The solutions provide examples of how issues can be dealt with and do not represent the only acceptable responses.

References to sections of the CICA Handbook, the Income Tax Act and the Rules of Professional Conduct have been included solely to assist candidates in their review.

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

Question 1 (8 marks) (14 minutes)i. Financial Instruments, Recognition and Measurement (2 marks)

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

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

ii. Leases (2 marks)

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

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

iii. Audit of Accounting Estimates (2 marks)

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

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

iv. Materiality (2 marks)

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

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

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

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

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

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

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

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

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

Contract B

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

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

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

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

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

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

“**Related parties** exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. Related parties also include management and immediate family members.”¹

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

Part B – Recording – In Normal Course of Operations

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

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

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

Part C – Recording – Not in Normal Course of Operations

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

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

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

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

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

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

¹ CICA Handbook, 3840.03 (g)

² CICA Handbook, 3840.04 (f)

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

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

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

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

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

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

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

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

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

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

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

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

³ CICA HB s. 3461.088

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

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

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

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

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

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

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

Past Service Costs (HB s. 3461.079-086)

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

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

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

Question 4 (continued)

Transitional Asset (HB s. 3461.167)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 5 (continued)

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

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

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

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

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

Question 6 (6 marks) (11 minutes)

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

Part A – Early Adoption of Accounting Policy Change – Inventories

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

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

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

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

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

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

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

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

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

Part B – Change in Amortization for Capital Assets

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

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

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

Question 6 (continued)

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

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

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

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

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

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

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

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

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

Auditing the Fair Values

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

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

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

Question 8 (8 marks) (14 minutes)

Audit of Accounting Estimates (HB s. 5305)

Part A – Definition of Accounting Estimates

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

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

Part B – Auditor's Objectives and Planning

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

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

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

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

Question 9 (10 marks) (18 minutes)

Documentation (HB s. 5145)

Part A – Content and Extent of Documentation

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

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

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

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

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

Part B – Subsequent Changes to Audit Documentation

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

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

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

Question 10 (8 marks) (14 minutes)

Review Engagement (HB s. 8100)

Part A – Content of Review Engagement Report

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

1. The scope paragraph:

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

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

2. The disclaimer paragraph:

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

3. The negative assurance paragraph:

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

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

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

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

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

Question 11 (8 marks) (14 minutes)

Communication with the Audit Committee (HB s. 5751)

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

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

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

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

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

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

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

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

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

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

Question 11 (continued)

Part B – Communication Near the Completion of Audit

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

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

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

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

Question 12 (3 marks) (6 minutes)

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

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

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

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

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

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

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

Question 1 (12 marks) (22 minutes)

Income Tax Savings or Deferral from Incorporating

Part 1

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

Income Earned Through a Corporation Paid as Dividend

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

Income Earned Personally

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

Comparison

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

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

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

Question 1 (continued)

Part 2

Dividend

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

Bonus

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

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

Note that the dividend does not trigger additional payroll taxes.

Part 3

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

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

Question 2 (15 marks) (27 minutes)

Due Dates

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

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

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

Deemed Disposition

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

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

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

Property Transferred to Spouse

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

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

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

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

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

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

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

Registered Retirement Savings Plan (RRSP)

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

Income

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

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

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

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

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

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

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

Question 2 (continued)*Income* (continued)

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

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

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

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

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

Question 3 (8 marks) (14 minutes)

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

ITA 8(1)(f) Sales Expenses

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

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

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

ITA 8(1)(j) Motor Vehicle Costs

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

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

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

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

Question 4 (15 marks) (27 minutes)

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

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

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

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

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

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

Part C – Tax Implication of an Employment Loan

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

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

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

Question 4 (continued)

Home Loan

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

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

Investment Loan

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

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

Part D – Tax Implication of S.85

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

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

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

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

Part E – Tax Implications of Share Redemption

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

No capital gains will be realized:

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

Question 5 (6 marks) (11 minutes)

Contract and Tort Laws

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

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

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

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

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

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

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

Question 6 (14 marks) (25 minutes)

Contract, Tort, Professional Responsibility and Negligence

Elements needed for a contract to exist:

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

The Offer

The terms of an offer must be clear and unambiguous.

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

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

Consideration

The consideration only requires that each party give something up.

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

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

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

Question 6 (continued)

Acceptance

The acceptance has to be unequivocal.

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

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

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

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

Intention

Intention is determined by the outward conduct of each party.

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

Privity to contract

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

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

Tort

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

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

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

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

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

Question 6 (continued)

Tort (continued)

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

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

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

Connection between breach and damage

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

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

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

Question 7 (30 marks) (54 minutes)

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

Ralph Gora Paving

202 Integrity and Due Care

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

205 False or Misleading Documents

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

206 Compliance with Professional Standards

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

213 Unlawful Activity

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

Honest Ivan Ltd.

302 Communication with Predecessor

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

303 Co-operation with Successor

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

208 Confidentiality of Information

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

201.1 Maintenance of Reputation of Profession

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

Question 7 (continued)

Part B – Public Accounting Practice – Organization and Conduct

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

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

214 Fee Quotation

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

217.1 & .2 Advertising and Promotion & Solicitation

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

216 Payment or Receipt of Commission

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

216 Payment or Receipt of Commissions

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

217.1 Advertising and Promotion

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

408 Association of Member with Non-Member in Public Practice

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

502 Firm's Maintenance of Policies and Procedures: Competence and Conduct of Firm Members

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

Question 7 (continued)

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

201.1 Maintenance of Reputation of Profession

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

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

104 Requirement to Reply in Writing

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

209 Borrowing from Clients

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

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

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

214 Fee Quotation

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

206 Compliance with Professional Standards

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

215.3 Contingent Fees

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

217.2 Solicitation

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

Question 7 (continued)

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

201.1 Maintenance of Reputation of Profession

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

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

Blake

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

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

206 Compliance with Professional Standards

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

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

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

Jane

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

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

205 False or Misleading Documents

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

206 Compliance with Professional Standards

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

Question 7 (continued)

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

208 Confidentiality of Information

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

201.1 Maintenance of Reputation of Profession

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

211 Duty to report breach of RPC

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

202 Integrity and Due Care

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

Cliff

202 Integrity and Due Care

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

201.1 Maintenance of Reputation of Profession

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

Part E – Public Accounting Practice – Conflicts

210.2 Conflict of Interest

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

Question 7 (continued)

Part E – Public Accounting Practice – Conflicts (continued)

204.8 Disclosure of Impaired Independence

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

208 Confidentiality of Information

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

Conclusion

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