

UFE

2010 Uniform Evaluation Report



The Institutes of Chartered Accountants in Canada and Bermuda

**UNIFORM EVALUATION
REPORT
2010**

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THE BOARD OF EVALUATORS' REPORT ON THE 2010 UNIFORM EVALUATION

Objectives of the report

The objectives of this report are:

1. To assist education committees and councils of the provincial and Bermuda institutes and provincial boards of examiners in their review of the results of the 2010 Uniform Evaluation (UFE).
2. To assist the profession in improving pre-examination educational and screening processes and, in turn, the performance of candidates on the UFE.

The report sets out the responsibilities of the Board of Evaluators, the methods of guide development and marking the UFE, and the results of the marking process. The report concludes with the recommendation of the Board of Evaluators. Three appendices provide more detailed information on the design, guide setting, and marking of the 2010 UFE, the evaluators' comments and expectations of candidates on the simulations, and sample responses. Readers are cautioned that the solutions were developed for the entry-level candidate and that therefore all the complexities of a real life situation may not be fully reflected in the content. The UFE report is not an authoritative source of GAAP.

Responsibilities of the Board of Evaluators

The Board of Evaluators (BOE or board) comprises a chair and nine members. The chair and one bilingual member are appointed by the Professional Learning Committee (PLC); the other eight are appointed by the provincial institutes. Board members are appointed for a three-year term and the chair for a two-year term.

The BOE's responsibilities, as set out in its terms of reference, include:

- Setting the UFE in accordance with the *UFE Candidates' Competency Map* (the *Map*) and other directions from the PLC.
- Submitting the UFE and the evaluation guides to the provincial institutes for review.
- Marking the candidates' responses and recommending to the provincial institutes the pass or fail standing that should be given to each candidate.
- Reporting annually on the UFE to the provincial institutes, in such form and detail and at such time as is satisfactory to the Education and Qualification Committee (EQC) and the PLC.

Each board member is actively involved in the preparation of the UFE simulations, the setting of the passing profile, the preparation of evaluation guides, and the supervision of the evaluation process. Board members are jointly responsible for determining the passing standard.

The UFE

The purpose of the UFE is to assess whether candidates possess the competencies required of an entry-level CA through a uniform written evaluation that all CAs must pass in order to qualify for entry to the profession.

The Decision Model

The pass/fail decision model used by the board is presented in Exhibit 1. Three key decision points, or levels, are applied in reaching the pass/fail decision, as follows:

1. The response must be **sufficient**, i.e., the candidate must demonstrate competence on the primary indicators (Level 1). In assessing sufficiency, the board considered the number of times that a candidate achieved “Competent” and/or “Reaching Competence” across all primary indicators (both specific competencies and pervasive qualities).
2. The response must demonstrate **depth** in the areas of Performance Measurement and Reporting and Assurance (Level 2). In assessing depth the board considered the number of times that a candidate achieved “Competent” in each of the Assurance and Performance Measurement and Reporting primary indicators.
3. The response must demonstrate **breadth** across all areas of the *Map* (Level 3). In assessing breadth the board considered the number of times that a candidate achieved “Reaching Competence” across primary indicators in each of the specific competency areas, except for Assurance and Performance Measurement and Reporting. If a candidate failed to demonstrate breadth on the basis of the primary indicators, the board considered the information provided by the secondary indicators for the deficient competency area.

Evaluation guides

An evaluation guide was prepared for each simulation included in the 2010 Uniform Evaluation. Besides identifying the primary and secondary indicators of competence, each evaluation guide includes carefully defined performance levels to assist markers in evaluating a candidate's competence relative to the indicators. Five categories of performance are given for each **primary** indicator. The candidate's performance must be ranked in one of the five categories, namely:

- Not addressed
- Nominal competence
- Reaching competence
- Competent
- Highly competent

For each **secondary** indicator, the candidate's performance is ranked in one of three categories:

- Not addressed
- Nominal competence
- Competent

Preparation and structure of the UFE

The CA Qualification staff of the Education Services department of the CICA maintains a pool of simulations sufficiently large and broad in scope to provide a variety of alternative simulations embracing all sections of the *Map*. The board provides guidance as to the content and nature of simulations to be included in the pool.

The board staff work in conjunction with authors to ensure that simulations achieve the overall intent and design objectives while adhering to the competencies and the proficiency levels specified in the *Map*. The board selects simulations from the pool maintained by the staff, and reviews and refines these simulations to make up the annual three-paper evaluation.

Nature of the simulations

Taken as a whole, the three papers must meet the requirements laid down by the PLC for *Map* coverage and simulation type. **Appendix A** shows that the 2010 UFE met the *Map* coverage requirements.

The 2010 UFE comprised a balanced combination of comprehensive and multi-subject simulations, which were both essential and effective in evaluating the candidates with regard to their readiness to practise public accounting. The first paper was a five-hour paper consisting of a single, comprehensive simulation. The board designed a four-hour comprehensive simulation, but allowed candidates an extra hour in which to complete their responses. The second and third papers were four-hour papers, each consisting of three simulations.

Detailed comments by the Board on each of the 2010 UFE simulations appear in **Appendix C**.

Primary and secondary indicators of competence

The board applies evaluation procedures that enable it to decide which candidates demonstrate readiness to practise public accounting. **Appendix A** contains a comprehensive description of the evaluation process.

To attain a “pass” standing, candidates must address the issues in the simulations that are considered mission critical. The board distinguishes between the mission critical issues and other relevant issues by classifying them as primary indicators and secondary indicators of competence respectively.

Primary indicators of competence answer the question: “What would a competent CA do in these circumstances?” If the issues identified in primary indicators are not adequately addressed, the CA could, in real life, be placed in professional jeopardy or could place the client in jeopardy.

Secondary indicators of competence answer the question: “What other issues could a CA raise?” Although such issues are valid, it is not essential for a competent CA to address them.

Board members devote a great deal of time to reviewing and refining evaluation guides to ensure the expectations for achieving competence are fair and reasonable for an entry-level CA.

Marking-centre leaders and assistant leaders provide valuable input to the evaluation guides before live marking begins. Board members hold regular meetings with the leaders and their assistants during both the guide-setting and the marking process. In the board's opinion, the commitment, energy, and skill demonstrated by all the markers were outstanding, resulting in the sound application of marking procedures and producing an appropriate evaluation of the candidates.

The marking results for the secondary indicators do not appear in the statistical reports (**Appendix B**), as they reflect the performance of only that segment of the population whose responses were deemed borderline. However, **Appendix C** does contain comments on the candidates' performance for the responses that were marked.

Setting the passing standard

In determining which candidates pass the UFE, the Board uses a passing profile. A candidate is judged in relation to the board's pre-established expectations of an entry-level chartered accountant. To meet the passing profile, a candidate's response must meet the three levels defined earlier (see Exhibit 1).

In setting the passing profile, the board considers the following:

- The competency area requirements.
- The level of difficulty of each simulation, as a whole.
- The level of difficulty of each individual competency indicator.
- The design and application of the evaluation guides.
- Comments from leaders and assistant leaders regarding any marking difficulties encountered or any time constraints noted.
- Possible ambiguity of wording or of translation of a simulation.

Determining which candidates pass

Near the completion of the marking process, board members each read a sample of candidate responses for their assigned simulation to satisfy themselves that the markers had applied the judgments as intended. Based principally on these readings, and on the evaluation of each candidate made by the markers, the board reviewed its pre-established passing profile and set preliminary requirements for Level 2-depth in the areas of Performance Measurement and Reporting and Assurance, and for and Level 3-breadth across all competency areas.

Prior to the fair pass meeting, board members each read another sample of candidate responses, this time for their assigned competency area, to satisfy themselves as to the levels they had set for Levels 2 and 3. They finalized those Level 2 and 3 requirements at their fair pass meeting, taking into account the number of valid opportunities available to candidates to demonstrate their competence in each of the competency areas. The board then established the Level 1 requirement for the three-paper set. In establishing the Level 1 requirement, the board considered whether the results could be wholly or partly explained by any inconsistency in the evaluation or in the board's process.

After considerable discussion, the board concluded that the 2010 evaluation was easier than the 2009 evaluation. After taking into account that the 2010 UFE was easier, candidate performance on this evaluation was assessed as stronger than that of 2009. Based on the stronger candidate performance, the board set a Level 1 standard that yielded 3,046 successful candidates (3,127 candidates in 2009).

In reaching its decision, the board determines which candidates pass on a national basis only, without regard to provincial origin or language. Similarly, the detailed comments are based on analyses of the performance of all candidates. The board leaves the interpretation of provincial results to the provincial institutes.

Reporting

The board assigned a pass or fail standing to candidates for the three-paper set.

The board reported the following information to each province by candidate number:

- Overall pass/fail standing and pass/fail standing for each of Levels 1, 2 and 3.
- For failing candidates at Level 1, a sufficiency grouping for Level 1 and a decile ranking for both the comprehensive simulation and the non-comprehensive simulations.
- For failing candidates, a colour code (red, yellow, green) reflecting their performance for each of the competency areas.

Recommendation

The Board of Evaluators recommended that only those candidates who succeeded at each of Levels 1, 2, and 3 should earn a pass standing on the 2010 Uniform Evaluation.

In conclusion, all board members wish to express their warm and sincere appreciation for the outstanding energy, support, and commitment of the small group of Board of Evaluators staff members whose dedication and talent contributed in large measure to the achievement of our objectives and the fulfilment of our responsibilities.

We also wish to acknowledge the contributions made by our markers, authors, translators, provincial reviewers, and editors. Their commitment to the quality and fairness of the process is appreciated.



Terry Booth, CA
Chair
Board of Evaluators

COMMENTS ON THE CANDIDATES' PERFORMANCE ON THE 2010 UNIFORM EVALUATION

To attain a pass standing, candidates must demonstrate sufficient competence in all areas, as well as appropriate depth and breadth in their responses.

A message to candidates

EXECUTIVE SUMMARY

The Board of Evaluators analyzed the performance of candidates on the 2010 UFE. Overall, candidates' performance improved over the prior year. Information on candidates' performance on the 2010 UFE is provided here, in a summary format, to help candidates understand how to further improve their performance. Detailed comments on the performance for each simulation can be found in the evaluation guides in **Appendix C**. The following paragraphs elaborate further on the improvements as well as the common detracting characteristics identified by the Board.

On a positive note, candidates were well prepared for the inclusion of International Financial Reporting Standards (IFRS) on the 2010 UFE. Candidates were placed in an IFRS situation in two simulations: Paper I and Paper III, Simulation 1. Generally, candidates were able to correctly identify the IFRSs that were applicable and discuss the standards in reasonable depth.

As well, although there is still some room for improvement, candidates performed better than in prior years on the indicators in the Pervasive Qualities and Skills competency area. Candidates integrated various issues within their responses and often gave relevant business advice to their clients.

Candidates demonstrated stronger communication skills for the second straight year. They continued to limit their use of short forms, acronyms, and bulleted lists. This resulted in clearer discussions and improved the overall flow of the candidates' responses.

There was also some evidence to suggest that candidates were consulting their *CICA Handbook* more often to research and analyze the accounting issues. This was noted as a key detractor on the 2009 examination. In 2010, many candidates applied appropriate criteria from relevant accounting resources (such as IFRS and Canadian GAAP) to their accounting discussions. This was particularly true for issues such as asset impairment, research and development expenditures, bill and hold sales, and multiple deliverables. The Board encourages candidates to continue to refer to relevant accounting resources to provide guidance in their responses and to use these resources to discuss significant accounting issues.

As for major detractors, the Board would like to highlight serious concern regarding candidates' lack of technical knowledge in the area of taxation.

General lack of taxation knowledge

On the 2010 UFE, there were three primary indicators in taxation. In general, candidates avoided these taxation issues and often left the analysis of these issues until the end of their responses. The taxation responses were often very brief and, therefore, displayed little competence. In two of the three simulations, the Board expected candidates to apply tax knowledge relevant to specific sections of the *Income Tax Act*. Candidates should be able to demonstrate technical knowledge beyond discussion of the tax generalities, particularly since they were able to access their *Income Tax Act*. Candidates are reminded that they are required to display competence in all areas to attain a passing standard on the exam. Avoiding *any* competency area will lead to a failing grade, regardless of the competence displayed in the other areas of the examination.

Nature of the 2010 UFE

Overall, the 2010 UFE contained one less primary indicator when compared with 2009. The opportunities in Performance Measurement and Reporting, Assurance, Finance, Taxation, and Governance, Strategy, and Risk Management were the same as in 2009. There was one less pervasive indicator. The number of secondary indicators was also the same as the prior year, which again resulted in many of the simulations having no secondary indicators at all.

The 2010 UFE was more direct in nature compared with some examinations in the past. As a result, candidates generally were able to identify the significant issues in each of the simulations.

The Board did not see evidence of candidate time constraint on the comprehensive or non-comprehensive simulations. However, the importance of ranking remains a concern. Candidates appeared to spend more time on issues they understood and were comfortable discussing. Candidates were generally able to identify issues, even in areas where they were not as knowledgeable (such as taxation issues), but they had difficulty discussing these issues with any depth. As a result, their responses on these issues tended to be very brief, and candidates did not display the required competence.

Unusual roles and simulation settings

The roles assigned and scenarios presented to the candidates on the 2010 UFE continued to be varied, with only two simulations presenting a traditional assurance role (Paper II, Simulation 1, and Paper III, Simulation 3). Candidates generally adapted to the roles, which included an advisor to an executive committee (Paper I), a financial advisor on a proposed merger (Paper II, Simulation 2), an advisor for a new business opportunity (Paper II, Simulation 3), a mergers and acquisitions consultant advising on a potential purchase (Paper III, Simulation 1), and an advisor to a client on various issues associated with the death of a spouse (Paper III, Simulation 2). For the most part, candidates presented information that was suited to these roles. The one exception was on Paper III, Simulation 1, where candidates were asked to develop due diligence procedures for a potential purchase. Some candidates struggled to fulfill this role and, instead, fell back into the traditional auditor role.

Specific Comments by Competency Area

Assurance

Candidates were asked to perform a variety of assurance related tasks on the 2010 UFE, since most simulations addressed Assurance in some way. Candidates' performance in Assurance improved over the prior year. In the examination, candidates were asked to:

- provide an audit plan to assess the accuracy of a CRTC Fee calculation,
- provide relevant audit procedures part way through an audit,
- provide relevant due diligence procedures for a potential takeover target,
- draft a preliminary management letter,
- assess internal control weaknesses in a proposed new business,
- discuss matters related to issuing an audit report, and
- plan multiple engagements for a group of companies, including both audit and review engagements.

Overall, candidates understood the assurance roles assigned and the issues presented, but often struggled with the details of the assignments. In particular, candidates sometimes struggled to provide valid and relevant procedures for the scenario presented. For example, on Paper I, Primary Indicator #1, candidates were asked to prepare an audit plan for SableTel's CRTC submission. Some candidates failed to focus on the relevant risks involved in the audit of the submission and, instead, provided generic procedures that would apply to any audit engagement (for example, testing cut off of revenue). Likewise, on Paper III, Simulation 1, Primary Indicator #2, some candidates had difficulty discussing relevant procedures that would be carried out in a due diligence assignment. Instead, they tended to list standard audit procedures that were not relevant for this type of engagement. Similarly, on Paper III, Simulation 3, Primary Indicator #2, candidates were asked to develop procedures to cover off any outstanding issues. Some candidates failed to tailor their procedures to the incomplete audit work described in the case.

Candidates are encouraged to always consider the effectiveness of the procedures they provide. Procedures should address the risk area identified. In addition, when presenting an audit plan to an audit committee or a client, candidates should explain why the procedure is necessary, in other words, how it would successfully address the client's assurance needs.

Performance Measurement and Reporting

The majority of simulations contained accounting issues that required an understanding and ability to apply GAAP. Throughout the three days of the 2010 UFE, candidates were examined on a range of issues, some of which were more complex and others more straightforward. Overall, candidates' performance in Performance Measurement and Reporting was stronger than in 2009.

In 2010, candidates appeared to be well prepared for the full adoption of IFRS. In two of the simulations, candidates were placed in an IFRS environment. On Paper I, Primary Indicator #2, candidates were required to recognize that the manner in which SableTel had recorded some of its transactions was not in accordance with IFRS. Most candidates performed well on this indicator and seemed to be comfortable applying the relevant standards. As well, on Paper III, Simulation 1, Primary Indicator #3, candidates were asked to discuss the accounting issues that arose when reporting under IFRS. In general, candidates did a good job identifying the issues. It is worth noting that the accounting issues in these scenarios were relatively simple. In the future, the complexity level of the IFRS accounting issues presented will likely increase.

There were also three indicators that were based on traditional scenarios. For each of these simulations, there was a clear differentiation between the strong candidates and the weak candidates. Strong candidates discussed more issues, demonstrated greater technical knowledge, and incorporated appropriate simulation facts into their analysis.

For example, on Paper II, Simulation 1, Primary Indicator #2, candidates were asked to address the accounting issues arising from the changes at BSL during the year (multiple deliverables, related party transactions, inventory valuation, capitalization of training costs/licence, and non-controlling interest). Strong candidates discussed more of the significant accounting issues thoroughly with a clear understanding of GAAP and applied relevant simulation facts in their discussion. On Paper II, Simulation 3, Primary Indicator #1 candidates were asked to advise the owners of a private car-sharing company on the appropriate accounting policies to employ under current Canadian GAAP. Strong candidates discussed the revenue recognition criteria, applied the criteria appropriately to each of the various membership plans, and provided reasonable recommendations for accounting for the plans. Many candidates did not analyze each of the plans in sufficient depth, and, instead, tried to compare them at a higher level (time vs. kilometres). On Paper III, Simulation 3, Primary Indicator #1, candidates were asked to discuss the accounting issues arising from the audit. Strong candidates generally discussed at least one of the key revenue recognition issues in depth (early order program and/or demo units) by applying relevant simulation facts and their technical knowledge to their discussion of the issue.

Overall, candidates are reminded of the need to provide depth of analysis when addressing accounting issues. To demonstrate competence, candidates need to show their understanding of what the issue is, explain why it is an issue, and explain how the issue should be addressed.

Primary Indicator #5 on Paper I was the one Performance Measurement and Reporting indicator that did not deal with accounting issues. Instead, it required candidates to focus on the reporting aspect. Candidates were asked to comment on a reporting document (which was intended to be included in an MD&A) and to suggest improvements. Candidates that understood this requirement were typically able to identify some of the specific statements made in the document that were vague, misleading, or insufficient, and recommend changes to make the information more useful to the shareholders. However, most of the candidates seemed to be uncomfortable with this requirement, and used Dan's comments in the reporting document to provide management or operational advice rather than to critically analyze the document from a reporting perspective. Reporting is an essential part of the profession, and candidates would benefit by becoming more familiar with important reporting tools, such as the MD&A.

Taxation

The level of taxation knowledge displayed on the 2010 UFE was disappointing. Candidates performed very poorly on the tax issues on Paper II, Simulation 1 and Simulation 2. In both cases, candidates provided very brief analyses of the taxation issues and were generally unable to display the required level of competence. Candidates performed better on Paper III, Simulation 2. However, even in this simulation, candidates tended to do better on the minor tax issues but had difficulty analyzing the significant taxation issues in depth.

On Paper II, Simulation 1, Primary Indicator #3, candidates were specifically asked to address Jack's tax concerns. Candidates often did not recognize that the new property might qualify as a replacement property and, as a result, provided weak tax analysis of the building issue. Other candidates discussed the sale of trucks to Transport and were able to recognize the possible terminal loss, but seemed unaware of the stop loss tax provisions.

On Paper II, Simulation 2, Primary Indicator #4, candidates were asked to discuss the tax strategy available to CLI related to the merger of CLI and QLL. Most candidates identified the need to discuss the QSBC rules. However, some candidates were not able to relate case facts to their discussion. Some candidates only listed the QSBC criteria without applying them to CLI's situation or without concluding whether CLI met the QSBC criteria. The vast majority of candidates identified either implicitly or explicitly that the deal as currently structured would not trigger a gain. However, the majority of these candidates were not able to provide to the client a valid option to trigger the gain. As well, candidates showed poor technical knowledge as their analysis included many deficiencies, and poor integration of case facts.

On Paper III, Simulation 2, Primary Indicator #3, candidates were asked to discuss the tax implications of Don's death and the sale of the practice. While candidates generally discussed the minor taxation issues in sufficient depth (RESP, RRSP rollover, etc.), they were not able to discuss the sale of the partnership interest with any accuracy. Many candidates lacked the technical expertise to discuss this issue in any depth.

Management Decision-Making

Although candidates demonstrated reasonable understanding of Management Decision-Making concepts, performance on some of the indicators was surprisingly poor. Despite the directedness of the requirement, many candidates did not address Primary Indicator #3 on Paper I. Most candidates either missed this indicator altogether, only made passing comments on a variance or two as part of their work on other indicators, or deferred this work back to Dan or management for further explanation. Candidates are reminded to read the simulation carefully to ensure that they pick out all of the requirements, as well as the case facts that will help them address the requirements. For example, the simulation contained a breakdown of the revenue and cost of sales by product line. A comparison of revenues by product line to the prior year would have directed candidates to highlight the large decrease in SableTel's most significant product line, long-distance service revenues.

Remaining competency areas

Candidates performed well in the areas of Finance and Governance, Strategy, and Risk Management. Candidates did a good job identifying most of the issues, discussing them in sufficient depth, and using the case facts to support their positions.

Pervasive qualities and skills

The 2010 UFE included four pervasive skills indicators, one less than the 2009 UFE. In general, candidates performed better than in prior years on the pervasive indicators, particularly in Paper I where a high level of integration was delivered by the candidates. Candidates were also able to come to an appropriate overall conclusion for SableTel. However, as in the prior year, candidates had difficulty identifying underlying issues where a high-level analysis was needed to get to the issue. There were two pervasive indicators on which candidates' performance was weak: Paper II, Simulation 3, Primary Indicator #3; and Paper III, Simulation 3, Primary Indicator #4. Both of these indicators required the candidates to understand, on an overall basis, the scenario presented and to identify higher-level concerns. Candidates were not directed explicitly to these overriding issues; rather, candidates were required to step back and consider the broader issues.

The Board continues to emphasize the importance of being able to identify and appropriately address underlying issues on the UFE. These analytical skills are critical for a chartered accountant, and they will continue to play an important part not only in the Level 1 assessment on the UFE, but also in the assessment of competence at Levels 2 and 3.

Additional Information for candidates related to SecurExam

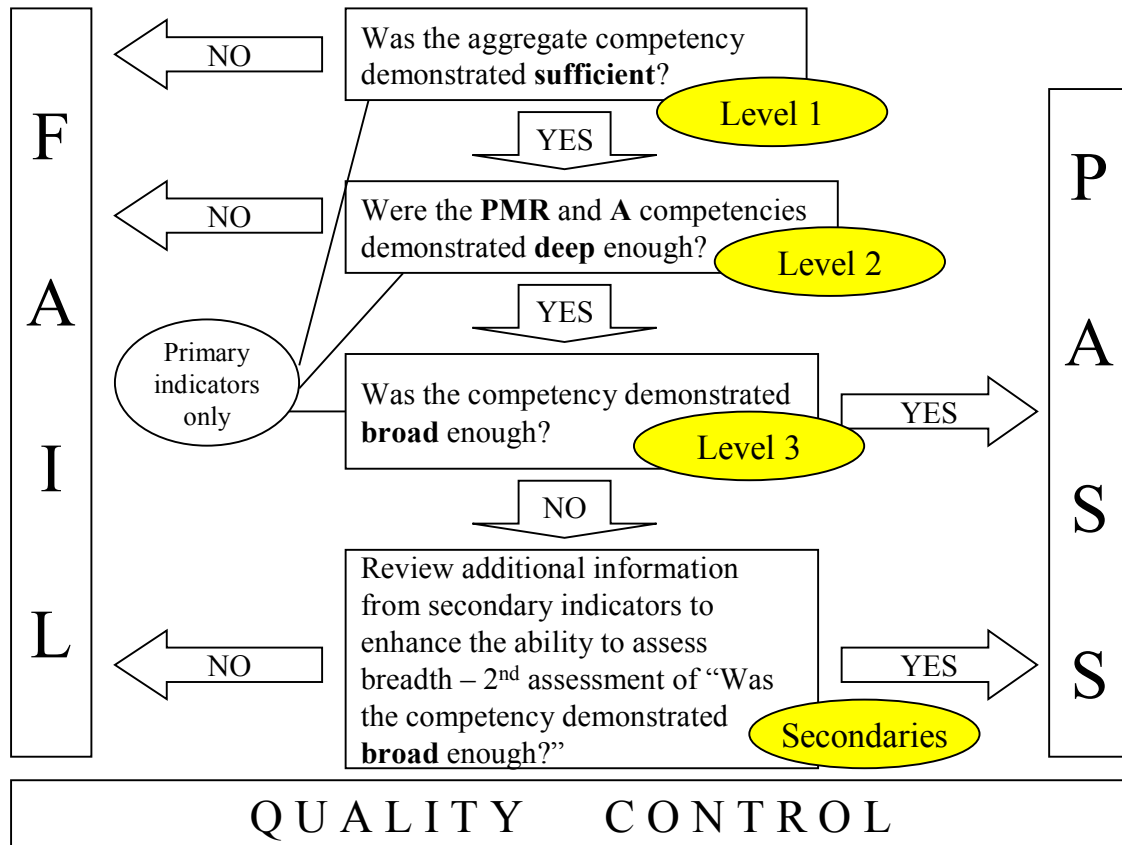
As part of the BOE's audit and control processes, candidates' uploaded responses were compared to their USB key responses to ensure the integrity of the responses and fairness to all candidates.

Beginning in 2011, additional measures will be put in place as part of the BOE's continuous improvements to the examination process. First, candidates will no longer be allowed to take the exam booklets with them at the end of each exam day. Exam booklets will be collected along with the USB keys. The CICA will instead post the examination booklets on the CICA's website the week following the UFE for those that wish to refer to it.

Second, in 2011, candidates will again be required to upload their responses, however, candidates will be given a shorter period of time to upload responses, that being until midnight on the Friday night after the UFE is written. Although candidates were required to upload their exams to the secure SecurExam website in 2010, many candidates failed to do so by the deadline of the Monday 5:00pm following the UFE, and the BOE was required to gather the information from the USB keys. This process requires significant additional effort on the part of the BOE staff. In addition, those failing to do so will be charged an administration fee of \$100¹ for the alternate loading of their responses through the loading of USB keys.

¹ or as approved by each provincial council

EXHIBIT 1
THE DECISION MODEL



APPENDIX A**DESIGN, GUIDE DEVELOPMENT, AND MARKING
OF THE 2010 UNIFORM EVALUATION****Design**

The Professional Learning Committee (PLC) determines the policies for the minimum coverage of the *UFE Candidates' Competency Map* on each Uniform Evaluation. The coverage requirements for the 2010 UFE were identical to those in the prior year.

The coverage requirements and the actual percentage coverage on the *2010 Uniform Evaluation* for each section of the *Map* when both the primary and the secondary indicators of performance are considered together are set out below:

Specific competency	Required Relative weight	Actual Relative weight
Governance, Strategy and Risk Management	5 – 10%	10%
Finance	10 – 20%	14%
Taxation	10 – 20%	14%
Assurance	25 – 35%	27%*
Performance Measurement and Reporting	20 – 30%	23%
Management Decision-Making	10 – 20%	12%*

*The BOE is required to include a minimum of two Information and Information Technology indicators on the UFE. The board fulfilled its commitment on the 2010 UFE by including one indicator in Assurance and one indicator in Management Decision-Making.

All simulations were designed to fit within the “normal circumstances” in which all entry-level CAs are expected to demonstrate the required competencies.

Normal circumstances are circumstances where:

The entity, situation, event or transaction is of a size or degree of complexity likely to be encountered by an entry-level CA, and

- The entity is a business in the private sector, formed as a proprietorship, as a partnership, as a private corporation; or
- The entity is a small public corporation, or as a division of a large public corporation; or
- The entity is in the public sector or is a not-for-profit organization or a division of either; or
- The entity is an individual.

Type of simulation

The evaluation is made up of a comprehensive case and several multi-subject simulations. The indicators on the comprehensive case are weighted so that the comprehensive case represents one third of the evaluation.

The development of evaluation guides and the provincial review centre

In June 2010, provincial reviewers met to examine the *2010 Uniform Evaluation* and the preliminary evaluation guides. The provincial reviewers' comments on the *2010 Uniform Evaluation* were considered by the board when it finalized the evaluation set in June 2010 and again when the senior markers reviewed the guides in the context of actual responses in September 2010.

Evaluation centre

From the marker applications received, the board carefully selected 171 chartered accountants to participate in the 2010 evaluation centre. The criteria for selection included marking experience, motivation, academic achievement, work experience, personal references, and regional representation.

Before the opening of the evaluation centre, board members, leaders, and assistant leaders attended a five-day meeting, the preliminary evaluation centre (PEC). Participants reviewed the evaluation guides, applied them to randomly selected candidate responses, and made appropriate revisions. The written comments on the evaluation guides received from provincial reviewers were carefully considered at this meeting, with the board approving necessary changes.

The comprehensive simulation was marked by English-speaking and French-speaking teams of between 8 and 10 markers in Montreal from October 14 to October 29, 2010. Paper III was marked in Montreal from October 14 to October 25, 2010, and Paper II was marked from October 18 to October 29, 2010. Each non-comprehensive simulation was assigned marking teams of between 16 and 20 people, with each team having a leader and an assistant leader, and both French-speaking and English-speaking markers. Each team had one or more markers who were capable of marking in both languages. Borderline marking took place on October 30, 2010.

At the beginning of the comprehensive and non-comprehensive centres, the leaders and the assistant leaders presented the evaluation guides to their teams. The team undertook a two-phase test marking procedure prior to actual marking. Phase one consisted of two steps: guide familiarization, during which markers applied the guide for the primary indicators to copies of candidates' responses, and joint review, when markers collectively reviewed their results. Phase one thus ensured that all markers understood the issues in the evaluation guide and the basis on which to apply each proficiency level. Phase two was an expanded test marking of another set of responses to establish marker congruence. When marker congruence was achieved for a simulation, live marking of that simulation began. The start-up period varied between two and three days for the various simulations.

After the training and test marking phases, live marking commenced. The simulations were marked by English-speaking and French-speaking markers.

The BOE strives for the highest possible marking consistency and quality control. This means that leaders and assistant leaders devoted much of their time to cross marking and other monitoring activities. Markers' statistics were reviewed to ensure that marking was consistent. Based on analysis of the statistics, leaders reviewed papers marked by their team members to ensure that the indicators were assessed fairly. Bilingual markers marked papers in both languages, and their results were compared to ensure that the marking was consistent in both languages. Leaders also discussed, on a selective basis, the results of arbitration with their markers once the second marking began.

Double marking

Each candidate's paper was marked independently for the primary indicators by two markers. If the two initial markings differed on any indicator, an arbitrator (the leader, assistant leader, or a senior marker) compared the two initial markings and determined the final result for that indicator. Based on the results of this marking, borderline responses that had met Level 1 and 2, but not Level 3, for the primary indicators were identified and were marked for secondary indicators. Only the leaders and the assistant leaders marked responses for secondary indicators.

As an added measure to ensure that markers were consistently applying the marking guide, a two-day rule was put in place. This meant that the second round of marking did not begin until two days had elapsed since the first marking. This rule ensured that any movement of the guides due to marker interpretations being established during the first two days of live marking were stabilized before the second marking and arbitration procedures began.

Subsequent reviews of results and/or performance analyses

Reviews of evaluation results are allowed by all provincial institutes. In addition, failing candidates may apply for a performance analysis review to assist them in assessing their performance on the 2010 UFE.

How to apply for a review of results

Applications for a review of a candidate's evaluation results must be forwarded to the Board of Evaluators through the provincial institutes. If candidates wish to apply for such a review, they should notify their respective institutes within the specified time limit.

Candidates may only apply for review of their examination results as a whole.

Review approach

The following review procedures are applied to all three papers constituting the Uniform Evaluation:

Under the supervision of the Chair of the Board of Evaluators, and the Principals CA Qualification, the papers are reviewed by the leaders and assistant leaders who did the original marking. The team leaders and assistant team leaders read the answers and compare them to the evaluation guides used at the original marking centre. In reviewing candidates' results, two aspects are considered by the board. First, it must be determined that the basis of marking the papers has been consistent with that accorded other candidates who wrote the evaluation. Second, all papers reviewed are subjected to a careful check to ensure that the markers have indicated that consideration has been given to all material submitted by the candidate.

The results are then tabulated and the decision made whether any candidates have been treated unfairly and should be granted a pass in the examination. There have been a relatively insignificant number of changes made to reviewed papers over the years, which is attributable to the care exercised in the original marking and tabulating of the papers and results and to the consideration given to individual papers in the review procedure.

The results of the review are forwarded to the provincial institutes for approval and notification to the candidates.

How to apply for a performance analysis review

Applications for a performance analysis review must be forwarded to the Board of Evaluators through the provincial institutes. If candidates wish to apply for both a review of their examination results and a performance analysis review, they can do so. Should the review of a candidate's paper result in his or her standing being changed to a pass, the performance analysis review will not be performed and any associated fees will be refunded.

APPENDIX B**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

PERVASIVE QUALITIES AND SKILLS					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #8 The candidate integrates information from various sources and explains why SableTel is not likely to be successful in the future without significant changes.	0.0	8.2	38.9	52.4	0.5
II-2 Primary Indicator #2 The candidate identifies that there are different business philosophies, and other factors, that could impact the success of the merger.	0.6	8.3	46.7	44.3	0.1
II-3 Primary Indicator #3 The candidate discusses why it may not be a good idea for Peter and Taylor to go into the car sharing business.	17.6	26.0	32.0	23.9	0.5
III-3 Primary Indicator #4 The candidate recognizes the high degree of control the CFO has and the potential impact on the company.	0.7	26.2	52.1	21.0	0.0
OVERALL	4.7	17.2	42.4	35.4	0.3

APPENDIX B (continued)**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

GOVERNANCE, STRATEGY AND RISK MANAGEMENT					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #6 The candidate evaluates the strategic plan, recognizes that it is flawed and suggests recommendations for improvement.	0.2	5.4	29.6	64.3	0.5
III-1 Primary Indicator #1 The candidate discusses the strategic decision to purchase Points North Airways through a discussion of the risks and opportunities associated with the purchase.	0.4	4.0	29.7	65.3	0.6
OVERALL	0.3	4.7	29.7	64.8	0.5

FINANCE					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #4 The candidate calculates financial ratios to determine the financial condition and operating performance of SableTel relative to its competitors.	0.6	5.8	57.2	36.0	0.4
II-2 Primary Indicator #1 The candidate considers the value of each laboratory and analyzes whether receiving an equal share of the newly amalgamated company is reasonable.	1.7	15.4	41.1	41.8	0.0
III-2 Primary Indicator #2 The candidate evaluates the offers received by Jan for the partnership interest and provides advice to Jan based on her cash needs.	0.0	10.8	30.9	57.8	0.5
OVERALL	0.8	10.7	43.0	45.2	0.3

APPENDIX B (continued)**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

TAXATION					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
II-1 Primary Indicator #3 The candidate addresses Jack's tax concerns.	0.8	34.6	43.4	20.7	0.5
II-2 Primary Indicator #4 The candidate discusses the tax strategies available to CLI related to the merger of CLI and QLL (trigger gain).	2.4	36.9	47.3	13.3	0.1
III-2 Primary Indicator #3 The candidate discusses the tax implications of Don's death and the sale of the partnership interest.	0.1	7.5	44.9	46.3	1.2
OVERALL	1.1	26.3	45.2	26.8	0.6

APPENDIX B (continued)**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

ASSURANCE					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #1 The candidate provides an audit plan, recalculates the CRTC Fee and provides auditing procedures to test the accuracy of the Fee calculation.	0.0	6.7	41.5	51.5	0.3
II-1 Primary Indicator #1 The candidate discusses the planning considerations for both the audit of the consolidated financial statements and the reviews of the individual subsidiary companies.	0.1	2.7	58.0	39.0	0.2
II-3 Primary Indicator #2 The candidate suggests ways to automate the manual control processes and discusses the internal control weaknesses that can be eliminated as a result.*	0.2	2.9	43.4	52.5	1.0
III-1 Primary Indicator #2 The candidate describes the due diligence procedures that should be performed and explains their importance.	0.1	12.9	36.5	50.0	0.5
III-2 Primary Indicator #1 The candidate discusses the issues related to issuing the audit report for Green.	0.6	4.1	29.2	64.6	1.5
III-3 Primary Indicator #2 The candidate discusses the outstanding audit issues and suggests additional audit procedures.	0.1	9.5	37.4	52.4	0.6
III-3 Primary Indicator #3 The candidate prepares a draft management letter.	0.4	20.3	49.9	29.2	0.2
OVERALL	0.2	8.4	42.3	48.5	0.6

* Information and Information Technology indicator

APPENDIX B (continued)**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

PERFORMANCE MEASUREMENT AND REPORTING					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #2 The candidate discusses the significant accounting issues related to the 2010 financial statements.	0.1	4.0	26.5	68.9	0.5
I Primary Indicator #5 The candidate identifies weaknesses within the executive reporting document as presented and recommends improvements.	5.3	24.6	29.8	39.9	0.4
II-1 Primary Indicator #2 The candidate addresses the accounting issues arising from the changes at BSL during the year.	0.1	4.2	55.3	39.6	0.8
II-3 Primary Indicator #1 The candidate discusses appropriate accounting policies to implement for the car sharing business.	0.0	4.9	42.8	51.3	1.0
III-1 Primary Indicator #3 The candidate discusses the accounting issues that arise when reporting Points North Airways under IFRS.	0.2	5.2	48.0	46.6	0.0
III-3 Primary Indicator #1 The candidate discusses the accounting issues arising from the audit.	0.1	9.6	49.5	40.5	0.3
OVERALL	1.0	8.7	42.0	47.8	0.5

APPENDIX B (continued)**CANDIDATE PERFORMANCE ON PRIMARY INDICATORS
BY COMPETENCY AREA**

MANAGEMENT DECISION-MAKING					
	Not addressed %	Nominal competence %	Reaching competence %	Competent %	Highly competent %
I Primary Indicator #3 The candidate performs a variance analysis on the 2010 financial statements.	4.6	56.4	25.1	13.9	0.0
I Primary Indicator #7 The candidate analyzes the financial budget provided for 2011 and concludes on whether the results are likely to be achieved.	0.9	15.8	33.8	49.3	0.2
II-2 Primary Indicator #3 The candidate analyzes the two current processes and recommends what processes would be best suited to the combined operations.*	0.4	3.6	53.7	42.1	0.2
OVERALL	2.0	25.3	37.5	35.1	0.1

* Information and Information Technology indicator

APPENDIX C

**2010 SIMULATIONS, EVALUATION GUIDES,
AND SAMPLE RESPONSES**

THE INSTITUTES OF CHARTERED ACCOUNTANTS OF CANADA

2010 Uniform Evaluation

PAPER I

Time: 5 hours

NOTES TO CANDIDATES:

- (1) *Simulations that require knowledge of the Income Tax Act, the Income Tax Application Rules 1971, and the Income Tax Regulations are based on the laws enacted at March 31, 2010, or in accordance with the provisions proposed at March 31, 2010.*

Provincial statutes, including those related to municipal matters, are not examinable.

- (2) *Tables of present values, certain capital cost allowance rates, and selected tax information are provided at the end of the evaluation paper as quick reference tools. These tables may be used in answering any simulation on the paper.*
- (3) *Answers or parts of answers to simulations will not be evaluated if they are recorded on anything other than the CICA-provided USB key or the writing paper provided. Rough notes will not be evaluated. You are asked to dispose of them rather than submit them with your response.*

* * * * *

StarNova is a publicly traded company that operates exclusively in Canada. Its revenue exceeded \$800 million for the year ended August 31, 2010. The company has a diversified portfolio of businesses ranging from consumer goods to high technology. All of StarNova's businesses operate independently and must be self-sufficient. Typically StarNova expects all of its businesses to generate a 15% return on investment.

SableTel Limited (SableTel) is a 100%-owned subsidiary of StarNova and operates in the telecommunications industry. SableTel sells long-distance, local telephone access, mobile, and Internet and data services to end users. SableTel's reporting document (Exhibit II), as well as its 2010 financial statements (Exhibit III) provide more information about its operations. Each subsidiary's reporting document is expected to meet StarNova's Management Discussion and Analysis (MD&A) requirements so that StarNova's senior management can easily incorporate it in StarNova's annual report to shareholders.

The telecommunications industry in Canada is strictly regulated, and each year SableTel must have its operating licence renewed by the Canadian Radio-television and Telecommunications Commission (CRTC). Further information about the telecommunications industry is provided in Exhibit IV.

On September 13, 2010, Dan Wilson, Chief Executive Officer (CEO) of SableTel, presented an overview of SableTel's 2010 financial results and 2011 strategic plan (Exhibit VII) to the executive committee (EC) of StarNova. The EC was confused by the results for 2010 and concerned about the 2011 strategic plan, particularly because SableTel is requesting funding from StarNova of \$21 million.

Today is September 14, 2010. You, CA, work in StarNova's finance department. You were copied on an email (Exhibit I) from John McReynolds, the Chair of the EC, to Dan Wilson, outlining concerns raised by the EC. John has asked you to drop everything to respond to the issues raised in the email.

INDEX TO EXHIBITS

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EXHIBIT I

EMAIL FROM JOHN MCREYNOLDS TO DAN WILSON

To: Dan.Wilson@SableTel.com 09/14/2010 08:14am
Cc: CA@StarNova.com
Bcc:
Subject: Follow-up to yesterday's presentation

Hi Dan:

As you are aware, SableTel is the key to strategic growth within the technology segment of StarNova's business. Based on your presentation yesterday, the EC would like further information and analysis. We have asked CA to prepare the following on our behalf and report back to us at our next meeting:

- An evaluation of SableTel's operating performance relative to its competitors;
- Comments on the reporting document, including suggested improvements;
- A more thorough analysis of the variance in results between 2010 and 2009;
- Comments on the points raised in the 2011 strategic plan, including suggested improvements to the plan; and
- An evaluation of the 2011 budgeted financial information and of the likelihood of the result being achieved.

In addition to these issues, we reviewed the letter from the CRTC regarding its fee calculations. We are not sure if the initial calculations prepared are accurate. We have asked our internal audit group to perform procedures to ensure that the CRTC submission is correctly calculated. CA will participate in this work by preparing an audit plan for SableTel's 2009 CRTC resubmission and 2010 CRTC submission, including a preliminary estimate of the error, a risk analysis, and a description of procedures that will need to be performed.

Please assist CA by providing whatever information may be helpful.

John McReynolds, FCA

Chairman, StarNova Executive Committee
Chairman, StarNova Audit Committee

EXHIBIT II

SABLETEL REPORTING DOCUMENT FOR THE YEAR ENDED AUGUST 31, 2010

Report to StarNova's executive committee

The following is dated September 13, 2010, and should be read in conjunction with the financial statements of SableTel for the year ended August 31, 2010.

SableTel had an outstanding year in 2010. We turned the corner from a loss in 2009 to profitable operations in 2010 despite difficult economic conditions. We continue to benefit from decisions our excellent management team has implemented over the past several years.

Highlights from fiscal 2010 include:

- Net income of \$1,178,000 based on robust revenue of \$65,072,224
- Reduction in operating costs of \$2,783,365 due to cost restraint
- Cost of sales were contained
- Strong liquidity at year-end based on liquid assets totalling \$16,215,519
- Solid balance sheet at year-end, with shareholder's equity totalling \$26,338,280

We plan to do even better in the future by increasing revenue and decreasing expenses. We also expect the impact of our new Wireless Technology Project to be substantial in the short term.

Unfortunately, Hurricane Baylee hit Nova Scotia in August 2010. Although no injuries were reported by SableTel employees, a number of communication towers were damaged and the mobile telephone network was disabled.

We have also taken steps to decrease our risk profile. We established an occupational health and safety committee in 2010, which decided to remove all fried foods from the cafeteria menu and installed hand sanitizers at all doorways as a result of the H1N1 pandemic. Reducing our risk was mandated by our parent company, StarNova, and we believe we have met this objective.

We are not aware of any new significant lawsuits to which SableTel has been named defendant.

We continue to focus on evolving our core business. We have no significant new projects planned for the foreseeable future.

Finally, we would like to request that StarNova's MD&A thank a long-time employee of our company who will be retiring next month. Mr. Dudley Oldmun has been working with our sales department for 25 years.

Dan Wilson

EXHIBIT III**EXCERPTS FROM 2010 SABLETEL LIMITED DRAFT FINANCIAL STATEMENTS*****DRAFT STATEMENT OF FINANCIAL POSITION******As at August 31******(unaudited)***

	<u>2010</u>	<u>2009</u>
<u>Assets</u>		
Current assets		
Cash	\$ 351,018	\$ 8,320,677
Accounts receivable	15,864,501	6,788,745
Inventory (Note 3)	<u>3,219,431</u>	<u>883,318</u>
	19,434,950	15,992,740
Non-current assets		
Property, plant and equipment (Note 6)	62,532,502	65,643,101
Deferred taxes	35,629	35,629
Intangible assets (Note 4)	<u>10,753,709</u>	<u>1,654,530</u>
	<u>\$ 92,756,790</u>	<u>\$ 83,326,000</u>
<u>Liabilities</u>		
Current liabilities		
Trade and other payables	\$ 13,065,938	\$ 8,718,978
Current portion of long-term debt	<u>9,200,000</u>	<u>7,800,000</u>
	22,265,938	16,518,978
Non-current liabilities		
Long-term debt	<u>44,152,572</u>	<u>41,646,742</u>
	<u>66,418,510</u>	<u>58,165,720</u>
<u>Capital</u>		
Common shares	3,000	3,000
Retained earnings	<u>26,335,280</u>	<u>25,157,280</u>
	<u>26,338,280</u>	<u>25,160,280</u>
	<u>\$ 92,756,790</u>	<u>\$ 83,326,000</u>

EXHIBIT III (continued)**EXCERPTS FROM 2010 SABLETEL LIMITED DRAFT FINANCIAL STATEMENTS****DRAFT STATEMENT OF COMPREHENSIVE INCOME****For the years ended August 31****(unaudited)**

	<u>2010</u>	<u>2009</u>
Revenue (Note 1)	\$ 65,072,224	\$ 65,176,742
Cost of sales (Note 2)	<u>30,714,869</u>	<u>30,591,682</u>
Gross profit	<u>34,357,355</u>	<u>34,585,060</u>
Expenses		
Selling and marketing	16,875,413	16,583,825
Administration (Note 5)	<u>13,336,292</u>	<u>16,411,245</u>
	<u>30,211,705</u>	<u>32,995,070</u>
Operating profit	4,145,650	1,589,990
Financing		
Interest expense	<u>2,967,650</u>	<u>2,877,850</u>
Profit (loss) before income taxes	1,178,000	(1,287,860)
Income taxes	<u>-</u>	<u>-</u>
Profit (loss) and comprehensive income (loss)	<u>\$ 1,178,000</u>	<u>\$ (1,287,860)</u>

EXHIBIT III (continued)**EXCERPTS FROM 2010 SABLETEL LIMITED DRAFT FINANCIAL STATEMENTS****Additional Information**

Since 2008, the financial statements for SableTel have been prepared using International Financial Reporting Standards (IFRS) in order to consolidate with its parent company, StarNova. StarNova has been preparing IFRS financial statements since 2008 in order to access global capital markets.

Note 1 - Revenue

	<u>2010</u>	<u>2009</u>
Long-distance	\$ 28,050,628	\$ 33,069,103
Local access	24,567,800	23,679,870
Mobile	4,238,967	3,963,200
Internet and data services	3,789,070	2,896,739
Internet and data services – routers and modems	1,675,759	1,567,830
Government grant (see below)	<u>2,750,000</u>	<u>–</u>
	<u>\$ 65,072,224</u>	<u>\$ 65,176,742</u>

During the year, SableTel received \$2,750,000 from Industry Canada (IC) to assist with the development of its Wireless Technology Project. Once the project is complete, SableTel must share its technology with IC. IC will then formally approve the technology and will use the technology to support its own wireless initiatives.

Note 2 - Cost of sales

	<u>2010</u>	<u>2009</u>
Long-distance	\$ 11,943,020	\$ 12,561,728
Local access	11,067,818	10,684,562
Mobile	2,204,529	2,087,618
Internet and data services	1,002,159	795,119
Internet and data services – routers and modems	679,859	619,870
CRTC Fee	<u>3,817,484</u>	<u>3,842,785</u>
	<u>\$ 30,714,869</u>	<u>\$ 30,591,682</u>

Included in long-distance expenses is \$897,500 (2009 – \$788,000) that was paid to a US supplier for infrastructure charges and \$1,357,850 (2009 – \$1,458,760) paid to a related party for telecommunication distribution services.

EXHIBIT III (continued)**EXCERPTS FROM 2010 SABLETEL LIMITED DRAFT FINANCIAL STATEMENTS**

Note 3 - Inventory

Inventory consists of routers and modems that SableTel typically sells to end users to support its Internet and data services. Inventory is carried at cost. SableTel realizes a gross margin of approximately 60% on these items. Inventory tends to have a short life (typically 12 months) because of rapid technological change. In September 2009, SableTel paid \$2.5 million for inventory, which it purchased at a substantial discount. SableTel has not provided for obsolescence in the inventory balance at August 31, 2009 or 2010 because on an overall basis the inventory is still generating a profit.

Note 4 - Intangible assets

	2010	2009
Software	\$ 1,593,459	\$ 1,654,530
Deferred research and development costs (Note 5)	9,160,250	—
	<u>\$ 10,753,709</u>	<u>\$ 1,654,530</u>

Note 5 - Research and Development

Research and development (R&D) expenditures include projects in process that may or may not become commercially viable. All research and development costs are expensed as incurred in Administration on the Statement of Comprehensive Income unless they have been capitalized as noted below.

The largest project is the Wireless Technology Project, which is expected to improve margins by 5% for all products and services due to more efficient distribution methods. In 2010, management declared its intention to carry this project to market. All costs associated with this project are now being capitalized. In 2010, \$5,702,390 was spent on this project, and the entire amount was capitalized. As well, costs of \$3,457,860 that were originally expensed in 2009 were reversed and capitalized in 2010.

Note 6 - Hurricane Baylee

On August 24, 2010, a Class 4 hurricane (Hurricane Baylee) devastated the south shore of Nova Scotia. Sixty of SableTel's 340 communication towers were damaged, disabling the entire mobile network. Each tower had a carrying value of \$35,000. SableTel is currently assessing whether the mobile network can be fixed. It is also contemplating replacing the entire tower system with a faster system. While these assessments are ongoing, no accounting adjustments have been made. Revenues from the mobile network will be negligible until it is restored.

EXHIBIT IV**FURTHER INFORMATION ABOUT THE TELECOMMUNICATIONS INDUSTRY**

The telecommunications industry in Canada is dominated by three major public companies, each with large investments in infrastructure across the country. There are also many regional operators, like SableTel, that provide services to residents regionally. Regional operators pay a fee to one of the “big three” operators for the right to access their infrastructure.

Telecommunications Industry Ratios (Regional Operators Only)

	2010	2009
Profitability ratios		
Return on equity	9.6%	10.5%
Margin analysis		
Gross profit	52.2%	53.0%
Selling, marketing and administration	40.5%	40.3%
Operating profit	11.7%	12.7%
Turnover		
Accounts receivable turnover	6.7×	6.9×
Short-term liquidity		
Current ratio	0.8×	0.8×
Long-term solvency		
Operating profit/interest expense	8.1×	8.3×
Growth over prior year		
Revenue growth *	(2.6%)	(3.2%)

* Industry analysts expect revenue to grow by 1.5% in 2011.

EXHIBIT IV (continued)**FURTHER INFORMATION ABOUT THE TELECOMMUNICATIONS INDUSTRY****Canadian Radio-television and Telecommunications Commission (CRTC)**

As defined in the table below, SableTel, like all other telecommunication companies, is required to contribute a percentage of its adjusted margin (the Fee) to a fund administered by the CRTC. The Fee subsidizes services to rural and remote regions of Canada. On September 1, 2008, the calculation of the Fee changed in an effort to better balance the cost of the Fee with the services subsidized.

Description	Until August 31, 2008	After August 31, 2008
Revenue	100% of revenue.	100% of net Canadian telecommunications revenue (after any discounts) from long-distance, local access and mobile services. Related-party revenue is excluded.
Less: Qualifying costs	Qualifying costs are amounts paid that are directly attributable to providing telecommunications services to customers.	Qualifying costs are defined as cost of sales associated with long-distance, local access, and mobile services. Costs paid to non-Canadian entities and related parties are excluded from this calculation.
Add: 200% of the negative margin for any customers with a negative margin	Negative margin customers are defined as customers where any product is priced below cost.	No change.
Fee rate	10%	12%

Fees, along with supporting calculations, are due three months following the year-end.

EXHIBIT V

LETTER RECEIVED FROM CRTC

September 5, 2010

Third Notice

Mr. Dan Wilson, CEO
SableTel Limited
2435 Highwayman Road
Westbrook, NS B4D 1H4

Regarding: Violations of CRTC Regulations

Mr. Wilson:

This letter is to inform you of our intention to revoke your operating licence based on your continuing failure to comply with CRTC regulations regarding your 2009 CRTC Fee. Your licence will be revoked on November 30, 2010, if you do not provide us with the following:

1. Submission of your revised 2009 CRTC Fee calculation.
2. Submission of your 2010 CRTC Fee calculation.
3. Payment of all amounts owing for 2009 and 2010.

Should you have any questions, you may reach us at the number provided below.

Sincerely,

Ima Bulldog
Assessment Manager
1-888-555-1234
CRTC

EXHIBIT VI**INFORMATION REGARDING SABLETEL'S 2010 DRAFT CRTC SUBMISSION**

SableTel's 2009 Fee calculation (submitted to the CRTC on June 6, 2010) and the draft 2010 Fee calculation are as follows:

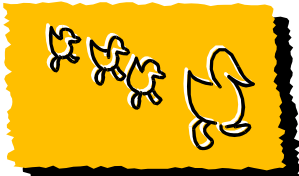
	2010	2009
Revenue	\$ 65,072,224	\$ 65,176,742
Less: Qualifying costs	26,897,386	26,748,892
Add: 200% of negative margin customers	0	0
Base as calculated	38,174,838	38,427,850
CRTC Fee rate	10%	10%
CRTC Fee	<u>\$ 3,817,484</u>	<u>\$ 3,842,785</u>

The information technology (IT) department produced a margin report on a per-customer and a per-product basis for the Finance department from the Finance database. The report showed that there were several customers with negative margins, that totalled \$1,130,000 for the 2010 fiscal year. This report was reviewed by the Marketing department, which used its own database to produce a similar report. The Marketing report showed no negative-margin customers, and this report was used in the CRTC Fee calculation. In explaining the discrepancy, IT said that the difference is in the databases, but they were not sure why the databases differed.

EXHIBIT VII

PRESENTATION FROM DAN WILSON

The following presentation of the 2010 financial results and the 2011 strategic plan for SableTel was given to StarNova's EC on September 13, 2010, by Dan Wilson, CEO of SableTel. After each slide there are notes regarding discussions that ensued between Dan and the EC.

<p>SABLETEL LIMITED EXECUTIVE SUMMARY <i>HAVING OUR DUCKS IN A ROW</i></p> <ul style="list-style-type: none">○ Return to profitable operations in 2010○ In 2011 a further \$20 million will be spent on the Wireless Technology Project○ 2011 budgeted revenue – \$75.4 million○ 2011 budgeted profit – \$4.22 million○ 2011 required funding from StarNova – \$21 million	<p><i>2010 Financial Results</i></p> <p><i>2011 Strategic Plan</i></p>  <p>1</p>
--	---

Discussion:

EC – “Why did you choose the slogan *Having our Ducks in a Row*”?

Dan – “Having our ducks in a row contributes to our preparation for growth and prosperity following difficult times.”

EC – “How confident are you that \$20 million will be enough to complete the Wireless Technology Project?”

Dan – “That’s a great question. I am not sure how accounting came up with that number. I will have to get back to you with an answer.”

EXHIBIT VII (continued)**PRESENTATION FROM DAN WILSON****2010 FINANCIAL RESULTS**

	2010 Actual	2009 Actual
Revenue (\$000's)	65,072	65,177
Gross profit (\$000's)	34,357	34,585
Gross margin (%)	53%	53%
SM&A ⁽¹⁾ and interest (\$000's)	33,179	35,873
Profit (loss) (\$000's)	1,178	(1,288)
Key financial ratios:		
Profit as a % of revenue	1.8	(2.0)
Profit as a % of gross profit	3.4	(3.7)
Profit as a % of SM&A and interest	3.6	(3.6)

(1) SM&A – SELLING, MARKETING AND ADMINISTRATION

2

Discussion:

Dan – “I am proud to announce that SableTel generated a profit for 2010 and improved all its key financial ratios despite the difficult economy.”

EC – “Why is 2010 revenue slightly lower than 2009 revenue?”

Dan – “Revenue has decreased for two reasons. First, the sales team didn’t meet its quota because of high staff turnover. Second, and more importantly, two large customers, each with monthly recurring revenue exceeding \$25,000, were lost in June 2010. These customers have not yet been replaced, but we plan to hire additional sales staff to increase sales. On a good note, our margins are holding up pretty well.”

EC – “Why did we lose those customers?”

Dan – “I’m not sure. I believe pricing was the main issue. I haven’t spoken directly to the customers to find out what happened.”

EXHIBIT VII (continued)**PRESENTATION FROM DAN WILSON**

2010 VARIANCE ANALYSIS	
2010 vs. 2009 Actual Results	Variance (000's)
Increase in net income (2009 – loss \$1,288; 2010 profit \$1,178)	\$ 2,466
Sales decrease	(105)
Cost of sales increase	(123)
Expenses decrease	2,784
Other variance (net)	(90)
Total variance explained	2,466
Unexplained variance	\$ 0

3

Discussion:

EC – “I see that overall expenses have declined, which on the surface is a good thing. Can you provide me with further details regarding what specific expenses were reduced?”

Dan – “I understand from our Marketing department that the reduction is the result of their cost containment.”

EC – “Do you know what accounts for the Other variance of \$90,000?”

Dan – “I think it may be made up of many smaller expense items such as lower depreciation charges, but I will check and get back to you.”

EXHIBIT VII (continued)

PRESENTATION FROM DAN WILSON

<p>Information Technology (IT)</p> <ul style="list-style-type: none">○ Goal – To introduce new technology to reduce cost of sales<ul style="list-style-type: none">• Completion of the Wireless Technology Project to improve margins by 5%• Implementation date – January 1, 2012• IT will focus all of its resources on this project in 2011 <hr/> <p>Human Resources</p> <ul style="list-style-type: none">○ Goal – Increase retention of existing employees<ul style="list-style-type: none">• Introduce new executive bonus plan in 2011 to ensure we retain our top talent	<p>SableTel 2011 Strategic Plan</p> <p>4</p>
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Discussion:

EC – “Does the IT department have the resources it needs to complete the Wireless Technology Project on a timely basis?”

Dan – “Yes I think they have all the brain power they need. They just need the money to complete the project. Without the financial support of StarNova we would not be able to proceed.”

EC – “How sound is the technology supporting this project?”

Dan – “We are currently waiting for a third-party feasibility assessment of the project which we expect within the next 60 days.”

EC – “How many employees will be covered by the new executive bonus plan, and how much are you expecting it to cost?”

Dan – “The plan will cover seven employees. The total bonus could range anywhere from \$500,000 to \$1,000,000 based on our future profitability.”

EXHIBIT VII (continued)

PRESENTATION FROM DAN WILSON

<p>Customer Service</p> <ul style="list-style-type: none"> ○ Goal – To increase customer satisfaction <ul style="list-style-type: none"> • The customer service department will visit 20% of all customers on a yearly basis. As a result, all customers will be visited once every five years (on a rotation) • Customer service staff will increase from 55 to 70 <hr/> <p>Sales</p> <ul style="list-style-type: none"> ○ Goal – To increase sales by 15% in 2011 and 10% in 2012 <ul style="list-style-type: none"> • 16 additional sales staff will be hired (bringing the total sales staff to 120) • Each sales person will be given a higher sales quota 	<p>SableTel 2011 Strategic Plan</p> <div style="position: absolute; bottom: 10px; right: 10px; background-color: orange; color: white; border-radius: 50%; width: 30px; height: 30px; display: flex; align-items: center; justify-content: center;">5</div>
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Discussion:

EC – “How many customers does SableTel have? How will you decide which customers to visit first?”

Dan – “Currently SableTel serves approximately 25,000 customers. Revenue from each of the largest customers is approximately \$300,000 annually. Smaller customers provide annual revenue of \$1,000 each. Customer service staff will first visit any customers that are close to our main office to keep travel costs down.”

EC – “How do you plan to increase sales as budgeted?”

Dan – “To meet targets, sales staff will be given higher quotas. Senior sales staff will be asked to lead by example, and hopefully when they are successful, there will be a trickledown effect.”

EC – “How do the wages paid to the sales force compare with industry norms?”

Dan – “Our salespeople are paid a base salary of \$45,000 per year. If they meet their quota, they can earn up to \$85,000 per year including commissions. Comparable positions in the industry are paid a base salary of \$65,000 plus commissions. I believe that keeping our sales force motivated to earn commissions through a lower base salary encourages them to make more sales.”

EXHIBIT VII (continued)

PRESENTATION FROM DAN WILSON

<p>Marketing</p> <ul style="list-style-type: none">○ Goal #1 – 60% gross margin<ul style="list-style-type: none">• 60% will be used for all standard pricing• Implementation of a “non-standard pricing policy” that will be used under specific circumstances○ Goal #2 – Increase cross-selling<ul style="list-style-type: none">• Insert a targeted advertising flyer with monthly invoices to cross-sell products and services – \$450,000 required to modify billing software <hr/> <p>Finance</p> <ul style="list-style-type: none">○ Goal – Increase profitability<ul style="list-style-type: none">• See budget (attached)	<p>SableTel 2011 Strategic Plan</p>
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6

Discussion:

EC – “Can you explain the non-standard pricing policy?”

Dan – “This policy will allow discounts to be offered to larger, higher-volume customers. Non-standard pricing requests will be approved by the Vice-President Marketing. Discounts could range from 1% to 15%. We expect to make up these discounts through increased sales volume.”

EC – “How will the cross-selling program increase sales?”

Dan – “Our IT department will develop software that will allow us to identify trends in phone, data, and Internet usage so we can make sales based on each customer’s habits.”

EXHIBIT VII (continued)

PRESENTATION FROM DAN WILSON

BUDGETED FINANCIAL INFORMATION		
	2010 Actual (000's)	2011 Budget (000's)
Revenue	\$ 65,072	\$ 75,400
Gross profit	34,357	41,470
Gross margin %	53%	55%
SM&A and interest	33,179	37,250
Profit	1,178	4,220
Add back: Depreciation and amortization (included above)	10,790	7,500
Less: Capital expenditures	(19,858)	(32,000)
Cash flow	(7,890)	(20,280)
Financing requested	N/A	21,000

7

Discussion:

EC – “Why is there a significant increase in Selling, marketing, administration and interest expenses for 2011?”

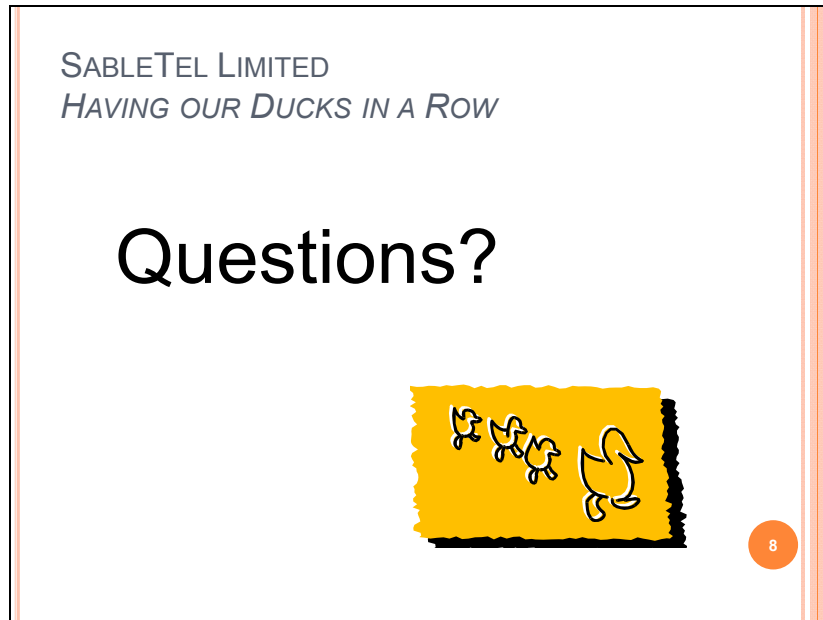
Dan – “We have budgeted an inflationary increase of 2% for 2011. Plus we anticipate hiring 31 additional employees.”

EC – “Where are the costs associated with the Wireless Technology Project?”

Dan – “In 2011, the \$20 million of expenditures will all be capitalized.”

EXHIBIT VII (continued)

PRESENTATION FROM DAN WILSON



Discussion:

EC – “What information is provided to the Vice-Presidents for them to execute the strategic plan?”

Dan – “They receive all the information required to complete their functions. Marketing receives product margin information. Finance monitors budget and actual financial results. Sales gets monthly sales. Human Resources receives staff-count information. As a result each department will focus on accomplishing its individual goals. Information resides in various departmental folders on the file server. IT has estimated that it would cost \$50,000 to provide cross-functional access to the files. However, the cost of this project is not justified given my belief that access to information should be restricted.”

EC – “Are there any regulatory or legal issues that we should be aware of?”

Dan – “We received a letter from the CRTC asking us to resubmit our Fee calculation for last year. I will send the EC a copy of the letter following this meeting.

“As well, we received a reassessment from the Canada Revenue Agency (CRA) on July 15, 2010. The reassessment relates to losses that we utilized in 2008 to offset taxes payable. On January 1, 2008, SableTel acquired all the shares of an inactive shell company, Spacolli Enterprises Inc. (Spacolli), a former cell phone manufacturer and distributor. The two corporations were amalgamated that day. Spacolli had \$500,000 in unutilized non-capital tax losses. SableTel used these losses to save \$160,000 of taxes in 2008. The CRA has denied these losses but I am not sure why or if there is anything we can do about it.”

EVALUATION GUIDE
COMPREHENSIVE SIMULATION — SABLETEL
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source of GAAP.

Memo to: StarNova Executive Committee
From: CA
Subject: SableTel's 2010 Year-End and 2011 Strategic Plan

As requested, I have assessed the strategic plan as formulated by the CEO of SableTel, Dan Wilson. I have also identified issues associated with the 2010 financial results and I have assessed the financial condition and future prospects of SableTel.

Primary Indicator #1

The candidate provides an audit plan, recalculates the CRTC Fee, and provides auditing procedures to test the accuracy of the Fee calculation.

The candidate demonstrates competence in Assurance.

Competencies

VI-1 – Analyzes, evaluates and advises on assurance needs (A)

VI-2.2 – Evaluates the implications of key risks and business issues for the assignments (A)

VI-2.4 – Develops guidelines to set the extent of assurance work, based on the scope and expectations of the assignment (A)

VI-2.5 – Designs appropriate procedures based on the assignment's scope, risk and materiality guidelines (A)

VI-2.10 – Prepares information for meetings with stakeholders (A)

SableTel has received a letter from the CRTC, which has threatened to revoke its operating licence based on the 2009 CRTC Fee as calculated by SableTel. The letter, dated September 5, 2010, requires SableTel to recalculate and submit its 2009 Fee, as well as calculate and submit its 2010 Fee by November 30, 2010. Since SableTel cannot operate without a licence, this matter requires my immediate attention. John McReynolds has specifically asked me to carry out this work, further emphasizing its importance.

I have been asked to plan an audit of SableTel's 2009 CRTC resubmission and 2010 CRTC submission, including a preliminary estimate of the error, a risk analysis, and a description of procedures that will need to be performed. I have not been asked to perform the procedures because they will be carried out by the internal audit group of StarNova.

The CRTC requires telecommunications companies to contribute a portion of their adjusted margin to a fund administered by the CRTC. The CRTC changed the calculations associated with this Fee on September 1, 2008. It would appear that SableTel did not change the way that it calculated this Fee and therefore is in violation of the CRTC agreement based on its 2009 submission. Its calculations and submission have been based on the rules in effect before September 1, 2008.

(Candidates clearly recognized that SableTel's calculation of the CRTC fee contained errors and attempted to address John McReynolds' requests.)

Overall Risk

The risk associated with this engagement is high because the CRTC licence is required in order for SableTel to continue operations. Should SableTel submit an inaccurate or incomplete Fee, there is a significant risk that the CRTC will revoke its operating licence, forcing SableTel to shut down its business (at least temporarily).

Preliminary Materiality

Given the sensitive nature of this engagement, the overall high risk associated with the engagement, and the scrutiny that this engagement will receive from its key users (the CRTC and the EC), preliminary materiality should be set at a low level. I will determine preliminary materiality based on 1% of the 2009 Fee as originally calculated by SableTel. One percent of \$3,842,785 is \$38,428. Materiality will be initially set at \$38,000 and should be reviewed during the engagement to ensure it is still appropriate.

Approach/Understanding the Environment

The approach to the assurance regarding the components of the CRTC Fee can be a combination of substantive and compliance procedures. The use of compliance testing will be tempered with the knowledge that there are discrepancies between the Finance and Marketing customer databases. Tests will need to be designed to determine if these systems feed into the general ledger, and if they do, whether the systems are accurate.

First, an accurate and full understanding of the rules for the calculation will need to be determined. The information that is available must be verified with documentation from the CRTC that defines the calculation. It is likely that there is signed communication from the CRTC that will explain the impact of the changes to the calculation to SableTel. If not, we can contact the CRTC to ensure we use the most up-to-date information. It may also be advisable to confirm with the CRTC whether the calculation should be based on financial information using International Financial Reporting Standards or another appropriate basis of accounting, such as Accounting Standards for Private Enterprises.

It is also possible that the internal audit group has performed an analysis on the systems at SableTel that may be useful for this engagement so as to avoid unnecessary duplication of testing.

Internal audit should perform a detailed review of the systems and controls over the data used in the calculation and perform walkthroughs of the key controls. Since the 2009 financial statements were audited (at the group level), there is already some assurance that the financial accounting systems are producing accurate results. However, the systems may have been audited only at the group level (with a much higher materiality), so this may not provide a great deal of comfort regarding SableTel's systems.

(Virtually all candidates addressed the risk of the engagement and recognized the gravity of SableTel losing its operating licence. Most of the risk factors discussed were valid and supported with case facts. However, the only audit planning issue most candidates discussed was engagement risk. Some candidates went on to calculate a preliminary materiality level for the engagement and discussed some of the factors that would affect the audit approach, such as the discrepancies noted in the different databases, but only a minority did so.)

(Some candidates seemed to misinterpret the case facts or misunderstand their role since they raised a non-existent independence issue with respect to the engagement. The Board cautions candidates to take the necessary time to fully understand the context of the simulation before beginning to respond.)

Preliminary Estimate of Error

We have been asked by John to determine a preliminary estimate of the error. This calculation is based on preliminary information and the main purpose of this calculation is to determine if a material misstatement is likely. This may influence the remaining planning activities for the engagement and may also influence the audit procedures suggested.

Description of Input	2010 Calculation	2009 Calculation
Revenue from long-distance, local, and mobile services (see Note 1 to the financial statements)	\$ 56,857,395	\$ 60,712,173
Less: Related-party revenue (assume = \$0)	0	0
Less: Qualifying costs (see Note 2 to the financial statements)	(25,215,367)	(25,333,908)
Add: Fees paid to non-Canadian entities (see Note 2 to the financial statements)	897,500	788,000
Add: 200% of negative margin customers (assume that the finance database is correct and assume 2009 = \$0)	2,260,000	0
Add: Related-party costs (see Note 2 to the financial statements)	1,357,850	1,458,760
Fee base	36,157,378	37,625,025
Contribution rate	12%	12%
Preliminary fee calculation	4,338,885	4,515,003
Fee as calculated	3,817,484	3,842,785
Adjustment required	\$ 521,401	\$ 672,218

From the above calculations it is apparent that the Fee as calculated is materially misstated. Adjustments will be required to the submission based on our preliminary estimate of the error. In addition, SableTel's 2009 financial statements are likely materially misstated. These will need to be corrected, and we should determine whether SableTel's statements are provided to any external users. Thankfully, this error should not have a material impact on StarNova: the company's annual revenue exceeds \$800 million, so StarNova's 2009 financial statements are not materially misstated.

(Most candidates were able to apply the new formula correctly, calculate a revised fee, and estimate the amount of the error. However, the Board was disappointed to see some candidates making careless errors, such as including all types of revenue or making unsupported assumptions, such as assuming that the related party costs have related party revenues associated with them.)

Specific Risks and Procedures

The internal audit group would need to perform many audit procedures to ensure that the CRTC Fee calculations are not materially misstated. Many of these procedures would be similar to any audit engagement, and the internal audit group would likely have standard audit programs for these procedures. In addition to these standard procedures, the internal audit group should perform the following procedures, which have been tailored to this unique engagement:

Risk Areas	Assertion	Specific Risks	Procedures/Extent
Qualifying Revenue	Classification	Revenue includes services not included in the CRTC calculation.	The formula specifies that only revenue associated with long-distance, local access, and mobile services needs to be included in the calculation. It would appear as though SableTel's general ledger (based on Note 1 to the financial statements) can track revenue in this fashion. The internal audit team will need to test a sample of the revenue to source documentation to ensure the system is accurately tracking revenues by product line.
	Classification	Related party revenue is incorrectly included in the calculation.	The amount of revenue received from related parties will need to be determined to ensure that it is properly excluded. The starting point will be any working papers prepared for the external auditors and the preparation of the financial statements at year-end. The internal audit team will need to determine the definition of related parties for regulatory purposes to verify if the same companies that were considered related parties for financial statement purposes are considered related parties for regulatory purposes. Note that this is a new exclusion as of September 1, 2008, and therefore is a high risk area of the audit.
Qualifying Costs	Accuracy	Foreign exchange amounts have not been properly calculated.	There is evidence that some of the purchases have been made in US dollars. The internal audit team needs to test these purchases, and any balances outstanding at year-end, to ensure the amounts have been translated into Canadian dollars using the appropriate exchange rates and to ensure the resulting foreign exchange gain or loss has been properly recorded.

	Classification	All non-Canadian costs are not captured.	<p>The internal audit team will need to determine if there are any transactions with non-Canadian entities. First, they will need to determine the definition of non-resident entities for regulatory purposes. Then they can scan the purchase documents or disbursement journals for any amounts paid to non-residents.</p> <p>They could then ask for a report based on the addresses of payees from the payables system, because the address would be a good indication of where the payee is resident. The report would show all payments to all payees with non-Canadian addresses. They could test the accuracy of the report through a sample. They could also ask management in charge of the purchasing function if there are other suppliers that are non-resident that are not on the report, or if there are payees on the report that are resident in Canada but that have a non-Canadian mailing address for some reason.</p>
	Classification	All related party costs are not captured.	<p>Finally, the internal audit team should determine what costs included in the qualifying costs above were paid to related parties. They can use the list of related parties that was generated for the sales testing to identify the appropriate related parties. Then they can exclude these costs from the calculation. During the revenue testing (above), there should be a comprehensive list of related parties documented. This list should be used to test for additional related party costs. The source documents, such as a purchase journal or similar document, could be scanned for related party purchases.</p>
Negative Margin Customers	Accuracy	Negative margin customers — the general ledger is not reflecting the underlying entries of the proper database.	<p>Test the accuracy of the upload from the billing system into the general ledger. It is possible that there are some inaccuracies, given the discrepancies in the databases for the negative margin customers, so additional work may need to be performed to ensure that the uploads are accurate. Select a sample of invoices from the billing system and trace them through to the general ledger to ensure they are recorded properly.</p>

	Accuracy	Negative margin customers are not identified or are recorded inappropriately.	<p>Testing negative margin customers will be difficult. There are already indications that discrepancies exist between the database used by Marketing and the database used by Finance. Therefore, it is unlikely that the internal audit team will be able to rely on the systems and must use a substantive approach.</p> <p>The first step may be to review the agreement with the CRTC to clarify what amounts are considered negative margin amounts for purposes of the CRTC calculation.</p> <p>Select a sample of inputs into each database and trace the amounts back to source documentation. This procedure will attempt to verify if one of the databases is accurate by performing manual recalculations on a sample basis. If one of the databases proves to be reliable using the sample, then this is the system that should be used for further testing.</p>
Fee rate	Accuracy	Arithmetical errors are included in the Fee calculation.	Test the overall mechanical accuracy of the Fee calculation and ensure that the proper calculations have been made by tracing the amounts back to the definitions in the agreement. Ensure the new rate of 12% is included in the calculations and not the old rate of 10%.

(Most candidates attempted to provide valid procedures but many fell short in this regard. Where most candidates faltered was in providing procedures that were specific to this engagement. Candidates should have focused on the areas of risk based on the errors committed by SableTel in their initial submission. For example, revenue is a significant component of the formula, so it will need to be audited. But more specifically, there is a significant risk with regards to the classification of revenue. Based on the new formula, only certain types of revenue are to be included, whereas SableTel has continued to incorrectly include all revenue. As a result, it would be important to perform procedures to test that types of revenue are properly classified. Instead of zeroing in on the elements of the CRTC formula and the significant risks involved, some candidates only provided generic procedures that would apply to virtually any engagement. For example, instead of trying to test the classification of revenue, they focused on testing revenue cutoff when there were no facts presented in the case to indicate that cutoff was an issue for SableTel.)

For Primary Indicator #1 (Assurance) the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.0%
Nominal competence — The candidate does not attain the standard of reaching competence.	6.7%
Reaching competence — The candidate discusses some of the audit issues surrounding the CRTC Fee calculation.	41.5%
Competent — The candidate discusses audit planning issues or makes a reasonable recalculation of the Fee AND provides some relevant audit procedures.	51.5%
Highly competent — The candidate discusses audit planning issues, makes a reasonable recalculation of the Fee, and provides several relevant audit procedures.	0.3%

(Candidates were asked to prepare an audit plan for SableTel's CRTC submission. They were asked to include a preliminary estimate of the error, a risk analysis, and a description of procedures that would need to be performed. To demonstrate competence, candidates were expected to provide some relevant procedures that would help the internal audit group audit the CRTC submission, and to either recalculate the CRTC Fee or discuss some of the planning issues with regards to the engagement.)

(Most candidates recognized the errors that had been made in SableTel's calculation of the CRTC Fee, and recalculated the Fee using the new formula and the appropriate amounts to determine a preliminary estimate of the error. Candidates who addressed the planning issues related to this engagement were also able to identify what factors affect risk, what materiality should be, and what approach should be used. Candidates sometimes struggled to provide specific and relevant audit procedures. Some candidates failed to focus on the specific risks involved in the audit of the submission, and instead provided generic procedures that would apply to any audit engagement. Candidates who used case facts to tailor their procedures to this particular situation had stronger responses.)

Primary Indicator #2

The candidate discusses the significant accounting issues related to the 2010 financial statements.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies

V-2.2 – Develops or evaluates accounting policies in accordance with GAAP (A)

V-2.5 – Prepares financial statements using the identified basis of accounting (A)

I have identified the following accounting issues with respect to SableTel's 2010 financial statements and, where possible, I have estimated the misstatement. I have adjusted the financial statements as presented to better reflect the actual financial condition and financial results of SableTel for its 2010 fiscal year.

Inventory — Obsolescence Provision

Guidance for accounting for inventory can be found in IAS 2 — *Inventories*. Inventory shall be measured at the lower of cost and net realizable value.

Inventory at SableTel consists of routers and modems that SableTel sells to its customers. Total inventory at August 31, 2010, had a book value of \$3,219,431. The continuity of the inventory for the 2010 fiscal year can be presented as follows:

Inventory — Opening	\$ 883,318
Purchases — Discounted Product	2,500,000
Purchases — Other (Regular)	515,972
Cost of Sales — Routers and Modems	(679,859)
Inventory — Closing	<u>\$ 3,219,431</u>

The inventory level at year-end would appear to be extremely high and may require a writedown. According to IAS 2, paragraph 28, *“the cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined.”* The main reason for the substantial increase in inventory relates to the \$2,500,000 of inventory that was purchased in September 2009. Given that the inventory tends to have a short life (typically 12 months), it is not clear why SableTel would purchase such a large quantity of inventory since its annual sales do not justify such a large purchase. It is now 12 months after this discounted product was purchased, so it is likely that much of this inventory can no longer be sold.

Sales of routers and modems for the 2010 fiscal year totalled \$1,675,759. The costs associated with these sales totalled \$679,859. Assuming similar sales in future years, SableTel has inventory on hand at August 31, 2010, that represents 4.74 years of sales ($\$3,219,431 \div \$679,859$). Given that these items have a short life (typically 12 months), a portion of the inventory is likely obsolete and requires a writedown. Further details would need to be gathered regarding the specific inventory items to determine an accurate obsolescence provision, but as an initial estimate, we could assume that items representing sales greater than one year will likely require a writedown. Therefore, the estimated obsolescence provision is \$2,539,572 ($\$3,219,431 - \$679,859$). SableTel should reduce its inventory balance on the financial statements by \$2,539,572 and increase its cost of sales by a similar amount (see the adjusted financial statements below).

(This issue was generally well done by candidates. The majority of candidates concluded that an obsolescence provision was needed and adjusted the financial statements accordingly. Where the quality of discussions varied was in the explanation of why a provision was needed. Some candidates reasoned that a writedown was needed simply because there was a large amount of inventory at year-end. However, there were much stronger arguments to support a writedown, such as the amount of inventory on hand compared to average sales or the short life of the goods.)

Deferred Research and Development Costs

Guidance for research and development costs can be found in IAS 38 — *Intangible Assets*

Deferred research and development costs represent costs associated with the Wireless Technology Project from 2009 and 2010 that have been capitalized. The amounts have been capitalized as management has “declared its intention to carry this project to market.” However, this is only one of the criteria that must be met in order for research and development costs to be capitalized.

IAS 38, paragraph 57 states:

“An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

- (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.*
- (b) its intention to complete the intangible asset and use or sell it.*
- (c) its ability to use or sell the intangible asset.*
- (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.*
- (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.*
- (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.”*

The first criterion requires that the technical feasibility be assured. Dan has indicated that SableTel is currently awaiting a third party feasibility study for this project. Therefore it is unlikely that this criterion has been met at year-end.

The second criterion requires an intention to complete the intangible asset. Management has indicated that they intend to complete the Wireless Technology Project, so this criterion is likely met.

The next criterion requires SableTel to prove that it will use or sell the intangible asset. We can assume that this criterion is met, and the Industry Canada grant may provide further evidence supporting this criterion since Industry Canada wants to use the technology (indicating that SableTel may be able to sell the technology as well).

The fourth criterion requires management to demonstrate how the asset will generate probable future economic benefits. SableTel will use the wireless technology internally, presumably to decrease costs and increase margins. Therefore, SableTel likely meets this criterion because the technology is supposed to increase margins by 5% across all of its product lines. This would provide substantial benefits (5% of \$65 million is \$3.25 million on an annual basis). SableTel would need to provide some evidence to support this assertion. This may be available once the third party feasibility assessment has been completed.

The fifth criterion requires adequate technical, financial, and other resources to complete the project. Dan has indicated that SableTel does not currently have the financial resources to finish this project and requires funding from StarNova to complete the project. Therefore, this criterion is likely not met currently since StarNova has not committed itself to the funding. However, should SableTel be able to provide support that StarNova or some other source will fund the remainder of the project, then this criterion may be supportable.

Finally, SableTel must be able to demonstrate that it can reliably measure the expenditures attributable to the project. It is not clear if SableTel can do this. Dan has indicated that accounting came up with the \$20 million necessary to complete the project, but he is not sure how they came up with this number. As well, SableTel would also need to demonstrate that it had the necessary systems in place to track the costs associated with this project reliably. Therefore, this criterion may be met, but more information is required.

Since all six criteria must be met in order to capitalize the costs, and at least two of the criteria were likely not met at year-end, the costs cannot be capitalized and must be expensed. As a result, SableTel should reduce the deferred research and development costs from \$9,160,250 to nil and increase administration expenses by the same amount (see the adjusted financial statements below).

Even if SableTel met all of the criteria for capitalization of the development costs, it would not be able to go back to 2009 and capitalize those research and development costs in 2010. IAS 38, paragraph 71 states *“Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date.”*

From a presentation standpoint, we would also have to separate the research and development costs from the administration expenses on the statement of comprehensive income since it is a significant amount and is likely of interest to users of the financial statements.

(Candidates performed best on this accounting issue. Most candidates seemed familiar with the recognition criteria for deferred research and development costs and were able to apply them to the case facts. Where a few candidates got confused was in their conclusion, as they seemed to forget that all of the criteria needed to be met in order for the costs to be capitalized.)

Industry Canada Grant

Guidance for government assistance can be found in IAS 20 — *Accounting for government assistance and disclosure of government assistance*.

There are two issues associated with the government grant. The first issue is whether SableTel has met the criteria for recognition of the government grant. IAS 20, paragraph 7 states:

“Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

- (a) the entity will comply with the conditions attaching to them; and*
- (b) the grants will be received.”*

SableTel has received the \$2.7 million, so we can safely state that the second criterion has been met. However, it is not clear if the first criterion, related to satisfying all of the conditions attached to the grant, has been met. There is some evidence that the conditions have not been met since SableTel must share its technology with Industry Canada (IC) and IC must formally approve the technology. However, we would need to gather further details relating to the grant in order to determine whether the first criterion has been met and, as a result, whether the amount can be recognized.

Assuming that the above two criteria have been met, the second issue regarding the government grant relates to its presentation. IAS 20, paragraph 24 states:

“Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.”

This government grant relates to the Wireless Technology Project. This project was initially recorded as an intangible asset. If the Wireless Technology Project was still recorded as an asset then SableTel would need to reverse the amount as revenue and record the amount as either deferred income or by deducting the amount from the carrying value of the Wireless Technology Project.

However, due to the adjustment proposed above (see Deferred Research and Development Costs), the Wireless Technology Project is now expensed as administration on the statement of comprehensive income. The presentation of grants related to income is discussed in IAS 20, paragraph 29, which states:

“Grants related to income are sometimes presented as a credit in the statement of comprehensive income, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense.”

I would recommend that the amount be recorded as a reduction of the related expense because it is clearly attributable to these expenditures. Therefore, the amount should be removed from revenue and recorded as a reduction of the research and development expenses (administration expenses) on the statement of comprehensive income (see the adjusted financial statements below). Note that the adjustment will have no net effect on the profit (loss) of SableTel. IAS 20, paragraph 12 states, *“Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.”* Therefore, the reduction of the expense should be recognized in proportion to the costs incurred in 2009, 2010, and the future.

(Most candidates did a good job of analyzing this accounting issue by either discussing whether the grant could be recognized by SableTel or by explaining how the grant should be recognized in the financial statements. The Board was pleased to see that many candidates linked their discussions of the proposed accounting treatment of the grant with the conclusion they had reached with regards to the recognition of the deferred research and development costs. This is the type of integration that the Board likes to see.)

Impairment of Mobile Network

Guidance for the impairment of assets can be found in IAS 36 — *Impairment of assets*.

In August 2010, Hurricane Baylee damaged several of the communication towers associated with SableTel's mobile network, disabling the entire network. In total, 60 of the 340 towers were damaged. Each tower has a carrying value of \$35,000.

SableTel must determine whether the communication towers require a writedown at year-end.

IAS 36, paragraph 9 states:

"An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset."

Clearly there is an indication that the assets may be impaired since the towers have been damaged. Therefore, SableTel should estimate the recoverable amount.

IAS 36, paragraph 18 states:

"This Standard defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use."

IAS 36, paragraph 22 states:

"Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 65–103), unless either:

- (a) the asset's fair value less costs to sell is higher than its carrying amount; or*
- (b) the asset's value in use can be estimated to be close to its fair value less costs to sell and fair value less costs to sell can be determined."*

It would appear from the facts of the case that the towers, as a whole, make up a cash-generating unit because the entire mobile network has been disabled by the damage to 60 of the towers. Therefore, it may be necessary to estimate the recoverable amount for the entire mobile network (the 340 communication towers) and not just the 60 towers that have been damaged.

IAS 36, paragraphs 66 and 67 state:

Paragraph 66 — “If there is any indication that an asset may be impaired, a recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset’s cash-generating unit).”

Paragraph 67 — “The recoverable amount of an individual asset cannot be determined if:

- (a) the asset’s value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and*
- (b) the asset does not generate cash inflows that are largely independent of those from other assets.*

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset’s cash-generating unit.”

As stated above, there are two possible ways to determine an asset’s (or group of assets’) recoverable amount. The first is to determine the asset’s fair value less costs to sell. We do not have a lot of information to determine this amount, but it is unlikely that SableTel could sell the damaged towers for any significant amount. As well, there is no indication that SableTel could sell its entire mobile network, but it is possible that another telecom company would want this network. The mobile network in its current state has no value because the entire mobile network has been disabled. It is important to note that the value in use is generally determined by its estimated future cash flows in its *current condition*. Therefore, SableTel’s decision to fix or replace the network is irrelevant. IAS 36, paragraph 44 states:

“Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

- (a) a future restructuring to which an entity is not yet committed; or*
- (b) improving or enhancing the asset’s performance.”*

Note that it is possible that all 340 towers and the entire mobile system (the cash-generating unit) would need to be written down to nil or the estimated recoverable amount (fair value less costs to sell) since the mobile network has no value in use based on its current condition. Further information would need to be gathered to determine the exact amount of the impairment, but as an estimate we could approximate that the recoverable amount of the 60 damaged towers is likely nil. SableTel should therefore recognize an impairment loss for this amount. The total for these sixty towers would be \$2.1 million ($60 \times \$35,000$) (see the adjusted financial statements below).

If the mobile network cannot be sold (in other words, the fair value less costs to sell is minimal) and SableTel does not plan to fix the network, then the entire network should be written down to nil. At a minimum, this amounts to \$11.9 million ($340 \text{ towers} \times \$35,000 \text{ per tower}$) for the towers, and may need to be higher if there are additional capital assets associated with the mobile network.

The impairment loss should be recorded as an impairment loss as stated in IAS 36, paragraph 59:

“If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.”

We should also determine if SableTel is likely to receive any insurance proceeds as a result of the damage to the towers. Any proceeds would reduce the loss.

Finally, once the towers are repaired or replaced, the impairment recognized can be reversed up to the extent that the value in use or the fair value of the towers after repair and replacement equals the original carrying cost (plus any betterments).

(The impairment of the mobile network was one of the complex issues in the case. The Board was not looking for perfection in this area. Rather, the Board was hoping candidates would question the value of the mobile network and use case facts to consider multiple viewpoints. Unfortunately, most candidates prematurely concluded that the 60 towers needed to be written off. Strong candidates took a step back and, in light of the circumstances, considered whether the entire network might be impaired. The Board reminds candidates that not all accounting issues are black or white. In some cases, the real value of a candidate's response is in a discussion that considers all of the possible accounting treatments and the reasons they may or may not be valid, not in a recommendation of a single treatment.)

Accounting Errors — CRTC Fee and 2009 R&D

IAS 8, paragraph 42 states, “an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.”

CRTC Fee

We have already recalculated the estimated misstatement in the 2009 and 2010 CRTC Fees. The total estimated misstatement is \$1,193,619. Of this amount, \$672,218 relates to 2009 and \$521,401 relates to 2010. The amount relating to 2009 (\$672,218) is an accounting error and, as such, should be added to accrued liabilities and should reduce the 2010 opening retained earnings. The amount for 2010 (\$521,401) should be added to cost of sales (CRTC Fee) and be added to accrued liabilities at August 31, 2010, since this amount relates to the 2010 fiscal year.

2009 R&D

The R&D expenses that were capitalized in 2009 are also considered to be an accounting error and therefore need to be treated similarly (in other words, retrospectively).

Deferred Revenue

There is no deferred revenue listed on the statement of financial position. Given the nature of the company — a telecommunications company — we would expect that some of its revenues would be billed in advance (it is typical for companies in this industry to bill a month of service in advance and, some also require substantial deposits). This should be investigated further. It is possible that this amount is buried in the “trade and other payables” line item on the statement of financial position. It is also possible that these amounts have been incorrectly recorded as revenue. Further information would need to be gathered to determine if an error exists.

(The treatment of the accounting errors and the lack of deferred revenue on the statement of financial position were minor issues, and most candidates appropriately did not address these.)

Adjusted Financial Statements

The financial statements for 2010 will require adjustment due to the cumulative material effect of the misstatements noted above. The following schedule adjusts the financial statements:

Item Description	2010 Actual F/S's (unadjusted)	Required IFRS adjustments	JEs	2010 Actual F/S's (adjusted)
Current assets				
Cash	\$ 351,018			\$ 351,018
Accounts receivable	15,864,501			15,864,501
Inventory	3,219,431	(2,539,572)	1	679,859
Total current assets	19,434,950	(2,539,572)		16,895,378
Property, plant and equipment	62,532,502	(2,100,000)	4	60,432,502
Deferred taxes	35,629			35,629
Intangible assets	10,753,709	(9,160,250)	2	1,593,459
Total assets	\$ 92,756,790	(13,799,822)		\$ 78,956,968
Current liabilities	\$ 22,265,938	1,193,619	5	\$ 23,459,557
Long-term debt	44,152,572			44,152,572
Total liabilities	66,418,510	1,193,619		67,612,129
Total shareholders' equity	26,338,280	(14,993,441)	(A),5	11,344,839
Total liabilities and shareholders' equity	\$ 92,756,790	(13,799,822)		\$ 78,956,968
Revenue	\$ 65,072,224	(2,750,000)	3	\$ 62,322,224
Cost of sales	30,714,869	3,060,973	1,5	33,775,842
Gross profit	34,357,355	(5,810,973)		28,546,382
Expenses:				
Selling and marketing	16,875,413			16,875,413
Administration	13,336,292	8,510,250	2,3,4	21,846,542
Interest expense	2,967,650			2,967,650
Total expenses	33,179,355	8,510,250		41,689,605
Profit (loss)	\$ 1,178,000	(14,321,223)	(A)	\$ (13,143,223)

The adjusted financial statements present a much different financial picture for SableTel for its 2010 fiscal year. These adjusted financial statements should be used when analyzing SableTel further.

Journal Entries (JEs)

JE #	Account Description	Debit	Credit
1	Cost of sales (routers and modems)	\$ 2,539,572	
1	Inventory To set up a provision for inventory obsolescence		\$ 2,539,572
2	Administration (R&D expenses)	\$ 9,160,250	
2	Intangible assets To reverse expenditures associated with the Wireless Technology Project that were capitalized		\$ 9,160,250
3	Revenue (government grant)	\$ 2,750,000	
3	Administration (R&D expenses) To reclassify the Industry Canada grant received during the year		\$ 2,750,000
4	Administration (impairment charge)	\$ 2,100,000	
4	Property, plant and equipment (mobile network towers) To record an impairment charge on the mobile network towers		\$ 2,100,000
5	Cost of sales (2010 CRTC Fee adjustment)	\$ 521,401	
5	Retained earnings (opening – 2009 CRTC Fee adjustment)	672,218	
5	Current liabilities (accrued liabilities) To record the estimated misstatement in the CRTC Fee for 2009 and 2010		\$ 1,193,619

(Most candidates were able to quantify the necessary accounting adjustments or explain the financial statement impact in the case where an exact number could not be determined. However, some candidates provided “one-sided” entries; in other words, they explained the impact on the statement of financial position or on the statement of comprehensive income, not both. Candidates were not expected to fully restate the financial statements and show the adjusting journal entries, as shown here. However, they were expected to fully understand the impact of the adjustments they were recommending.)

For Primary Indicator #2 (Performance Measurement and Reporting) the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	4.0%
Reaching competence — The candidate identifies some of the relevant accounting issues.	26.5%
Competent — The candidate discusses some of the relevant accounting issues and their impact on the financial statements.	68.9%
Highly competent — The candidate discusses most of the relevant accounting issues and adjusts the financial statements for most of the accounting adjustments.	0.5%

(Candidates were required to recognize that the manner in which SableTel had recorded some of its transactions was not in accordance with IFRS. While candidates were not directed explicitly to this indicator, they were presented with SableTel's financial statements as well as relevant excerpts from the notes, which provided a description of these transactions. There were a number of accounting issues associated with SableTel that candidates could have discussed, ranging from the need for an obsolescence provision for inventory to how costs incurred for the Wireless Technology Project (WTP) and the related grant received from Industry Canada should be recorded.)

(Most candidates performed well on this indicator and seemed to be comfortable applying the relevant IFRSs. In general, candidates recognized most of the accounting issues relating to SableTel and discussed them in sufficient depth. More specifically, most candidates included good discussions of deferred research and development costs related to the WTP, applying case facts to the criteria that need to be met before such costs can be capitalized. Most candidates also discussed how to recognize the related grant and realized that this discussion should be linked to their proposed treatment of the WTP costs. Finally, most candidates concluded that an obsolescence provision was needed for the large year-end inventory balance and were able to explain why.)

(The accounting issue candidates had the most difficulty with was the impairment of the mobile network. While there were several case facts provided to allow candidates to provide a generous discussion of this issue, most candidates jumped to the conclusion that the 60 damaged towers needed to be written off without considering whether the entire mobile network might be impaired as a result of the hurricane.)

Primary Indicator #3

The candidate performs a variance analysis on the 2010 financial statements.

The candidate demonstrates competence in Management Decision-Making.

Competencies*VIII-1.1 – Identifies management's information needs (B)**VIII-4.1 – Prepares, analyzes and monitors financial budgets (A)**VIII-4.3 – Analyzes and interprets budget variances (A)*

We have reviewed the variance analysis for the 2010 financial results of SableTel provided by Dan Wilson in the presentation (slide 3) that he made to StarNova's executive committee. We have noted a number of deficiencies in the variance analysis.

While the approach that was taken seems logical (explaining the difference in the bottom line between 2009 and 2010), there is no detail provided in the variance analysis and the explanations for the items contained in the analysis are inadequate.

Sales

Dan has identified a small negative variance as a result of decreased sales but has not provided any further explanation. Note 1 to the financial statements provides further relevant details on this variance. From this note we can determine the following more detailed variances:

Revenue Category	2010 Amount	2009 Amount	Variance	% Change
Long-distance	\$ 28,050,628	\$ 33,069,103	\$ (5,018,475)	(15.2%)
Local access	24,567,800	23,679,870	887,930	3.7%
Mobile	4,238,967	3,963,200	275,767	7.0%
Internet and data services	3,789,070	2,896,739	892,331	30.8%
Routers and modems	1,675,759	1,567,830	107,929	6.9%
Industry Canada grant	2,750,000	-	2,750,000	100.0%
Total	\$ 65,072,224	\$ 65,176,742	\$ (104,518)	(0.2%)

From the above analysis it is apparent that all of the revenue categories are growing except for the long-distance services. This is the largest revenue category for SableTel, and it has shrunk by more than 15% in 2010 versus 2009, which is a significant concern. As well, if the Industry Canada grant is excluded from revenue (as proposed in the adjusting journal entries above), then the overall negative variance increases to \$2,854,518, which equates to 4.4% year over year. On a positive note, the Internet and data services category grew by more than 30% in 2010.

Further relevant details would include whether these variances relate to lower sales volumes (volume variances) or a change in selling prices (pricing variances). Given the lack of a similar percentage decrease in cost of sales (noted below), we expect that most of this decrease would be related to a pricing decrease. Some of this decrease may be related to decreased volumes. Further details would need to be obtained to determine the exact breakdown of these variances.

Some possible explanations for the decreased sales volume may be the loss of key sales personnel and the high turnover in the sales department. The decreased sales may also be attributable to the loss of key customers throughout the year. Further investigation into the specific decrease in the long-distance segment should be undertaken to pinpoint the decrease.

Cost of Sales

An analysis of cost of sales, similar to the one for sales, should be provided. Note 2 to the financial statements provides relevant information on cost of sales. From this note we can determine the following more detailed variances:

Cost of Sales Category	2010 Amount	2009 Amount	Variance	% Change
Long-distance	\$ 11,943,020	\$ 12,561,728	\$ (618,708)	(4.9%)
Local access	11,067,818	10,684,562	383,256	3.6%
Mobile	2,204,529	2,087,618	116,911	5.6%
Internet and data services	1,002,159	795,119	207,040	26.0%
Routers and modems	679,859	619,870	59,989	9.7%
CRTC Fee	3,817,484	3,842,785	(25,301)	(0.7%)
Total	\$ 30,714,869	\$ 30,591,682	\$ 123,187	(0.4%)

From the above analysis we can see that costs in the long-distance segment of the business are decreasing somewhat. This is not surprising given the large decrease in revenue associated with the long-distance services. Given that both revenue and costs are decreasing in this category, we would expect that part of this variance would be the result of lost customer volumes (volume variances). However, the sales within this category decreased by 15.2% while costs decreased by only 4.9%, lending support to the assertion that the margin is shrinking as well (pricing variance).

Note that the cost of sales for the routers and modems category in the above analysis has not been increased by the \$2,539,572 representing the suggested adjustment for obsolete inventory at August 31, 2010. We have not made this adjustment because it is considered an isolated adjustment and would not provide any further meaningful information for this analysis. Similarly, the CRTC Fee has not been adjusted. If the CRTC Fee had been adjusted based on the adjustment proposed above, then the 2009 CRTC Fee would be \$4,515,003 (\$3,842,785 + \$672,218) and the 2010 Fee would be \$4,338,885 (\$3,817,484 + \$521,401), which equates to a decreased Fee of \$176,118 or 3.9%. This is reasonable given the decreased sales of 4.4% noted above.

While the individual variances for revenue and cost of sales provides some additional detailed variance information, an analysis of the gross margins for each category by product line may provide even more information. This information is readily available by combining the information in Notes 1 and Note 2 as follows:

Product Category	2010 Gross Profit	2010 Gross Margin %	2009 Gross Profit	2009 Gross Margin %	Change in Margin
Long-distance	\$ 16,107,608	57.4%	\$ 20,507,375	62.0%	(4.6) p.p.
Local access	13,499,982	54.9%	12,995,308	54.9%	0.0 p.p.
Mobile	2,034,438	48.0%	1,875,582	47.3%	0.7 p.p.
Internet and data services	2,786,911	73.6%	2,101,620	72.6%	1.0 p.p.
Routers and modems	995,900	59.4%	947,960	60.5%	(1.1) p.p.
Total	\$ 35,424,839	56.8%	\$ 38,427,845	59.0%	(2.2) p.p.

p.p. = percentage points

Note that the Industry Canada grant and the CRTC Fees are not included in the above analysis as they do not directly relate to one another and a comparison would not provide any useful information.

From the gross margin analysis we can see that the long-distance services, in addition to losing substantial revenue, have a significantly lower gross margin percentage in 2010 than in 2009. This is very troubling. For this product category, the analysis indicates that sales volumes are decreasing and costs (as a percentage of sales) are increasing.

The other product lines seem to have held their gross margins or are very close. Therefore, the significant negative variances identified can be primarily attributed to the long-distance services.

Expenses

Dan has noted that there is a positive variance of \$2,784,000 related to decreased expenses. However, no further details have been provided. Dan has indicated that this is likely due to cost containment in the marketing area.

From the draft financial statements and the related notes provided in Exhibit III we can further determine the source of this variance. From the draft income statement we can see that the variance is actually the result of positive variances in the administration expenses totalling \$3,074,953 (\$16,411,245 – \$13,336,292) offset partially by a negative variance in the selling and marketing expenses of \$291,588 (\$16,875,413 – \$16,583,825). Therefore, Dan's explanation that this variance is a result of cost containment in the marketing area is likely not accurate.

Note 5 provides further information on the administration expenses. This note indicates that \$9,160,250 of R&D expenditures have been capitalized in 2010. In prior years, R&D expenditures were expensed in the administration line item. If the R&D costs were expensed in 2010 like they had been in prior years (and as we have proposed in our adjusting journal entries), then the administration expenses in 2010 would actually have increased by \$6,085,297 (\$3,074,953 less \$9,160,250). This represents a significant increase in administration expenses over the prior year and needs to be investigated further. Certainly one explanation for this large negative variance is the increased expenditures on the Wireless Technology Project, which increased by \$2,244,530 in 2010 (\$5,702,390 in 2010 versus \$3,457,860 in 2009). This may not necessarily be a bad thing as R&D expenditures are typically made to increase sales or income many years into the future. However, this is only one part of the negative variance and the remaining negative variance should be researched further. We would need more details on the expenses for 2010 and 2009 to pinpoint additional sources of this variance.

Other Variance

Dan has explained that he believes that the other negative variance of \$90,000 is made up of "smaller expense items such as lower depreciation." However, this is not the source of the variance. The variance is made up completely of the negative variance of \$89,800 (\$2,967,650 – \$2,877,850) in interest.

Note that we used the unadjusted financial statements to perform our variance analysis in order to ensure we were comparing apples with apples. We wanted to analyze SableTel's performance year over year, not the impact of accounting treatment decisions.

We should also note that the variance analysis provided by Dan compares the 2010 results with the actual results for 2009. While this provides some meaningful information, it would also be appropriate to compare the actual results for 2010 with the budgeted results for 2010. Variances could then be calculated and explained against the approved budget for the year, which would provide StarNova with additional information on the results compared with what was expected.

(This proved to be the most challenging indicator for candidates. It should be noted that the Board was not expecting anything as comprehensive as the analysis performed above. What the Board was looking for when they developed this indicator was for candidates to use the product line detail as well as other information provided in the case to make some insightful comments about SableTel's results year over year. While some candidates rose to the occasion and provided StarNova with a very meaningful analysis, the majority of candidates struggled.)

For Primary Indicator #3 (Management Decision-Making) the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	4.6%
Nominal competence — The candidate does not attain the standard of reaching competence.	56.4%
Reaching competence — The candidate attempts to analyze areas of variance that provide relevant information to the executive committee.	25.1%
Competent — The candidate analyzes areas of variance that provide relevant information to the executive committee.	13.9%
Highly competent — The candidate analyzes the areas of variance that provide relevant information to the executive committee and recognizes that a comparison with the approved budget would provide additional meaningful information.	0.0%

(Candidates were asked to perform a more thorough analysis of the variance in results between 2010 and 2009. Candidates were expected to expand on Dan's high-level variance analysis, which did not provide any useful information to StarNova's executive committee. To demonstrate competence, candidates were required to identify some of the significant variances between the two years and provide some insight into the variance, such as why the variance occurred, why the variance was important, and how the variance could be addressed.)

(Candidates did not perform well on this indicator. Despite the directedness of the requirement, many candidates did not address this indicator. Most candidates either missed this indicator altogether, made passing comments on a variance or two as part of their work on other indicators, or deferred this work back to Dan or management for further explanation. Information provided in the simulation allowed the competent candidates to perform some meaningful variance analysis. For example, the simulation contained a breakdown of the revenue and cost of sales by product line. A comparison of revenues by product line to the prior year should have directed candidates to make more insightful comments, such as a comment on the large decrease in SableTel's most significant product line, long-distance service revenue.)

Primary Indicator #4

The candidate calculates financial ratios to determine the financial condition and operating performance of SableTel relative to its competitors.

The candidate demonstrates competence in Finance.

Competencies

VII-4.1 – Analyzes the entity's financial situation (A)

VII-2.2 – Analyzes the entity's working capital (A)

To determine the financial results and the financial condition of SableTel at August 31, 2010, we can compare certain key ratios with the industry ratios provided. Below is a comparison of the key ratios for 2010 followed by an explanation of the information that these financial ratios contain:

Financial Ratio	SableTel 2010 Actual (unadjusted)	SableTel 2010 Actual (adjusted)	SableTel 2009 Actual (unadjusted)	Industry Ratios (2010)
Profitability ratios				
Return on equity (1)	4.5%	(115.9%)	(5.1%)	9.6%
Margin analysis				
Gross margin % (2)	52.8%	45.8%	53.1%	52.2%
Selling, marketing, and administration % (3)	46.4%	62.1%	50.6%	40.5%
Operating profit % (4)	6.4%	(16.3%)	2.4%	11.7%
Turnover				
Accounts receivable turnover (5)	4.1x	3.9x	9.6x	6.7x
Short-term liquidity				
Current ratio (6)	0.9x	0.7x	1.0x	0.8x
Long-term solvency				
Operating profit/interest expense (7)	1.4x	(3.4x)	0.6x	8.1x
Growth over prior year				
Revenue growth (8)	(0.2%)	(4.4%)	Note 1	(2.6%)

Details of calculations (see numbers from financial statements in Primary Indicator #2):

- (1) Return on equity = profit ÷ total shareholders' equity
- (2) Gross margin % = gross profit ÷ revenue
- (3) Selling, marketing, and administration % = (Selling and marketing + administration) ÷ revenue
- (4) Operating profit % = operating profit (before interest) ÷ revenue
- (5) Accounts receivable turnover = revenue ÷ accounts receivable
- (6) Current ratio = current assets ÷ current liabilities
- (7) Operating profit/interest expense = operating profit (before interest) ÷ interest expense
- (8) Revenue growth = (2010 revenue ÷ 2009 revenue) – 1

Note 1: No information on 2008 revenue or net income was provided, so this ratio cannot be calculated.

The above ratio analysis indicates that SableTel is not performing as well as its peers, both from an operational (income statement) point of view and from a financial condition (balance sheet) point of view. The analysis also indicates that SableTel's financial condition has deteriorated over the past year. This assessment is based on the following:

- **Profitability Ratios** — SableTel's return on equity ratio is below the industry average, and after adjustments it is negative. This indicates that SableTel is not earning an adequate return for its shareholder (StarNova). StarNova has indicated that it typically expects all of its investments to earn a return of at least 15%. SableTel is not earning a return that is anywhere close to this percentage. As well, after the 2010 adjustments, SableTel's ratios have deteriorated significantly from 2009 due to the large loss in 2010.
- **Margin Analysis** — SableTel's margin analysis indicates that it is earning a gross margin that is slightly higher than its peers (before adjustments). This margin (before adjustments) is also similar to the prior year. However, its big problem appears to be its high SM&A percentage. This is causing SableTel to have a lower operating profit relative to the industry. SM&A expenses are 6% higher at SableTel than its peers (before adjustments) and after adjustments are almost 22% higher. This is one of the largest reasons for the poor financial results and we should investigate further why this is the case. Some of this will be due to the R&D at SableTel. Relative to the prior year, SableTel appears to have a better SM&A percentage before adjustments. However, this amount relates to the reversal of the R&D expenditures related to the Wireless Technology Project. Once these capitalized expenditures are reversed, the SM&A percentage is significantly higher in 2010 than in 2009.
- **Turnover** — SableTel is not "turning over" its accounts receivable fast enough. This is particularly true with respect to its accounts receivable in 2010, which appear to be abnormally high at August 31, 2010. This has also resulted in a turnover that is considerably worse than the prior year. SableTel appears to be tying up a significant amount of cash in its accounts receivable. If SableTel were able to increase its accounts receivable turnover to the average turnover in the industry, it would generate significant additional cash and would need to borrow less money from StarNova in order to meet the needs identified in its strategic plan. This low accounts receivable turnover may be an indication that SableTel has uncollectible accounts receivable. We would need to obtain further information to assess the amount for reasonableness and to determine if additional write-offs are required.
- **Short-Term Liquidity** — SableTel appears to meet the industry norms with respect to its current ratio. This is in part due to the high accounts receivable balance at year-end. The ratios are slightly worse than the prior year but all above the industry norms and are acceptable (before adjustments). After the adjustment to write off a portion of the inventory at year-end, the current ratio is worse than the industry average.
- **Long-Term Solvency** — Its interest coverage ratio is worse than the industry average and has deteriorated further in 2010, meaning that it may have trouble meeting its interest payments in the future. This is very troubling and indicates that, without some form of financial assistance, SableTel may not be able to meet its financing obligations in the near future.
- **Growth Ratios** — The industry has contracted over the past year and SableTel has contracted with the industry. Sales at SableTel have decreased by more than the industry (after adjustments), indicating a loss of market share as well. Note that the 2008 sales and profit figures were not available. These growth ratios should be computed over several years and trends identified and compared with the industry.

Dan's comments and the ratios presented to the StarNova executive committee are, at the very least, not informative and may even be misleading. The three ratios provided to the executive committee in Dan's presentation all essentially report the same information. All compare the net income of SableTel relative to some other balance so, since SableTel initially reported an increase in net income, appear to be better in 2010 than in 2009. However, none of the ratios presented explains anything related to the financial condition of SableTel or how SableTel compares with its peers in the industry.

To provide significantly enhanced information to the executive committee, SableTel should monitor and track some additional ratios and indicators, such as the following. These are all common indicators within the telecommunications industry:

- Churn rate — new customers ÷ customers lost
- Customer mix — % of small customers versus % of large customers
- Capex intensity — total capital expenditures ÷ total revenue

(Candidates also struggled with this indicator, but unlike the previous indicator, virtually all candidates attempted to address it. Candidates seemed to clearly understand that they were to use the ratios provided to compare SableTel with its competitors. Most candidates were able to calculate the ratios for SableTel and compare them to the industry figures provided. However, candidates seemed to be less familiar with the return on equity (ROE) and accounts receivable (A/R) turnover ratios as evidenced by errors in calculating these ratios. The next step in the analysis should have been to interpret the ratios. Unfortunately, most candidates did not push their analyses this far. The Board was disappointed because the interpretation of results could have taken many forms: an explanation of what the ratio means, the possible causes for the difference with the industry, or a suggestion as to how the ratio could be improved.)

For Primary Indicator #4 (Finance), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.6%
Nominal competence — The candidate does not attain the standard of reaching competence.	5.8%
Reaching competence — The candidate calculates relevant financial ratios for SableTel.	57.2%
Competent — The candidate calculates relevant financial ratios for SableTel and performs a meaningful analysis, comparing SableTel to the industry.	36.0%
Highly competent — The candidate calculates relevant financial ratios, including a full range of ratios related to the financial position (i.e. balance sheet) and the operations (i.e. income statement) of SableTel, and performs a meaningful analysis comparing SableTel to industry.	0.4%

(Candidates were asked for an evaluation of SableTel's operating performance relative to its competitors. To enable candidates to perform this analysis, they were provided with industry ratios for the past two years. To demonstrate competence, candidates were required to calculate some of the ratios for SableTel, compare those to the industry, and provide some value-added analysis.)

(Most candidates understood how the ratios were calculated and were able to use SableTel's financial statements to calculate some of the ratios for the company. After calculating SableTel's ratios, candidates then compared them to the industry and commented on whether SableTel's performance was better or worse than its competitors. This was a good first step; however, what was generally lacking was any type of value-added analysis. Candidates needed to step back and think about what the ratios were telling them about SableTel's operating performance.)

Primary Indicator #5

The candidate identifies weaknesses within the executive reporting document as presented and recommends improvements.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies

V-1.3 – Develops reliable information (A)

V-2.7 – Prepares or evaluates financial components of the Management Discussion and Analysis (MD&A) (B)

V-2.8 – Explains the financial statement results and balances to stakeholders (A)

The executive reporting document prepared by Dan is not informative and may in fact be misleading. The purpose of the executive reporting document is to provide meaningful, high level analyses for StarNova so that StarNova can prepare its external MD&A included in its annual report to shareholders. Therefore the information presented should be relevant for this group.

I have identified the following weaknesses in the executive reporting document:

- “[B]ased on robust revenue of \$65,072,224” — This would imply that revenue was very good in 2010. However, revenue has actually decreased from the prior year and is not “robust.” As well, \$2,750,000 of the revenue relates to a government grant. Without this revenue (which I have recommended allocating to offset expenses instead of increasing revenue in my accounting adjustments above), the revenue has actually decreased significantly.
- “Reduction in operating costs of \$2,783,365 due to cost restraint” — This statement implies that management has done a good job of controlling costs through management decisions. This is not true. The actual source of the decreased costs is a reduction in R&D expenses since these expenditures were capitalized in the current period (in prior periods these costs were expensed). In fact, we know that in general the administrative costs of SableTel are higher in 2010 than in 2009 and are significantly higher than the industry averages. As well, the administration expenses have increased by a very significant amount in 2010 after we consider the adjustments recommended above.
- “Cost of sales were contained” — While based on the cost of sales balance on the income statement this is true, it is clear that margins in the long-distance segment of the business (its most significant segment) are decreasing at a significant rate. As well, after we remove the government grant from revenue we know that overall the gross margin decreased by 2.2%. A better analysis in the executive reporting document would highlight the gross margin and compare the margin with prior years and with industry averages in order to provide meaningful explanations.

- “Strong liquidity at year-end based on liquid assets totalling \$16,215,519” — While it is true that SableTel has considerable liquid assets (cash and accounts receivable), this is primarily the result of an increase in accounts receivable that is tying up cash. It is not clear if these assets are “liquid.” The statement implies that SableTel could turn its assets into cash quickly if necessary to meet financial obligations or to take advantage of other investment opportunities. This may not be the case. For example, we know that SableTel only turns its accounts receivable into cash about four times each year. This does not imply liquidity.
- “Solid balance sheet at year-end, with equity totalling \$26,338,280” — This statement would imply that SableTel has a strong balance sheet and its financial position is strong. This is not the case at August 31, 2010. We know that SableTel has a considerable amount of debt and is relatively highly leveraged. This indicates a weak balance sheet rather than a strong balance sheet. After adjustments, SableTel has almost \$6 of debt for every \$1 of equity.
- The executive reporting document also includes a general statement that SableTel will “do even better in the future by increasing revenue and decreasing expenses.” This is a very general statement and provides no information to the users of the executive reporting document on how SableTel might achieve these financial goals. The goals themselves are not very specific and provide little basis for the users to monitor SableTel’s performance.
- The executive reporting document indicates that Hurricane Baylee damaged a number of communication towers and disabled the mobile network. However, the executive reporting document does not contain any information on the implications for SableTel from a financial perspective and offers no information for the users on when the system may be back up and running (if ever). This is information that StarNova and by extension investors are surely to be interested in.
- The executive reporting document indicates that the Wireless Technology Project will have a substantial impact in the short-term. There is no information on how the project may affect SableTel in the short term or even what SableTel means by “short term.” We know that it will not be up and running until January 2012 from the presentation made by Dan. Therefore, any benefits from the new technology will not be experienced until at least that date. This may not be “short term” from an investor’s perspective.
- The executive reporting document also indicates that SableTel has made decisions in the past year that have decreased the company’s overall risk. However, the risks that they have identified relate to health risks and not financial risks, which would be more useful for the readers. SableTel does not seem to grasp the risk concept from a financial perspective. From a financial perspective it would appear that SableTel’s risk has actually increased over the past year, as represented by its increased leverage. In addition to financial risks, SableTel would also face additional substantial risks such as technology, weather, and customer-related risks. These would all be relevant to users of the executive reporting document.
- SableTel has indicated that they are not the defendants in any new environmental lawsuits. While this may be true, it implies that SableTel may be defendants in previous lawsuits. If this is the case, and the lawsuits are material, then SableTel should discuss these significant issues within the executive reporting document. Investors would be very interested in this type of information because it would affect their investment risk.
- SableTel has indicated that they “continue to focus on evolving our core business” and they “have no significant new projects planned for the foreseeable future.” However, we know that SableTel’s strategic plan includes a very significant capital project (the Wireless Technology Project). This new project will cost a significant amount of money, and investors would surely be interested in the costs and benefits associated with this project. SableTel has not disclosed much information related to this project.

- Finally, SableTel would like StarNova's MD&A to thank a long-time employee of its organization for 25 years of dedicated service. While this may arise from good intentions, it is not clear how this information would be relevant to investors, especially at the StarNova level. SableTel should not provide information to be included in StarNova's MD&A that would not be of interest to investors.

(There were several statements included in the reporting document prepared by Dan that were vague, if not completely misleading. The Board did not expect candidates to prepare an MD&A for SableTel. What the Board did expect was for candidates to understand the purpose of an MD&A and to recognize that what Dan had prepared was not appropriate. The MD&A should be a true and balanced representation of how the company performed during the past year and provide information about its future prospects to help prospective and current investors decide whether they want to invest or continue to invest in the company. With that goal in mind, candidates should have been able to identify statements made by Dan that were incongruous. Most candidates had difficulty doing so. However, candidates were at least able to pick out some inappropriate statements made by Dan in the reporting document. The misleading statement most frequently addressed by candidates was the statement that no significant projects were planned for the future, whereas the WTP was clearly a significant project for SableTel on which they should be providing more detailed information to investors.)

SableTel could make a number of substantial improvements to its executive reporting document in order to provide meaningful information to StarNova, and by extension to the investors of StarNova. For example, the executive reporting document is simply reproducing 2010 financial information that is readily available in the financial statements without providing any additional information or analysis. Financial information should be presented in an MD&A, but the purpose of the MD&A is to expand on this financial information and to explain to the user what the financial information is saying about the company.

Some suggested improvements to its executive reporting document are as follows:

- SableTel should provide relevant and meaningful financial information within the executive reporting document. This information should contain comparisons with the prior year and comparisons with the industry. Key financial information on the liquidity and capital resources of the organization should be presented. SableTel could develop financial indicators or ratios that assist users in determining the health of the organization and could monitor these indicators over time.
- SableTel should also provide additional information on its cash flow. This is important because SableTel has a significant amount of property, plant and equipment on its statement of financial position and as a result has a significant amount of depreciation buried in the various line items in its statement of comprehensive income. Additional information on its capital expenditures (capex) would also be helpful so that users could understand the cash flow to be expected from the entity in the future.
- SableTel must strive to provide financial information that is accurate. Presenting misleading information can lead to mistrust and a loss of credibility for an organization. SableTel should present both good and bad financial information. It could also take the opportunity to explain to investors how it plans to improve its financial performance in the future. This would be provided with the overall strategic plan (such as "we plan to decrease our costs by 5% in the future through the use of our wireless technology, which will be implemented in 2012").

- SableTel should provide information on its risk profile (from an investor's perspective) and information to support its assertions on its risk profile. This risk profile would be primarily from a financial perspective. SableTel could also outline how it proposes to decrease its risk profile over time. This could be achieved through a targeted debt-to-equity ratio, for example.
- SableTel should provide relevant, forward-looking information within its executive reporting document. There is no mention of the strategic plan that SableTel has developed for the future. Nor is there any significant mention of the Wireless Technology Project, which is a key component of SableTel's strategic plan. The executive reporting document provides management with the opportunity to communicate their vision for the future of the company. This is not evident within the current document. This vision could and should be presented over a longer time frame, as well. The current strategic plan only contemplates the next fiscal year, which is not a long time frame from a strategic point of view. Where does SableTel see itself in 10 years?
- The executive reporting document could also contain strategies for dealing with any significant risks or concerns. For example, the document would provide SableTel with a great opportunity to explain to its users how it is dealing with the aftermath of Hurricane Baylee.
- Finally, SableTel should not include irrelevant information that would not be useful for investors. It is unlikely that most investors would be interested in retiring employees unless it affects the future prospects of the company.

(Candidates could have focused on critiquing the misleading statements made by Dan in the existing reporting document or they could have focused on what information was missing from the document. Most candidates who addressed this indicator chose to critique the statements made by Dan. However, some candidates also clearly understood the type of information that should be included in an MD&A and raised some valid omissions. Those candidates were rewarded for their added depth of discussion.)

For Primary Indicator #5 (Performance Measurement and Reporting) the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	5.3%
Nominal competence — The candidate does not attain the standard of reaching competence.	24.6%
Reaching competence — The candidate identifies some of the deficiencies in the executive reporting document.	29.8%
Competent — The candidate identifies some of the deficiencies in the executive reporting document and recommends improvements that would help readers understand the financial situation of SableTel or explains why the executive reporting document as presented is not useful.	39.9%
Highly competent — The candidate discusses several of the deficiencies in the executive reporting document, recommends improvements that help readers understand the financial situation of SableTel, and explains why the executive reporting document as presented is not useful.	0.4%

(Candidates were asked to provide comments on the reporting document, including suggested improvements. Candidates were provided with the SableTel reporting document that Dan had prepared for the executive committee. The simulation explained that the reporting document should meet StarNova's MD&A requirements because it would be used to develop StarNova's annual report. Based on this direction, candidates were expected to critique the existing document since it contained obvious shortcomings.)

(Many candidates struggled with what they had been asked to do. Some candidates had difficulty understanding exactly what the reporting document was and what they were supposed to do with it. Those candidates who understood the requirement were able to identify statements in the reporting document that were vague, misleading, or insufficient, and recommend changes to make the information more useful to the shareholders. However, many candidates incorrectly used Dan's comments in the reporting document to provide management or operational advice rather than critically analyze the document from a reporting perspective. Candidates are reminded that the MD&A is an important reporting tool, and they should be familiar with its contents.)

Primary Indicator #6

The candidate evaluates the strategic plan, recognizes that it is flawed, and suggests recommendations for improvement.

The candidate demonstrates competence in Governance, Strategy, and Risk Management.

Competencies

IV-2.1 – Understands the entity's strategic plan and planning process (B)

IV-2.3 – Identifies and evaluates opportunities and risks (A)

IV-2.6 – Identifies the factors that impact the entity's financial strategies (B)

IV-2.7 – Evaluates the entity's performance measurement and reporting strategy (A)

IV-4.1 – Evaluates decision-making and accountability processes (B)

IV-4.2 – Understands the need for access to information (B)

Customer Losses

During the year, SableTel lost two large customers, each with annual revenue exceeding \$300,000. There has been no follow-up to determine why SableTel lost these customers.

The result is that SableTel has no idea why these customers left and has not identified potential problems within its organization or pricing strategy. Left unresolved, these problems may continue to grow and more customers may be lost.

SableTel should follow up on these large customer losses and determine the exact reasons it lost them. Once the reasons have been determined, SableTel can improve its systems or adjust its prices if necessary so that it does not lose additional customers in the future for the same reasons. Furthermore, no customer retention policies are documented in the strategic plan. The lack of a plan to retain customers could mean that current customers will be lost in the future. It is much more cost effective and simpler to retain existing customers than to obtain new customers. A customer retention policy and plan should be implemented immediately. If a successful customer retention policy is instituted, current customers would be more likely to stay with SableTel, which would assist the sales team with the ability to achieve their sales targets.

(Few candidates commented on the fact that SableTel had not followed up with the two large customers lost during the year or that it lacks a customer retention plan.)

Customer Visits

The customer service department plans to visit all customers (big and small) once every five years. Sales staff will visit those customers that are close to SableTel's office first in order to keep travel costs down.

While this may be a great way to enhance customer service, it is not clear that the benefits will exceed the costs. For example, visiting customers with annual revenues of \$1,000 may not be worth the costs associated with the visit. The department has already indicated that they will need to hire 15 additional staff to meet this goal. The plan also calls for visiting locations "close to our main office in an effort to keep travel costs down." This is not an appropriate basis for determining which customers to visit. Therefore, while the objective of increasing customer satisfaction is a good one, the plan to achieve this goal appears to be flawed and not cost effective.

Large customers with the potential for increased sales should be visited first. This would likely provide SableTel with the most reward for its efforts. In general, SableTel needs to plan these visits more logically to ensure they are cost effective. As well, there may be alternative methods, to ensure that customers are satisfied, that are less costly. For example, SableTel could call all of its existing customers or have all of its customers complete a satisfaction survey. Employees could also be trained to ensure that they are providing the best client service possible. Likely a combination of all of these methods, depending on the size of the customer and their potential for increased revenue, should be undertaken.

(This issue was the one most frequently addressed by candidates. Most candidates who correctly identified customer visits as an issue were able to explain why the current strategy was flawed and how it could be improved.)

Standard Margin Pricing

SableTel appears to derive its pricing from a standard 60% margin, which may or may not be indicative of the value of the product or service offered.

The implication of this is that SableTel cannot price products at a level above this margin. It is quite possible that some of its products and services could command a premium above this margin, but given the stated policy, SableTel could not realize this increased margin. This standard pricing policy issue will become even greater if it is not adjusted once the benefits of the Wireless Technology Project begin to be realized in 2012, since the costs for SableTel are expected to decrease across all products and services.

I believe we should review whether this method is appropriate. Another possible method is to base pricing on competitive prices or value pricing. SableTel is in a competitive industry — telecommunications — which means that the market will drive the ability to achieve margins on product. Pricing should be in line with the prices of competitors. The new policy of allowing some discounts with the approval of the Vice-President Marketing illustrates that SableTel is starting to realize that its prices need to be more flexible and more competitive. However, the non-standard pricing does not allow for the circumstance in which SableTel may be able to increase its prices,

driving margins higher while still remaining competitively priced compared with its competitors. This will be especially important when SableTel introduces its new wireless technology.

(About half of the candidates identified this issue, and most of them were able to explain its implications and propose a solution.)

Sales Quotas

SableTel plans to increase sales by giving sales staff higher quotas and having senior sales staff lead by example. We already know that the sales staff was unable to meet their existing quota in 2010; therefore, it would appear unlikely that they'd be able to meet an even higher quota in the future. In addition, sales quotas need to be realistic in order for them to be a motivating factor. If the quotas are set too high, the sales staff will be discouraged. A significant portion of their compensation is based on meeting quotas, so if these quotas are unrealistically high, they might leave to work for a competitor of SableTel that offers a higher base salary.

(Many candidates realized that increasing the sales quotas was likely not a good strategy for SableTel in light of other case facts.)

Plan to Increase Sales

SableTel has also indicated that they plan to increase sales by hiring additional sales staff. Adding sales staff is not sufficient in itself to increase sales. SableTel needs a detailed plan. It needs to provide its sales staff with proper incentives and the proper tools to drive sales. For example, SableTel could provide its sales personnel with a targeted customer listing to help identify potential new customers. Customer lists for competitors may also be available. As well, it could develop a potential client list from customers that it has lost over the past two years that may be ready to return to SableTel. Finally, the sales department and the marketing department should communicate and determine as a team how to best increase sales. The objectives of these two departments are ultimately the same and sharing information between these two departments in particular would likely be very useful.

(Few candidates commented on the need for SableTel to come up with a detailed plan to increase sales.)

Increase in Overhead Costs

The 2011 budget prepared by SableTel indicates that SM&A expenses will increase by approximately \$4.0 million in 2011. Most of this increase is likely due to the new staff that will be hired as contemplated in the strategic plan.

The plan calls for increased human resources, which results in increased overhead and will further increase the loss in 2011. After recasting the 2011 budget to take into account the problems that I have identified, there is no room for increasing overhead costs in 2011.

The plan should be adjusted to determine whether SableTel can do without the increased staff and operate more efficiently. More effective and efficient methods and procedures need to be identified and implemented to increase sales while holding the line or decreasing costs. Addressing the customer issues identified above could assist SableTel in maintaining and increasing revenues. Additional staff should not be hired at this point, and additional hiring should only be considered in the future when revenue warrants it.

(Very few candidates commented on the affordability of all the initiatives SableTel was proposing in their strategic plan. Strong candidates commented on the initiatives, thereby demonstrating integration across the indicators.)

Executive Bonus Plan

One of the goals of Human Resources for the year is to retain existing employees, which of course is a good thing. However, the only change noted that will help SableTel achieve this goal is to introduce a new executive bonus plan.

This new bonus plan is only relevant for seven employees (likely the executive group). It is unlikely that this program will have the desired effect on SableTel as a whole since most of the employees will not benefit from this program. Therefore, it is unlikely that SableTel will meet its goal of retaining existing employees.

Further research needs to be performed to determine the costs and benefits associated with this plan and to ensure that Dan and the other senior executives at SableTel are not simply adding an unnecessary perk to their compensation packages. The plan will undoubtedly cost more to administer as well. Specific measurement criteria should be developed to determine whether the bonus plan is successful. Bonuses should be based on a number of criteria and financial objectives should play a large part in the bonus. If SableTel incurs a loss for 2011, then there may be no justification for any bonus. The board, or the compensation committee of the board, should also review this plan since Dan is likely in a conflict of interest with respect to it.

There may be other ways to retain and improve the satisfaction of current employees, such as

- an employee survey,
- a compensation survey,
- a work/life balance program, or
- similar lifestyle programs.

(Most candidates recognized the shortcomings of the proposed bonus plan and made suggestions for its improvement.)

Compensation Policies

Salespeople at SableTel are paid a base salary of \$45,000, while comparable positions in the industry pay a base salary of \$65,000. Dan has indicated that this is done to encourage the sales staff to make sales in order to increase their commissions.

There seems to be a large difference between the compensation offered to SableTel sales employees and the market. This may not be appropriate, and may account for the high turnover of SableTel sales staff and contribute to the lack of achievement of the sales targets.

This policy should be reviewed to ensure that SableTel's compensation is achieving its desired results. If necessary, the base sales amount should be increased to ensure it is competitive with the industry. In conjunction with this, the sales compensation program should be reviewed to ensure that it is meeting its stated goals (in other words, increasing sales) while still maintaining its cost effectiveness.

(Most candidates commented that SableTel's compensation policy appeared to not be competitive and may be contributing to its turnover issues. Candidates suggested alternative ways to structure the compensation package and often tied this discussion into their discussion of the proposed bonus plan.)

IT Focus/Wireless Technology Project

The IT department has indicated that it will focus all of its resources on the Wireless Technology Project. This technology has not been proven yet because the feasibility study is still outstanding, so the IT department's time may be better spent elsewhere. Can SableTel afford to put all other IT projects on hold until the Wireless Technology project is complete? For example, having IT provide cross-functional access to files may help improve the coordination between departments and the company's overall performance.

(Many candidates either discussed specific concerns with regards to the Wireless Technology Project or the fact that the IT department's time was valuable and other potentially useful projects had to be sacrificed.)

Cross-Selling Program

Marketing plans to implement a new program in an attempt to cross-sell products and services at SableTel. The program requires an investment of \$450,000 to modify the billing software. SableTel's IT department will develop the necessary software.

Resources need to be dedicated to this project if it is going to succeed. As well, there needs to be a cost/benefit analysis completed for this program or some type of "return on investment" analysis to ensure that the project is a good idea from a financial perspective. To perform such an analysis, SableTel will need to estimate incremental revenues and costs. It is also not clear if a "flyer" is the best way to proceed. As an alternative, a list of potential targets could be developed and given to the sales department for follow-up.

(Few candidates discussed the cross-selling initiative proposed by SableTel.)

Access to Information

There is some indication that information sharing is discouraged within SableTel. Managers below the level of vice-president are only provided with information that directly relates to their own departments.

This lack of information flow inhibits management decision-making abilities. Managers need to know the vision and strategic plan of the organization and need to understand how their department fits in with the overall goals. If they do not understand their part of the plan, they will likely not implement strategies to achieve the plan. Decisions made in isolation may have impacts on other areas that are unknown, and without the cooperation of the management of other departments, projected benefits of the decisions may not be achieved. Also, the IT group seems to be focused on its development of customer products while ignoring internal customers and their need for reliable data.

Managers should be given information on the overall goals and objectives of the organization and how these will contribute to meeting the organization's vision. Managers should also be encouraged to develop plans that are consistent with the overall goals and objectives of the organization and should be held accountable for meeting these departmental goals in order to meet the overall organizational objectives.

(Many candidates recognized that SableTel's approach of limiting managers' access to information is not appropriate and may in fact be detrimental to the company.)

Lack of Coordination between Departments

SableTel has a philosophy of restricting the use of information and, as noted above, discourages communication between the departments. Further evidence of the lack of coordination between the departments is provided by the IT department and the marketing department with respect to the targeted advertising flyer program. The strategic plan also appears to be formulated by each department independent of the other departments.

The departments at SableTel appear to operate independently and do not share information or knowledge to ensure that the goals of the organization as a whole are achieved. This may lead to the departments developing departmental goals and objectives that are not congruent with the organization as a whole.

The departments need to communicate and develop goals and objectives as a team to ensure that the goals and objectives of the organization are met. This will assist SableTel in meeting its strategic goals and objectives and its mission and vision.

(Few candidates commented on the lack of coordination between departments.)

One-Year Time Frame

The strategic plan as presented covers a one-year time frame — the 2011 fiscal year. The implication of a one-year time frame is that management at SableTel will focus on meeting the goals and objectives within the strategic plan over the next fiscal year and may not be focused on meeting long-term goals and objectives necessary to achieve its mission and vision (or the mission and vision of StarNova).

SableTel should develop a strategic plan with a longer time frame. Normally, strategic plans are prepared for 5 or even 10 years and set out measurable goals and objectives. For example, StarNova has indicated that it expects all of its investments to generate a 15% return. Currently SableTel is not generating a return that is close to this amount. SableTel should develop a long-term strategic plan that will put it on the path to achieving this required return, and senior management should be held accountable for meeting the milestones within this strategic plan.

(Very few candidates commented on the short-term outlook taken by SableTel in developing its strategic plan.)

For Primary Indicator #6 (Governance, Strategy, and Risk Management) the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.2%
Nominal competence — The candidate does not attain the standard of reaching competence.	5.4%
Reaching competence — The candidate identifies some of the weaknesses in the strategic plan.	29.6%
Competent — The candidate describes some of the weaknesses in the strategic plan, describes the implications of the weaknesses, and recommends improvements.	64.3%
Highly competent — The candidate describes several of the weaknesses in the strategic plan, describes the implications of the weaknesses, and recommends improvements.	0.5%

(Candidates were asked to comment on the points raised in the 2011 strategic plan, including suggested improvements to the plan. Dan outlined many of his plans for 2011 in his presentation to the executive committee, and candidates were expected to recognize that a number of these were not good ideas from a strategic point of view.)

(Candidates performed well on this indicator. Most candidates were able to identify and discuss several weaknesses in Dan's strategic plan and suggest improvements. Weak responses did not address the implications of some of Dan's proposed strategies or made impractical recommendations when attempting to resolve the issues.)

Primary Indicator #7

The candidate analyzes the financial budget provided for 2011 and concludes on whether the results are likely to be achieved.

The candidate demonstrates competence in Management Decision-Making.

Competencies

VIII-4.1 – Prepares, analyzes and monitors financial budgets (A)

VIII-4.2 – Prepares cash flow projections (A)

We have been asked by John McReynolds to perform “an evaluation of the 2011 budgeted financial information” and to comment on “the likelihood of the result being achieved.”

The analysis that follows takes the 2011 budget as presented by Dan Wilson on slide 7 in his presentation to the EC (Column 1), makes reasonable adjustments to the financial statement line items (Column 2), and comes up with a revised or adjusted budget (Column 3). Note that some assumptions have been made, and further information should be obtained and analyzed before this budget is finalized. As well, the budget needs to be “married” with the other components of the strategic plan to ensure they are consistent.

All items are in thousands of dollars.

Item Description	SableTel 2011 Budget (unadjusted)	SableTel 2011 Budget adjustments	SableTel 2011 Budget (adjusted)
Revenue (Note 1)	\$ 75,400	\$ (9,350)	\$ 66,050
Cost of sales (Note 2)	33,930	(2,226)	31,704
Gross profit (Note 2)	41,470	(7,124)	34,346
SM&A and interest (Note 3)	37,250	(750)	36,500
Profit (loss)	\$ 4,220	\$ (6,374)	\$ (2,154)
Depreciation (given)	7,500		7,500
Capital expenditures (given)	(32,000)		(32,000)
Cash flow	\$ (20,280)	\$ (6,374)	\$ (26,654)
Gross margin	55%	N/A	52%

Assumptions and Support for Adjustments

Note 1 — Revenue

The forecast shows projected revenue increasing by 15.9% in 2011 (this is before we adjust the revenue for the government grant in 2010). In 2010, sales at SableTel decreased by 0.2% before adjustments and by 4.4% after adjusting for the Industry Canada grant. As well, the average revenue increase within the industry is forecasted to be 1.5% for 2011. Therefore, it seems unlikely that SableTel will increase sales by 15.9% over the next year. As well, SableTel has lost one of its long time sales staff (Mr. Oldmun), which may result in customer losses. Further indications that sales may be lower in 2011 are that SableTel has lost two big customers in 2010 and the fact that its mobile network is currently disabled and likely not earning any revenues.

However, there are some factors that may mitigate decreased sales, including the implementation of the more flexible pricing policy that will likely increase the sales group's success. Also, the fact that many new sales people have been hired and may now be trained needs to be considered.

After considering all of the above, I have projected that SableTel will increase sales by 1.5% over the next year, consistent with the forecast in the industry. This requires a decrease in the sales projected of \$9,350,000.

We will have to monitor sales effectiveness closely over the next several months in order to determine whether these projections need to be revised further, since the increase of 1.5% may not materialize under the current strategy.

(Most candidates recognized that the revenue growth forecasted by SableTel was overly aggressive given other case facts, and recommended a lower percentage. Few candidates discussed the other factors affecting the revenue projection, such as the one-time grant, the loss of customers, and the potential loss in revenue as a result of the damaged towers, failing to integrate their analyses.)

Note 2 — Cost of Sales and Gross Margin

It is difficult to predict what the gross margin and, as a result, the cost of sales will be over the next year. On the one hand, competition is increasing and the industry gross margin has been decreasing over the past two years. On the other hand, SableTel is developing new technology that may significantly increase its margin. However, the Wireless Technology project will not be ready until 2012 and therefore will not affect the margin in fiscal 2011.

I have estimated that the gross margin will be 52% in 2011. This margin is close to the industry average for 2010 and also approximates SableTel's gross margin in 2010 once the effect of the government grant is removed from the gross margin calculation. Note that SableTel's gross margin, after all accounting adjustments, would actually be less than 46%, but this includes a one-time charge for inventory obsolescence which we do not expect to repeat in the future.

It is also not clear what impact the "non-standard" pricing policy will have on SableTel. This has not been factored into my analysis, but it could have a substantial negative impact on margin for 2011. However, it is expected that any lost margin would be made up through increased sales, so the net effect may be minimal.

(Roughly half of the candidates commented on the gross margin projected by SableTel and supported why it needed to be adjusted).

Note 3 — Expenses

SM&A and interest expenses in 2010 totalled \$33,179,355 before any adjustments. This amount was artificially low due to the capitalization of Wireless Technology Project expenditures. For 2010, a more normalized expense total would have been approximately \$42 million (\$33 million plus the 2009 and 2010 research and development expenditures that were incorrectly capitalized in 2010).

One big question that remains is whether the Wireless Technology Project will meet the criteria for capitalization in 2011. Assuming that it does, the expenses for 2011 should be about \$36.5 million: \$42 million in 2010 less \$9 million in R&D expenses (the expenses would be capitalized in 2011), plus 2% for inflation, plus additional staff (estimated at 31 new staff at about \$60,000 per staff member), plus the new bonus plan estimated at \$1 million. Therefore, we have decreased the budgeted expenses to \$36.5 million for the year ended August 31, 2010, based on this analysis.

If the Wireless Technology Project expenditures are not capitalized, then the expenses would likely be closer to \$60 million. Note that whether these expenses are capitalized or expensed will not have any effect on the cash flow for SableTel and on the amount of financing that SableTel requires.

Finally, there is no mention that SableTel has included estimates for the following items in the SM&A total included in the budget projection: cost to repair the damaged towers; cost related to the new bonus plan; the revised CRTC fee; cost to implement the planned cross-selling program; etc.

(Most candidates commented on at least one element of the expenses, such as the need to include the revised CRTC fee or the impact of the treatment of R&D expenses. However, there were many other expense items that candidates should have adjusted for that often went unnoticed.)

Other Amounts

No other amounts have been considered in the above budget from a cash flow perspective. For example, SableTel had a large amount of accounts receivable on its books at August 31, 2010. If it can turn these accounts receivable into cash in 2011 and reduce its accounts receivable balance to more acceptable levels, then the amount of financing required from StarNova may be reduced. Other working capital changes have also not been figured into the cash flow analysis and could influence the amount of funding required.

Summary of Adjusted Budget and Capital Requirements

The revised cash flow projections show that there will be a need for additional capital above the amount budgeted. The amount of funding required for SableTel for its 2011 fiscal year is estimated to be almost \$27 million. The projections should be extended beyond 2011 to ensure that 2012 and future years will provide adequate free cash flow to justify the expenditures on the Wireless Technology Project. This work would need to be performed no matter which source of additional funding is selected.

Is the Budget Likely to be Achieved?

The adjusted 2011 budget indicates that the budget as set out by Dan is not achievable and SableTel will not be profitable in 2011. Significant changes will need to be made in order for SableTel to become profitable. SableTel should take immediate actions to either increase sales or decrease expenses or both in order to become profitable. It cannot afford to wait for the benefits associated with the Wireless Technology Project, which at this point in time are not proven.

Should StarNova continue to support SableTel and its Wireless Development Project, then it must find a financing source to fund SableTel. Potential sources of funding that should be explored are funding from StarNova's other profitable operations, external funding (such as an issue of additional shares by StarNova), or debt financing based on the projected cash flows that will prove out the investment. SableTel could also generate additional cash flow by improving the collection cycle for its accounts receivable.

(Most candidates restated the budget, or qualitatively concluded on whether the budget was likely to be achieved, or did both.)

For Primary Indicator #7 (Management Decision-Making), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.9%
Nominal competence — The candidate does not attain the standard of reaching competence.	15.8%
Reaching competence — The candidate attempts to analyze specific areas of the budgeted financial information that are not realistic.	33.8%
Competent — The candidate analyzes specific areas of the budgeted financial information that are not realistic and recognizes that the results are not likely to be achieved.	49.3%
Highly competent — The candidate analyzes specific areas of the budgeted financial information that are not realistic, recognizes that the results are not likely to be achieved, and makes adjustments to the 2011 budget.	0.2%

(Candidates were asked to evaluate the 2011 budgeted financial information and the likelihood of the result being achieved. Candidates were expected to analyze the budget that had been prepared by Dan, contemplate whether the assumptions made by Dan were reasonable, and conclude whether the budget was achievable.)

(Most candidates were able to indentify some of the flawed assumptions made by Dan in the preparation of his budget. The one most often cited by candidates was overly optimistic revenue growth. Most of the candidates who saw flaws in Dan's budget were able to use case facts to support the reasons why Dan's numbers were unreasonable. However, aspects of the budget that should have been questioned, such as the one-time grant and the impact of the damaged towers on both revenue and expenses, were often ignored by candidates. Overall, where most candidates fell short was that their analysis was too brief; some candidates just did not identify a sufficient number of the errors contained within the budget that Dan had prepared.)

Primary Indicator #8

The candidate integrates information from various sources and explains why SableTel is not likely to be successful in the future without significant changes.

The candidate demonstrates competence in Pervasive Qualities and Skills.

Competencies (lists the Persavise Qualities for the entire simulation)*II-2 – Demonstrates leadership and initiative**II-4 – Strives to add value in an innovative manner**III-1.1 – Gathers or develops information or ideas**III-1.2 – Develops an understanding of the operating environment**III-1.3 – Identifies the needs of internal and external clients and develops a plan to meet those needs**III-2.1 – Analyzes information or ideas**III-2.3 – Verifies and validates information**III-2.4 – Evaluates information and ideas**III-2.5 – Integrates ideas and information from other sources**III-2.6 – Draws conclusions/forms opinions**III-3.1 – Identifies and diagnoses problems and/or issues**III-3.2 – Develops solutions**III-3.3 – Decides / recommends / provides advice**III-4.1 – Seeks and shares information, facts and opinions through written discussion**III-4.2 – Documents in written and graphic form**III-4.3 – Presents information effectively**III-5.1 – Plans projects***Integration**

Many of the issues affecting SableTel are related and should not be considered in isolation. The following are some of the areas where one analysis may affect another analysis:

- The CRTC Fee analysis (and the assurance concepts from this analysis) should be integrated into the adjusted financial statements. It is clear that SableTel has not calculated its 2009 or 2010 CRTC Fees correctly, and these must be corrected. Once these revised Fees have been audited, the revised amounts should be incorporated into SableTel's adjusted financial statements for 2010. In addition, the increase in the CRTC Fee should be included in the budget.
- The adjusted financial statements should be used when analyzing the financial condition and financial results of SableTel for 2010. The ratio analysis, and the comparisons with the industry ratios and with SableTel's 2009 financial statements, would be more meaningful using the adjusted financial statements. Again, the differences in the ratios between SableTel and the industry may also be explained, in part, by the adjustments made to the financial statements.
- The MD&A discussion (executive reporting document discussion) should use information from various parts of our response. The executive reporting document would be improved by using the adjusted financial statements since they provide the most relevant information for investors. As well, the executive reporting document could report significant items from the assessment of SableTel's financial condition and financial results for 2010 or from SableTel's variance analysis. It could reference various industry statistics to provide a useful comparison to investors. The document could also be improved by including additional information about SableTel's 2011 (and future) strategic plan and by providing future budgeting information.
- When reviewing and commenting on the strategic plan for 2011, different information could be used to support the analysis. For example, integrating the strategic plan with the 2011 budget analysis would be very helpful, as would using the adjusted 2010 financial statements when analyzing the specific information contained in the strategic plan.

- The adjusted 2010 financial statements could be used as the starting point for the 2011 forecasts since they provide the most relevant information on the financial results and condition of SableTel for 2010. The 2010 results could then be adjusted for items such as increased staffing levels or decreased margins, for example.

As well, a number of other “high level” issues could be discussed in relation to SableTel’s current operations and its future prospects.

(The Board was pleased to see that most candidates provided an integrated response. Many used their adjusted financial statements when calculating ratios, considered the need to revise the CRTC Fee when preparing their adjusted financial statements or their budgets, and referenced their revised numbers when discussing the reporting document. Integration was one of the key skills the Board was evaluating with this particular comprehensive case.)

Competence of SableTel Management

There are many indications that senior management at SableTel does not have the skills required to return the company to profitable operations or put in place the tools to ensure it meets its potential in the future. There is also evidence that management at SableTel, particularly Dan Wilson, does not understand the details of the business and either intentionally or unintentionally is providing misleading information. This is evident throughout his presentation to the EC: he did not have the answers, or was making up answers as he went, to relatively simple questions. It is possible that Dan does not have the necessary skills for this position.

Evidence to support our assertion questioning the competence of management includes:

- The purchase of \$2.5 million of routers and modems in September 2009 when the annual cost of sales for routers and modems is less than \$700,000. These products also have a short life, making this decision even more questionable.
- A misunderstanding of the concept of “risk” from an investor perspective, which is evident in the executive reporting document.
- The lack of answers to relatively simple questions posed by the EC.
- Significant errors in the financial statements for 2010.
- The losses in 2009 and in 2010 and deteriorating results.
- Poor analysis of the variances for 2010.
- The poor preparation and support for the 2011 budget and the 2011 strategic plan.
- CRTC calculations that are inaccurate, and the apparent lack of understanding of the seriousness of the letter received from the CRTC.
- Evidence that the control environment is not adequate (for example, the marketing and finance databases do not agree).
- The acquisition of Spacolli Enterprises Inc. in 2008, which did not appear to be carefully considered.

Overall, it would appear that the strategic plan presented by Dan is not well thought out, contains inconsistencies between departments, and is flawed in many ways. StarNova may wish to consider hiring an external consultant who is familiar with the telecommunications industry to review and recommend changes to the strategic plan.

(Most candidates raised valid concerns with regards to Dan's performance and supported their concerns with several examples of his incompetence. While these discussions were generally very well done, some candidates went on to accuse Dan of fraud. Candidates should be cautioned that fraud is a serious accusation. Fraud implies that Dan's errors were intentional and deceitful in nature, whereas the case facts lead us more to believe that Dan may just not have the knowledge and judgment required to effectively run SableTel.)

Overall Conclusion

There are many indications that SableTel is not performing up to expectations and without significant changes will not meet the 15% return target in the future. These indications include:

- A CRTC Fee calculation that was not correct, and indifference from the SableTel management regarding this problem which could potentially have devastating implications for the company.
- Financial statements that contain significant errors where adjustments are needed. All of these adjustments negatively affect SableTel, as well lending some support to the theory that these errors may have been intentional.
- A financial condition that has deteriorated badly over the last year and is well below industry averages. This includes a high amount of leverage, indicating a financially risky operation.
- A variance analysis (on the 2010 financial results) that was not informative and did not properly disclose the real variances inherent in the 2010 financial results.
- A strategic plan that is inconsistent, not well thought out, and short-sighted.
- An executive reporting document that is, at a minimum, not informative, and is potentially misleading.
- A budget for 2011 that is not achievable given the current plans and the current financial situation of SableTel.
- An investment of over \$9 million dollars in the Wireless Technology Project when the feasibility of the technology has yet to be proven.

We would like to draw to the attention of the executive committee the serious nature and the urgency of our concerns, and we recommend immediate changes and further analysis for SableTel.

(The Board was disappointed to see that more candidates did not comment on the overall performance of SableTel and the urgency of its current situation. However, while most candidates did not address these issues, strong candidates clearly highlighted their concerns with the overall performance of SableTel and questioned whether SableTel would be able to meet StarNova's 15% return target.)

For Primary Indicator #8 (Pervasive Qualities and Skills) the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.0%
Nominal competence — The candidate does not attain the standard of reaching competence.	8.2%
Reaching competence — The candidate integrates some of the issues in the response or concludes that SableTel is not likely to be successful in the future without significant changes.	38.9%
Competent — The candidate integrates several of the issues in the response to conclude that SableTel is not likely to be successful in the future without significant changes.	52.4%
Highly competent — The candidate integrates several of the issues in the response to conclude that SableTel is not likely to be successful in the future without significant changes and provides a plan to address the concerns identified.	0.5%

(There were two elements included in this indicator. The first element required candidates to integrate issues throughout their response. Integration could be demonstrated in many ways, such as by using adjusted financial statements when calculating SableTel's ratios or including elements of the strategic plan in the revised budget. The second element required candidates to take a step back and question issues underlying the entire simulation, such as Dan Wilson's competence and SableTel's ability to meet StarNova's expectations. Candidates were not directed to this pervasive indicator. However, the number of opportunities for integration and the variety of case facts should have led candidates to discuss both SableTel's overall performance and senior management's ability to effectively run the company.)

(In general, candidates performed well on this indicator. The majority of candidates questioned Dan's competence and supported their concerns with specific examples from the case, such as Dan's lack of knowledge and poor judgment. Candidates also did a good job of integrating their responses, most commonly through the use of restated numbers in their ratio analysis and the inclusion of the CRTC Fee in their adjusted financial statements.)

EVALUATION GUIDE
COMPREHENSIVE SIMULATION — SABLETEL
SECONDARY INDICATORS OF COMPETENCE

Secondary Indicator #1

The candidate discusses the relevant corporate income tax issues related to SableTel.

The candidate demonstrates competence in Taxation.

Competencies

IX-1.1 – Understands the entity's tax profile (A)

IX-1.2 – Identifies and advises on compliance and filing requirements (A)

IX-2.3 – Calculates basic taxes payable for a Corporation (A)

Scientific Research and Experimental Development (SR&ED) Tax Credits and Expenditures

The 2010 financial statements include capitalized research and development expenditures in the amount of \$9,160,250 (\$5,702,390 relating to 2010 and \$3,457,860 incurred in 2009) related to the Wireless Technology Project. These expenditures may qualify for SR&ED tax credits as defined in the *Income Tax Act*. It is not clear if SableTel has filed an SR&ED claim for this project. As SableTel is a wholly-owned subsidiary of a Canadian public company and is therefore not a Canadian Controlled Private Corporation (CCPC), SR&ED tax credits would offset income taxes payable and would not be refundable. SR&ED tax credits are only refundable to CCPCs.

For SableTel, the investment tax credits will offset federal income taxes payable in the current, three previous, or next 20 years. As discussed below, there appears to be a loss-carryback available to SableTel for 2009. If that loss is carried back, it may wipe out all previous taxes. Then, the investment tax credits for SR&ED will be carried forward to offset 2010 and future taxes payable. Since it is unlikely that there will be any taxable income in 2010, the amounts would be carried forward. As noted above, the amounts will expire, therefore SableTel may want to consider reducing some of its discretionary expenses for tax purposes (CCA) in order to manage taxes payable to use up these amounts.

It should also be noted that the SR&ED expenditures go into a separate expenditure pool and can be used by SableTel in any taxation year. The expenditures in this pool never expire. This allows SableTel flexibility in using these expenditures to “manage” taxable income so that it can use other losses and tax credits that will expire.

As well, the grant received from Industry Canada may reduce the eligible SR&ED expenditures if it directly relates to these expenditures.

Spacolli Enterprises Inc. (Spacolli) Tax Losses

SableTel received a notice of reassessment from the Canada Revenue Agency (CRA) denying the use of \$500,000 in non-capital losses related to its acquisition of Spacolli in 2008.

The acquisition of Spacolli in 2008 appears to have been done so that SableTel could use the substantial tax losses that Spacolli had to offset future taxable income. However, the *Income Tax Act* contains rules governing the use of losses of acquired corporations. When there has been an acquisition of control of a corporation, like there was in the case of Spacolli, the acquiring corporation can only use the losses of the acquired corporation to offset income earned in the same or similar business, and the business of the acquired company that incurred the losses must be carried on after the acquisition of control with a view to a profit. It is likely that the CRA has denied the use of the Spacolli losses because:

- 1) the business carried on by SableTel may not be a same or similar business, and
- 2) the business of Spacolli was discontinued prior to the acquisition.

Spacolli was in the business of manufacturing and distributing cell phones. SableTel is in the business of providing telecommunications (phone and internet) services for its customers. On the surface, these seem like very different businesses, therefore it is questionable if SableTel could use the losses of Spacolli to offset income in SableTel. Additional details will need to be provided to determine if this is actually the case.

Note that the letter from the CRA is dated July 15, 2010. SableTel has 90 days from the date of the reassessment to submit a Notice of Objection should it wish to challenge the reassessment. There may also be penalties and interest associated with the reassessment. These amounts should also be accrued (if not done so already). Penalties and interest are not tax deductible and will therefore be added back to income (loss) on SableTel's 2010 income tax return.

Deemed Year-End

At a minimum, there was an acquisition of control of Spacolli on January 1, 2008 (the amalgamation date). Both the acquisition of control and the amalgamation cause a deemed year-end for tax purposes, therefore tax returns should have been prepared with a December 31, 2007, year-end for both Spacolli and SableTel. We should ensure this was the case. This will necessitate a separate set of financial records as at that date as well.

The deemed year-end for SableTel caused by the amalgamation will count as one year in the carryforward of any losses or investment tax credits.

Loss-Carryback

It appears from the data provided that SableTel had a non-capital loss in 2009 and may have another non-capital loss in 2010. These losses may be available to be carried back to the immediately preceding three prior years to offset taxes paid if those prior years were profitable. This should be investigated, with any expected refund reflected in SableTel's 2009 or 2010 financial statements.

For Secondary Indicator #1 (Taxation) the candidate must be ranked in one of the following three categories:

Not addressed — The candidate does not address this secondary indicator.

Nominal competence — The candidate does not attain the standard of competent.

Competent — The candidate addresses some of the corporate income tax issues in sufficient depth.

(Some of the transactions that SableTel had entered into in the current year had tax impacts, the most significant being the potential scientific research and experimental development (SR&ED) credit related to the WTP expenditures, and the non-capital losses related to SableTel's acquisition of Spacolli. To demonstrate competence on this secondary indicator, candidates were expected to discuss some of these corporate tax issues.)

(Many candidates identified at least one of the tax issues facing SableTel, but only some of these candidates went on to discuss the appropriate tax treatment for the issues identified.)

Secondary Indicator #2

The candidate analyzes the Wireless Technology Project to determine if SableTel/StarNova should continue to fund this project.

The candidate demonstrates competence in Finance.

Competencies

VII-3 – Develops or analyzes investment plans, business plans and financial proposals (B)

VII-4.1 – Analyzes the entity's financial situation (B)

VII-5 – Analyzes the purchase, expansion or sale of a business (B)

Dan's presentation to the EC included some details on the Wireless Technology Project, which it appears is forming a significant portion of SableTel's strategic plan for the future.

From a financial perspective we know the following:

- SableTel has spent a total of \$9,160,250 in 2009 and 2010 on this project.
- SableTel plans to spend an additional estimated \$20 million in 2011 to fund the remainder of this project.
- Once the project is complete, margins are expected to improve by 5% for all products and services.

For the purposes of this analysis (in other words, whether SableTel should continue to fund the project), the costs that have already been incurred in 2009 and 2010 are irrelevant as they are sunk costs. Therefore, the only relevant costs are the estimated \$20 million to be incurred in 2011.

The benefits will be an estimated increased margin of 5% on all products and services. Using estimated revenue of \$65 million (revenues for both 2009 and 2010 were approximately \$65 million and revenue in 2011 is expected to be approximately \$66 million), the increased margin on an annual basis would be \$3,250,000. Dividing the \$20 million in costs by the \$3,250,000 in annual benefits gives an estimated payback period of 6.15 years.

Note that this analysis does not take into account the time value of money. The analysis also does not factor in the grant received from Industry Canada. If this grant must be repaid if the technology is not completed, then this should also be factored into the financial assessment. Thanks to the grant, the next cost of the project could be reduced from \$20 million to \$17.25 million.

Some additional qualitative factors should also be taken into consideration:

1. SableTel operates in an industry in which technology changes quickly. Therefore, the timeframe to recoup the costs associated with a project such as this needs to be relatively short. A payback period of 6.15 years may not be acceptable in this industry.
2. It is possible that SableTel has already committed to some significant expenditures associated with this project. If this is true, then these amounts would need to be factored into the analysis (in other words, the sunk costs may increase and the \$20 million of relevant costs may decrease, leading to a shorter payback).
3. The \$20 million in costs is an estimate only and may increase or decrease as the project proceeds. This adds additional risk to the project from a financial assessment perspective.
4. As with all projects in the technology area, there are substantial technological risks that the project would not lead to the desired outcomes. The technology is unproven, and the project may not generate the expected 5% increase in margin for all products and services.
5. In recent years, SableTel, and the telecommunications industry in general, has experienced decreasing sales. Decreasing sales mean that the benefits of the project would continue to diminish over time.
6. Taxes have not been factored into the analysis because SableTel is currently not taxable and may not be taxable for many years. If taxes were included in the analysis, this would decrease the benefits and increase the payback period.

One final note is that SableTel is expecting an independent feasibility study to be completed on the project within the next 60 days. This may mitigate some of the qualitative risk factors noted above and provide better information for this analysis.

Recommendation

I recommend that SableTel and StarNova wait for the feasibility study, which is expected within the next 60 days. Once that study is received, SableTel and StarNova should weigh all the costs, benefits, and risks to determine whether they should proceed with the project. From the preliminary information available, I would not recommend proceeding with the project since the projected benefits and payback of over six years do not justify the significant risks involved.

For Secondary Indicator #2 (Finance) the candidate must be ranked in one of the following three categories:

Not addressed — The candidate does not address this secondary indicator.

Nominal competence — The candidate does not attain the standard of competent.

Competent — The candidate performs a qualitative and quantitative assessment of the Wireless Technology Project to determine if SableTel should continue to fund this project.

(SableTel had already invested a significant amount of money into the development of the WTP and planned to invest another \$20 million in the coming year. The project was supposed to result in a 5% improvement in margins. Candidates were expected to perform a simple cost/benefit analysis to determine whether the WTP was a good idea and to discuss some of the relevant qualitative factors that would need to be considered when evaluating this project.)

(Most candidates questioned the feasibility of the WTP from a strategic point of view; however, very few candidates considered whether the promise of higher margins justified the high costs of the project. Those candidates who did address this indicator were generally able to perform a quick cost/benefit analysis and appropriately conclude whether or not to go ahead with the project.)

(Overall, the Board was relatively pleased with the quality of the responses on the comprehensive simulation. This was a highly integrated simulation, and the Board was delighted to see candidates attempting to take an integrated approach in their responses. The Board hopes that this continues.)

(As in prior years, candidates were provided with five hours to respond, while the comprehensive simulation was developed to be a four-hour exam. There was no evidence of significant time constraints, which confirms the Board's belief that five hours provided the candidates with sufficient time to carefully read the simulation, plan their responses, and address the primary indicators. Most candidates addressed each of the primary indicators, but they struggled when asked to perform a variance analysis (Primary Indicator #3) and to comment on the reporting document (Primary Indicator #5). Although these competencies may not be tested as frequently as others, they remain important for entry-level CAs. Candidates seemed to be well prepared to address accounting issues in an IFRS context as demonstrated by their performance on Primary Indicator #2.)

SAMPLE RESPONSE
PAPER 1 SABLETEL LIMITED

The following is a candidate response for Paper 1. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

To: John McReynolds
Re: SableTel 2010 Results and 2011 Budget Issues

Overall:

SableTel is in a very high risk position right now. Its financial position is far worse than Dan presented to the EC and in addition the companies neglect to submit CRTC fees properly has resulted in the threat for the CRTC to revoke their license which would cease SableTel's operations. NovaStar must lend them over \$30 million as shown in exhibit 4 in order for SableTel to pay the \$9 million in fees owing to the CRTC for 2010 and 2009 (see exhibit 3).

Further, there are serious weaknesses in the budgeting process as Dan cannot explain many of the variances in the 2009 and 2010 budget. This will impact operations negatively going forward as he does not know why SableTel is losing large customers and there is high employee turnover. Thus I have provided recommendation in my 2011 budgeting critique to address some of these operation issues.

The audit for the CRTC should be carried out immediately and the payment made to them by November 30, 2010 to ensure the license is not revoked. Going forward however, SableTel should be required to present to EC more frequently as there appears to be a lack of governance oversight given that such large issues have been allowed to go unaddressed until now.

Further, a big issue will be providing financing to SableTel to fix or replace its towers which were damaged in the storm causing approximately \$2.1 million in damage which has further losses for fiscal year 2010.

Accounting Issues

1) Research and Development Costs

- Currently SableTel is capitalizing all of the costs related to the Wireless Technology Project
- Need to assess if this is appropriate based on IFRS criteria which is as follows:

Analysis:

- 1) technical feasibility - unclear if this criteria is met as Dan says that "I think they have all the brain power they need" but does not demonstrate any concrete evidence of this being the case and the third party feasibility study has yet to be completed
- 2) Measurability - so far the costs appear to be measurable as spending has been quantified as \$5.7 million in 2010
- 3) availability of necessary resources including financial resources - SableTel may not have the financial resources needed as it is currently asking for \$21 million more in resources from StarNova and has not been given approval that it will receive the funding

- 4) demonstrated future economic benefit - the future economic benefit is the 5% decrease for all products and services due to more efficient distribution
- 5) management intention to complete the project - management declared its intention to complete thus this criteria is met
- 6) ability to use or sell technology - plan is to use in distribution to increase efficiency; it appears that it will be used thus this criteria is likely met but should be considered in conjunction with the FEB because there is no guarantee that if it is used efficiency will increase
 - The above criteria indicates that several of the criteria have not been met (all are required for capitalization under IFRS)
 - The technical feasibility will not be proven until the third party is completed which isn't expected for another 60 days
 - Also it is unclear whether the necessary resources have been obtained since SableTel is requesting further \$21 million financing that hasn't been approved from the EC and Dan is not sure if SableTel has the "brain power"
 - Also given that the future economic benefit is dependent on increased efficiency it appears this benefit also has not been proven as it would be difficult to demonstrate these increases until the technology is complete

Conclusion:

Based on the assessment above, SableTel has not met the criteria required by IFRS in order to capitalize its research and development costs relating to the Wireless Technology Project

The \$5.7 million in spending needs to be expensed for fiscal 2010 and thus assets will be reduced and expenses increased for the fiscal year.

Further, the reversal of the \$3.458 million was inappropriate as IFRS does not allow that expenses which are originally expensed to be capitalized. Expenditures can only be capitalized once the criteria has been met as assessed above and then capitalization is done on a prospective basis.

Conclusion:

The \$3.5M capitalized in 2010 must be reversed again such that it remains expensed in 2009 as was originally recorded.

2) Impairment of towers due to Hurricane Baylee

- 60 of SableTel's communication towers were damaged disabling the network on August 24th and currently unsure if the towers can be fixed or if they should be replaced with a faster system
- no adjustment has been made for the decrease in value of the towers

Analysis:

- IFRS requires that long-lived assets are tested for indications of impairment at each reporting date
- Given that the hurricane damaged 60 of the towers this would be an indication of impairment and thus an impairment test should be completed
- the impairment test compares the carrying value with the "Recoverable amount" to determine if the carrying value is greater than the recoverable amount
- The recoverable amount is based on the greater of the "value in use" and the fair value less costs to sell

- Value in use is based on the expected discounted cash flows
- Given that the 60 damaged towers had a carrying value each of \$35,000 the total potential impairment write down would be \$2.1 million
- Given that SableTel has not decided whether or not it will replace the towers or fix them it is difficult to determine the appropriate amount of the impairment, however, under IFRS any recovery in value after an impairment write down can be reversed subsequently if the value is partially or completely recovered (only up to the amount originally written down)
- Assuming that these towers are completely replaced or that fixing them would incur very significant costs the entire amount for the 60 towers should be written off completely as their fair value will be 0 since they are damaged and there appears to be no chance to sell them and their value in use is 0 until they are repaired because no revenues will be earned until restored (negligible amount)

Conclusion:

An impairment write down should be recorded for fiscal year 2010 for \$2.1 million (\$35k x 60) which will decreased fixed assets and increase expenses

Operating Performance Relative to Competitors

Exhibit 2 shows that overall profitability, margins, turnover and solvency are below the industry average for SableTel.

Once the impairment and research and development expenses are considered SableTel is actually in a loss position and as a result has a far poorer profitability result than its competitors showing a negative ratio.

Gross profit has also slipped which is likely a result of the reduced revenue which was probably partially due to the loss of SableTel's two largest customers and at the same time cost of sales increased slightly to \$30.7 million from \$30.59 million in 2009 even though sales declined. This indicates that despite Dan's comments cost constraints were not successful as the gross margin declined.

The A/R turnover ratio also highlights another issue which is collections. On average it is taking SableTel 63 days (as shown in exhibit 2) to collect its accounts receivable compared with 55 days on average in the industry. Receivables had over doubled in the year while sales have declined which indicates there is an issue with collections and there may be a need to record a provision as Receivables are less likely to be collectible the older they get.

Further the current ratio although it is slightly higher than average at 0.87 compared to 0.8 on average in the industry is actually not reflective of the poor liquidity position. SableTel's cash position has significantly worsened and is only about 1.8% of current assets compare with 52% in 2009.

Receivables and inventory have both more than doubled and now account for a far greater % of total current assets. This is problematic as inventory and Receivables are far less liquid and impose higher risk that they will actually ever be converted to cash due to collection issues (A/R) and obsolescence issues (inventory).

Solvency is also worsening for SableTel as the operating loss is even greater in 2010 and interest expense has increased slightly from 2009 due to increasing debt (per draft financial statement). This trend is reflected in the negative operating profit/interest expense ratio compared to 8.1 in the industry. This is a problem as NovaStar overall wants SableTel to reduce its risk and this reduce solvency position means that SableTel has actually increased its financial risk.

Conclusion:

SableTel is performing much worse than it has disclosed in its reporting document and must address operating issues to improve its performance for 2011, as will be discussed below.

Review of Reporting Document and Suggested Improvements

Issue 1: Financial statistics and claims are misleading in the document

- Overall this document is misleading
 - once accounting adjustments are made SableTel did not in fact turn a profit and has not had an "outstanding year" when compared to 2009 and to industry averages as analyzed above
- Net income must be revised to show a \$6.6 million loss based on IFRS standards not a \$1.178 million net income
- Cost of sales actually worsened and were not "contained" as gross margins actually declined (i.e. costs of sales increased even though sales decreased)
- Liquidity has declined as total current assets are composed primarily of Receivables which show slow turnover and inventory and are made up of only 1.8% cash compare with approx 50% in 2009

Recommendation for Improvement:

- All of these financial result measures are misleading as they have not been adjusted and the commentary provided is not reflective of the actual financial position SableTel is in and as a result will cause users of the report to make inappropriate decisions thus the information needs to be revised and consistent with the IFRS adjusted results
- Further the comparison with industry averages should be used as a base of financial commentary and explain that the financial picture has many associated risk such as weakening liquidity, solvency and profitability ratios
- Although doing so is less attractive results for inventors it provides a more fair representation of the information and SableTel should focus on what it will do to remedy these current negative results to "improve" the financial picture for users of the report

Issue 2: The document claims that the Wireless Technology Project will have a "substantial impact in the Short term" however the project is not expected to be implemented until January 1, 2012 which is not likely to be considered Short term by investors

- This means that it is unlikely that users of the report and financial statements will not likely see any "significant" positive impact on the financial statements related to the project until at the very earliest the end of 2012 which is 2 years away from this annual report and thus would not be considered short term
- Investment in new technology to increase distribution efficiency is likely to be a long term investment in Sable's future and investors should understand that this is the case so they do not have false expectations based on the report

Recommendation:

- The report should be rewritten to say that investing in this project "has the potential to have a substantial long-term improvement in efficiency and cost reduction" as this more accurately reflects the benefits likely to be derived from the investment

Issue 3: The report says that steps have been taken to reduce SableTel's Risk profile but cites primarily occupational health and safety changes

- changes such as hand sanitizers and less fried food while they may improve health in the work force do not account for the many other forms of risk included in SableTel's risk profile such as financial risk (leverage)
- Thus it would be inappropriate to say that by implementing hand sanitizers "we have met this objective" set by NovaStar
- the fact that solvency ratios (operating income over interest) has declined shows increased risk and thus the conclusion that risk has been decreased relates only to one small aspect of the overall risk profile
- This conclusion is thus misleading to users and may cause them to make inappropriate decisions

Recommendation:

- The statement should be rewritten to say "we have taken steps to reduce certain risks such as occupational health and safety other risks including financial risk have increased in 2010" and then describe solvency ratio results and explain how SableTel plans to mitigate this risk

Analysis of Variance in Results from 2010 to 2009

Trends of concern:

1) Long Distance revenue decline

- The decline in revenue is a result of the decline in long distance
- This is of concern as this is the largest revenue stream
- Also this revenue stream is likely to continue to decline as there increased use of other serves such as mobile and internet as customers change the way they communicate
- SableTel needs to determine a plan that will ensure it can replace this \$28 million stream of revenue to ensure that its market share and total revenue don't continue to decline

2) Increase in A/R

- see discussion above in industry averages for discussion of this increase

3) Administration expenses

- these expenses have declined by \$3million, however this is largely a result research and development costs being capitalized
- As discussed in the accounting issues this was not appropriate and actually resulted in a loss as shown in Exhibit 1
- This shows that costs are not necessarily being "contained" but the accounting treatment was being used to manipulate the fiscal 2010 results showing a reduction in costs
- From a cash flow perspective there was in fact no improvement in financial position which was reflected once the accounting adjustment was made

4) Cost of goods sold has actually increased by 1% as gross margins have decreased from 53% to 52%

- Although the marketing department claimed it had contained costs and Dan discussed in his presentation that costs are down this is not actually the case
- The gross margin has actually decreased which means as a % costs are up as a proportion of sales
- Long distance cost of sales explain this increase as the cost of sales as a percentage of sales is 43% approximately in 2010 versus 38% in 2009

- This means that cost of sales likely did not decrease as rapidly as sales did when the 2 large customers were lost because many costs would be fixed such as sales peoples salaries

Conclusion:

The variance analysis of 2009 to 2010 shows there are some concerning trends which must be addressed. See the discussion of budget 2011 which provides recommendation to address these issues going forward.

Evaluation of 2011 Budget and Likelihood of Results being Achieved

I have recalculated Dan's cash flow in exhibit 4 to ensure that all costs he discussed were included in his summarized financial figures and determined that in fact almost twice the financing in fiscal 2011 is required, approximately \$14 million, and \$31 million in 2012 which is greater than the requested \$21 million. My cash flow includes the over \$4 million required each year for CRTC fees relating to 2011 and 2012, however, it is more alarming because that does not include the fees for 2009 and 2010 which will need to be paid in fiscal 2011- by November 30th - which will cost over \$9 million dollars in additional financing.

This shows that SableTel is in a very high risk position and incurring further debt will only increase the solvency risk (financial risk) even more. I have concerns with the budget as follows:

1) Growth rate projected at 15% for 2011 and 10% for 2012 for revenues

- This seems overly optimistic given that analysts based on industry averages expect growth of only 1.5% in 2011 thus our plans to cross promote and hire more sales staff may support a growth rate higher than that. I feel it is still overly ambitious to use a rate of 15% and 10%.
- Also given the fact we have lost one of our longest serving employees Mr. Oldmun, which may have an negative impact on sales; and additionally we have increased sales force turnover which may result in lost sales relationships, and thus declining revenue, which will have a negative impact on revenue growth rates

Recommendation:

The budget should be revised to include a growth rate of 5% or Dan should provide us with objective support as to why he believes 15% and 10% is appropriate.

2) The 60% margins and non-standard pricing policy

- This new policy increases the risk that budgeted income will not be achieved as it is difficult to budget when there is so much discretion in how pricing will be determined and it is unclear really the amount of discounts that will be offered as the range that has been provided is very wide, from 1% to 15%
- This will impact the gross margin earned and ultimately have a significant impact on the actual results achieved on the budget

Recommendation:

- Dan needs to meet with his sales department including the V.P. and determine a more concrete plan with specific budgets for discounts applicable to various size ranges of customers (i.e. customers with \$50,000 volume sales will get a discount of 7% for example) so that this can be better incorporated in the budget

Overall:

It is not likely that the budgeted profit and cash flows Dan has presented will be achieved based on the current plan and further budgeting needs to take place to make it more precise and thus useful and relevant as discussed above.

Comments on Points Raised in 2011 Strategic Plan and Suggested Improvements

1) Wages compared with industry norms:

- Dan has told us that our sales people are paid \$20,000 less base salary than competitors because he believes it is important to keep the sales force motivated to earn commissions and make more sales
- However this appears to be problematic as there has been increasing turnover in fiscal 2010
- This turnover has caused the sale team not to meet their quota which means it appears that the commission pay structure is actually counter productive
- Turnover is expensive for companies which may have contributed to the reduced gross margins in 2010 as well
- In addition will result in lost relationships causing an overall decrease in sales

Recommendation:

The sales department should be surveyed as to whether their preferred pay structure is % of commission versus base pay and the EC should determine the appropriate changes to pay structure based on this input to improve employee satisfaction and reduce turnover

2) SableTel does not know why it lost its two large customers

- this is problematic as there may be a reason why two large customers were lost, for example bad service or high prices compared to competitors
- IF SableTel does not communicate with customers and find out why they have left SableTel – i.e. Dan had not spoken to the customers to find out why - then SableTel will not be aware of potential operational issues it is having
- This could mean further business is lost for the same reasons and overall sales will decline due to unsatisfied customers

Recommendation:

- SableTel should implement a policy that all cancelled customers over \$5,000 in sales are directly contacted to determine why they left SableTel and enquire what they could have done better to keep the business. This should be documented and recorded in the marketing database.

3) SableTel does not know why expenses have declined

- knowing the explanation behind a variance whether it is a good or bad variance is key to a proper budgeting process
- Also it is good to contain costs but if it is not for the right reasons problems may arise as a result - for example if marketing sales are declining but at the same time sales are too this may be an indication that cutting those costs is having a negative impact on attracting new customers and retaining customers
- Without information as to why expenses are declining Dan cannot determine if it is a trend that should be encouraged or requires attention to correct

Recommendation:

Each department should have to provide a report to the finance department explaining the variances in its budget to actual on a quarterly basis and this should then be reviewed by the budget committee in the finance department to see if there are any trends of concern that need to be addressed. This review should then be presented to the EC for final review.

CRTC Fee Calculation

See exhibit 3 for the revised fee calculations for 2010 and 2009. This shows that using the new CRTC agreement revised after August 31, 2008 SableTel owes approximately \$9.2 million in fees to the CRTC. It is imperative this payment is made by November 30, 2010 or SableTel will have to cease to operate as it will no longer have its license as the CRTC has threatened to revoke unless payment is revised and received based on the revised numbers.

Since NovaStar plans to rely on SableTel for growth in high tech we need to ensure that SableTel has the cash available to make that payment which will likely requires us loaning them the funds as they only have \$351,000 in cash per the 2010 August 31, balance sheet.

This revision of the fees shows that the error of the draft calculation was approximately \$500,000 for 2010 and \$1.1 million in 2009. (using Exhibit 3 calculation less the draft submission estimates of \$3.8 million for each year).

Audit Planning For CRTC Fees**Risk Analysis**

- risk that fees payable to the CRTC will be understated by SableTel as they don't have the cash flow to pay the large amount of fees owing
- Controls over gross margins appear to be weak as the finance department and the marketing department had conflicting information in their data bases which means there is increased risk that the fees will be understated as there is incentive not to report the negative gross margins that will increase the fee by SableTel and risk due to error as the databases appear unreliable

As a result of the risk identified I assess risk for the audit as high.

Procedures to be performed**Risk Area: Negative gross margins**

- There were discrepancies noted between the marketing database and as a result no negative margin base was included although it is unclear if there is a liability to the CRTC for this or not
- Thus completeness of negative gross margins is the risk

Procedure:

- Report from the finance department showing the negative margins should be obtained by internal audit
- The reports should select a sample of negative margin contracts and agree sample items to the sales contract they relate to and to costing/progress reports for the contract
- They should then recalculate the negative margin based on the sale price and the costs incurred on the contract
- If there is in fact a negative margin this indicates that the finance reporting is likely more accurate and thus should be included in the fee calculation

- Note although: selecting items from a report is usually considered testing an existence assertion; this is appropriate in this case since the finance department negative margin report was conflicting and thus never included - thus a procedure showing their listing is accurate will ultimately be used to ensure completeness of the negative margins included in the CRTC submission
- 2) Existence of expenses
- There is incentive for SableTel to overstate expenses so that it reduces the base used to calculate the CRTC fee (applying the 12% rate)

Procedure:

- Obtain listing of all major expenses included in the various Cost of sales streams
- Internal audit should then select a sample of expenses from the various listing to get representative sample and obtain the supporting documentation for the expenses to vouch the expenses - for example the invoice from the supplier of long distance or time sheets from employees working on a mobile service
- these invoices/time sheets should be reviewed to ensure they relate only to eligible expenses and are for the appropriate amount showing in the invoice/timesheet - for example they don't relate to US suppliers as this is not eligible

- 3) Completeness of revenues
- revenues increase the base calculation of the fee thus there is incentive to understate revenues
 - the internal audit should obtain the location of revenue contracts in the sales department and select a sample of contracts
 - the contracts should then be traced to the sale journal to ensure that the sales were included in the appropriate revenue stream – i.e. internet versus long distance and then ensure the total sales journal amount was included in the CRTC submission form if it was an eligible revenue stream - example long distance

Exhibit 1 Revised Results Based on Accounting Adjustments

Purpose: To revise Net Income for accounting errors made

	2009	2010	
Net Income Unadjusted	-1287860	1178000	
Adjustments			
Expense R&D costs (2009 costs)	-3457860		See accounting discussion 1
Expense R&D costs (2010 costs)		-5702390	See accounting discussion 1
Impairment of Towers	0	-2100000	See accounting discussion 2
Revised Net Income	-4745720	-6624390	Assuming that the draft FS had included this reversal adjustment

Conclusion:

Based on the adjustments above SableTel did not actually generate a profit in 2010 but a loss off over \$6.6M

Exhibit 2: Performance Relative to Competitors

Purpose: To compare operating performance of SableTel with competitors based on ratio analysis

	SableTel 2010	Competitors 2009	2010	2009	
Return on Equity	-0.25151		0.105		Based on revised net income in exhibit 1
Gross Profit	0.50716		0.52		Note 1
Operating Profit	-0.1018		0.127		Based on revised net income above and revenue per the draft F/S
A/R Turnover	5.745068		6.7		Based on Sales divided by average A/R (2009 to 2010) given in draft F/S
Days A/R	63.53275		54.4776119		365 days/ A/R turnover gives Days A/R ratio
Current Ratio	0.872856		0.8		
Operating Profit/Interest	-2.2322		8.1		based on revised net income from exhibit 1 and interest expense from draft financial statements

Conclusion:

Based on revised Net Income and operating income from exhibit 1 the ratio analysis compared to competitors shows that SableTel is performing below industry average over all. See report for further discussion

Note 1

Remove grant funding of \$2.75M as this is non recurring amount and is not reflective of operating results compared with competitors going forward as it is unlikely this stream of revenue will continue thus a more reflective measure of performance removes this amount as I have done

Exhibit 3: CRTC Fee Recalculation for 2009 and 2010

Purpose: To recalculate the CRTC fee for 2009 and to calculate the fee for 2010 as required by the CRTC letter received in order to maintain licence

	2010	2009	
<i>Revenues</i>			
Adjustments	65072224	65176742	Per draft fee calculation
Government Grant	-2750000	0	Note 2
Internet and Data Services	-3789070	-2896739	Note 1
Routers and Modems	-1675759	-1567830	Note 1
Total Fee Revenue Base	56857395	60712173	
<i>Less Qualifying Costs</i>			
Adjustments	26897386	26748892	Per draft fee calculation
US Supplier Charges	-897500	-788000	Per CRTC Fee formula costs paid to non Canadian entities are excluded from the formula base
Related Party Services	-1357850	-1458760	Per CRTC Fee formula costs paid to related parties are excluded from the formula base
Internet and data Services	-1002159	-795119	Note 3
Internet and data - Modems	-679859	-3842785	Note 3
Total Qualifying Costs	22960018	19864228	
200% of Negative Margin Customers			
Negative Margin per Finance Report	1130000	0	Note 4
At 200% of negative margin	2260000	0	
Total Fee Base	36157377	40847945	Revenue less qualifying costs plus 200% of netative margin customers
CRTC Fee Rate 12%	4338885	4901753	Total fee base x 12% per agreement after August 31 2008

Conclusion:

Based on the revised calculation using the new CRTC agreement after August 31, 2008 the fee calculation is actually \$4.3M for 2010 and \$4.9M for 2009 which means each year's fee is approximately \$1M greater than budgeted.

Note 1

Internet and Routers are not included in the revenue calculation per CRTC specified fee formula provided thus the amounts relating to these revenue streams have been removed based on the 2010 draft F/S

Note 2

Government grants is also not a revenue stream to be included in the revenue base for the fee calculation and thus has been removed based on the amount per the draft FS 2010

Note 3

Per the CRTC fee agreement formula the internet data services costs streams should not be included in the qualifying cost base thus need to be removed

Note 4

The finance department determined that there were \$1.13M in negative margins but this was adjusted in the original calculation of the fee by Sabletel because there was a discrepancy according to the marketing department database and IT could not explain the difference. I assumed that these costs should be included in the base of the fee calculation as the marketing department has incentive to say that there are no negative margin customers as this reflects badly on their pricing and selling and cost containment efforts. Thus I assume that the finance department has less bias to misstate this information and more expertise in the area of margin calculations so I have relied on their numbers until the database issue is resolved.

Exhibit 4: 2011 Revisions to Budget

	2011	2012	
2012 Net Income	1178000	1178000	Base of 2010 not adjusted as impairment of towers due to hurricane not expected to be recurring and R&D has been included in capital spending
Increase in Sales 15% and 10%	4674167	3349819.54	Note 1
Gross Margin Adjustment	0	0	Note 5
Executive Bonus Plan	-750000	-750000	Assume midpoint in range of \$500k to \$1M provided by Dan as we have little information how the bonus is calculated
Service Staff Increase	-3575000	-4550000	Note 2
Sales Staff Increase	-1040000	-1040000	Assume fee increases at the same revenue growth rate of 15% and 10%
CRTC Fee	-4989718	-5488689.8	Per Dan's budget in presentation
Add: Depreciation	10790000	7500000	
Total Cash flows from Operations	6287449	199129.711	
Capital Spending	0	32000000	Per Dan's budget in presentation for 2012 as not provided with specific outflows
Wireless Technology Project	20000000	0	Note 6
Modification to Billing software	450000	0	Note 4
Total Investing Cash flows	20450000	32000000	
Total Cash Flows	-14162551	-31800870	

Conclusion: Based on the revised estimates above SableTel requires at least \$32M in financing for 2012 and \$15M in 2011.

Note 1

Assume revenue will increase by 15% as Dan has provided in 2010 based on report draft 2010 revenue less the government grant as not anticipated to be recurring of \$2.75M and then compounded growth of 10% in 2012

The increase in sales was included at 50% to account for a 50% margin i.e., increase in sales is net of increase in cost of sales based on a 50% margin

See note 5 for discussion of 50% gross margin

Note 2

To account for increase in staff as a result of customer service plan as it is estimated 55-70 service staff employees will be hired

I assumed 55 new employees in 2011 and the full 70 will be employed by 2012 as it takes time to recruit that many new people and I assumed an average salary of \$65k as this is what the market is paying and will likely be necessary to attract new people

Note 3

16 employees at \$65k expected to be hired based on Dan's plan
note salary of \$65k was used as SableTel base is \$45k but employees have opportunity to earn commission and competitors base is \$65k
thus \$65k accounts for some commission earned and at the very minimum meeting the competitors base salary

Note 4

Modification is required in order to be able to do cross selling plan to increase revenues

Note 5

No increase in budgeted cashflows from operations was included as although the plan is to increase margins to 60% there are also plans to offer discounts of 1% to 15% for the largest customers and to us a "non-standard" pricing policy which will allow for more discretion in pricing. As a result I assume that margins will actually decline to 50% to make a conservative estimate considering the implementation of this new policy.

Note 6

Per Dan Wilson Presentation and assume once implement in 2012 no further research and development costs will be incurred

THE INSTITUTES OF CHARTERED ACCOUNTANTS OF CANADA

2010 Uniform Evaluation

PAPER II

Time: 4 hours

NOTES TO CANDIDATES:

- (1) *Simulations that require knowledge of the Income Tax Act, the Income Tax Application Rules 1971, and the Income Tax Regulations are based on the laws enacted at March 31, 2010, or in accordance with the provisions proposed at March 31, 2010.*

Provincial statutes, including those related to municipal matters, are not examinable.

- (2) *To help you budget your time during the evaluation, an estimate of the number of minutes required for each simulation is shown at the beginning of the simulation.*
- (3) *Tables of present values, certain capital cost allowance rates, and selected tax information are provided at the end of the evaluation paper as quick reference tools. These tables may be used in answering any simulation on the paper.*
- (4) *Answers or parts of answers to simulations will not be evaluated if they are recorded on anything other than the CICA-provided USB key or the writing paper provided. Rough notes will not be evaluated. You are asked to dispose of them rather than submit them with your response.*

* * * * *

Paper II - SIMULATION 1 (80 minutes)

It is Monday, September 13, 2010. You, CA, work at Fife & Richardson LLP, a CA firm. Ken Simpson, one of the partners, approaches you mid-morning regarding Brennan & Sons Limited (BSL), a private company client for which you performed the August 31, 2009, year-end audit.

“It seems there have been substantial changes at BSL this year,” Ken explains. “I’m going there tomorrow, and since you will be on the audit again this year, it would be beneficial for you to come. I took the liberty of retrieving information from last year’s files so you can refresh your memory about this client (Exhibit I).”

The next day, you and Ken meet with Jack Wright, the accounting manager at BSL. Jack gives you the internally prepared financial statements (Exhibit II). To your surprise, there are also financial statements for two new companies. Jack quickly explains that BSL incorporated two subsidiaries in January 2010, each with the same year-end as BSL:

Brennan Transport Ltd. (Transport) – 100% owned by BSL

Brennan Fuel Tank Installations Inc. (Tanks) – 75% owned by BSL

You diligently take notes during the meeting (Exhibit III). Jack states that BSL will prepare consolidated financial statements for audit based on Canadian Generally Accepted Accounting Principles (GAAP) to satisfy the bank’s request, and that the owners have also asked for review engagement reports at the subsidiary level.

Ken asks that you work on the overall planning for these engagements. As part of your planning, he asks you to discuss the new accounting issues that arise as a result of the changes during the year and to evaluate their implications for the engagements.

Later that day, Ken also forwards you an email from Jack (Exhibit IV), and asks you to make some notes on the companies’ tax situation and any other issues that are relevant.

Paper II - SIMULATION 1 (continued)

EXHIBIT I

INFORMATION FROM LAST YEAR'S AUDIT FILES

EXCERPT FROM PERMANENT FILE

Date of incorporation: October 27, 1982
Year end: August 31
Ownership: 50 common shares Harold Thomas
50 common shares Kyle Stanton

Nature of the business: BSL operates as a scrap metal dealer and processor. It buys used scrap metal from individuals and businesses, then bundles the different metals and sells them in larger quantities at a higher price to bigger recycling businesses. BSL's revenue fluctuates significantly because of the volatility in the market rates for steel and non-ferrous metals. To help control costs, BSL uses its own trucks and trailers to do the pickups. BSL earns additional revenue by providing transportation services to other businesses and by renting out the trucks during slower periods.

As part of BSL's overall strategy, the owners admit a willingness to take risks. They monitor the marketplace and are always on the lookout for new business opportunities. They even found a piece of land on the outskirts of the city that they thought would be great for a dump they considered operating themselves. They decided not to make an offer, but may reconsider in 2010.

EXCERPT FROM 2009 AUDIT FILE

For BSL's 2009 audit, materiality was set at \$70,000.

Paper II - SIMULATION 1 (continued)**EXHIBIT II****INTERNAL FINANCIAL STATEMENTS*****BRENNAN & SONS LIMITED******BALANCE SHEET******As at August 31******(in thousands of dollars)***

	2009		2010	
	(audited)		(unaudited)	
	BSL	BSL	Transport	Tanks
<u>Assets</u>				
Cash	\$ 467	\$ 75	\$ 67	\$ 82
Accounts receivable	970	603	119	-
Inventory	10	500	-	15
	<u>1,447</u>	<u>1,178</u>	<u>186</u>	<u>97</u>
Note receivable	-	431 (note 1)	-	-
Property, plant & equipment	4,768	13,400	400	80
Investment in subsidiaries	-	2	-	-
Intangible asset	-	-	-	20 (note 2)
	<u>\$ 6,215</u>	<u>\$ 15,011</u>	<u>\$ 586</u>	<u>\$ 197</u>
<u>Liabilities</u>				
Accounts payable	\$ 315	\$ 813	\$ 128	\$ 166
Note payable	-	-	431 (note 1)	-
Mortgage payable	100	6,500	-	-
	<u>415</u>	<u>7,313</u>	<u>559</u>	<u>166</u>
<u>Shareholders' equity</u>				
Common stock	1	1	1	1 (note 3)
Retained earnings	5,799	7,697	26	30
	<u>5,800</u>	<u>7,698</u>	<u>27</u>	<u>31</u>
	<u>\$ 6,215</u>	<u>\$ 15,011</u>	<u>\$ 586</u>	<u>\$ 197</u>

Notes:

1. Note receivable/payable for sale of trucks and trailers from BSL to Transport, interest at 8%
2. Training costs for Sean Piper, owner/installer
3. Includes Sean's equity interest

Paper II - SIMULATION 1 (continued)**EXHIBIT II (continued)****INTERNAL FINANCIAL STATEMENTS****BRENNAN & SONS LIMITED****INCOME STATEMENT***For the year ended August 31,**(in thousands of dollars)*

	2009		2010	
	(audited)		(unaudited)	
	BSL	BSL	Transport	Tanks
	(12 months)	(12 months)	(8 months)	(8 months)
Revenue				
Scrap metal	\$ 11,000	\$ 10,003	\$ -	\$ -
Transportation services	900	300 (note 4)	700 (note 4)	-
Fuel tank installations	-	-	-	320
	11,900	10,303	700	320
Cost of sales				
Scrap metal	1,600	1,440	-	-
Transportation services	700	340	550	-
Fuel tank installations	-	-	-	220
Gross margin	9,600	8,523	150	100
General & administration (note 5)	8,491	7,930	90	50
Interest expense	9	120	16	-
Income before other income	1,100	473	44	50
Other income				
Gain on sale of equipment	-	84	-	-
Gain on sale of property	-	2,500	-	-
Interest income	-	16	-	-
Property rental	-	90 (note 6)	-	-
Income before income tax	1,100	3,163	44	50
Income tax	440	1,265	18	20
Net income	\$ 660	\$ 1,898	\$ 26	\$ 30

Notes:

4. Transport took over transportation services in January
5. 2010 General & administration includes amortization
6. \$10,000 per month from Transport and \$5,000 per month from Tanks for six months

Paper II - SIMULATION 1 (continued)

EXHIBIT III

NOTES FROM YOUR MEETING WITH JACK WRIGHT

BSL continues to operate the scrap metal business. BSL's management thinks the price of metal is going to go up in the near future, and has therefore started stockpiling for the first time. Unfortunately BSL doesn't really have an inventory tracking system in place. If in fact it turns out stockpiling is a good way for BSL to make money, it will install a better system. The company did its best to log each of the amounts going into the stockpile as it was added, knowing that an amount for its year-end inventory balance would need to be determined. BSL also used a known engineering formula to come up with an estimate for year-end inventory and tried to measure the different piles of metal as a way of counting what was on hand at August 31, 2010. The different methods came up with different amounts, so management went with the initial amount based on the log. Jack noted that we would have had a good laugh at the different ways they tried to measure the piles if we'd been there to see it.

As soon as it was incorporated on January 1, 2010, Transport took over BSL's transportation operations. Transport provides transportation services to BSL and external customers, the same as BSL did. BSL sold the trucks to Transport in late January at fair market value (Exhibit IV); however, Transport didn't have the funds to buy the equipment, so BSL issued a note receivable at what Jack believed to be the market interest rate.

Tanks installs and maintains pre-engineered, above-ground fuel storage tank systems, a new line of business for BSL. Sean Piper, a good friend of one of BSL's owners, approached BSL last fall with the idea. Sean was willing to take the necessary training to become a certified fuel tank installer, and he wanted 50% ownership in Tanks. The owners of BSL agreed it was a great opportunity but wanted more control. The parties settled on Sean's receiving 25% ownership of Tanks.

As part of the agreement, BSL was required to provide a guarantee pertaining to Tanks' licensing application to the environmental authority since Tanks was a newly formed corporation. Although other vendors sell the same tanks and installation services separately, Tanks only sells the tank combined with installation and service. The tank is marked up by 20% on the price paid and is sold including installation and a five-year maintenance package for a total of \$40,000. One hundred percent of the revenue is recognized when the sales agreement is signed by the client. The tank is then delivered and installed at the client's site within two to three weeks of signing. The fuel tanks need to be pressure-tested every year and the measurement gauge needs to be checked. Tanks will perform the maintenance services for clients for the first five years. Thereafter, Tanks will offer to continue to perform the maintenance for a contract price of \$5,000 a year.

Paper II - SIMULATION 1 (continued)

EXHIBIT III (continued)

NOTES FROM YOUR MEETING WITH JACK WRIGHT

BSL's owners decided it was time to move to a bigger location, so in March 2010 the company sold its land and building on Frank St. and bought land and a building in the Johnson Industrial Park. The new building is large enough to accommodate all the companies' operations, and more. BSL's owners are thinking of renting some of the extra space to other businesses and have already been approached by a few interested parties. All tenants, including BSL's subsidiaries, will be charged the same rent per square foot, based on current market rates.

The next venture the owners are thinking of pursuing is to use part of the new building to run a used furniture store, which they would operate in another subsidiary company.

BSL made a large profit on the Frank St. property since it was bought back in 1982, but Jack is concerned that because the old building fell into Class 3 (pre-1988 buildings) and the new building will be Class 1, a large tax liability will result from this transaction due to the recapture and capital gain.

Paper II - SIMULATION 1 (continued)**EXHIBIT IV****EMAIL FROM JACK WRIGHT**

Hi Ken,

Further to our discussion this morning, I thought I'd send over the details of the vehicles we sold to Transport. We had them valued in January when we made the transfer. I've included their net book value, fair market value, and undepreciated capital cost at that time. I'm no tax expert, but I think I get some losses that I would like to use. Any insight you could give us into this transaction would be a big help!

	<u>NBV</u>	<u>FMV</u>	<u>UCC</u>
Trailers	\$ 37,000	\$ 41,000	\$ 46,000
Trucks	<u>310,000</u>	<u>390,000</u>	<u>450,000</u>
	<u>\$ 347,000</u>	<u>\$ 431,000</u>	<u>\$ 496,000</u>

I thought while I was at it I would give you some details on the land and buildings sold and acquired.

		<u>Acquisition Cost</u>	<u>NBV/UCC</u>	<u>Sales Proceeds</u>
Frank St	Building	\$ 4,500,000	\$ 3,000,000	\$ 5,250,000
	Land	<u>500,000</u>	<u>500,000</u>	<u>750,000</u>
		<u>\$ 5,000,000</u>	<u>\$ 3,500,000</u>	<u>\$ 6,000,000</u>
Johnson	Building	\$ 9,000,000		
	Land	<u>1,000,000</u>		
		<u>\$ 10,000,000</u>		

Thanks again for all your help,

Jack

EVALUATION GUIDE
PAPER II, SIMULATION 1 – BRENNAN & SONS LTD.
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source of GAAP.

Memo to: File
 Subject: Planning the 2010 engagements for BSL group of companies

In the past, we have audited the Brennan and Sons Ltd. (BSL) financial statements. For the current year, we will be performing multiple engagements for this client for its 2010 year-ends, including review engagements for the subsidiaries and an audit of the consolidated statements for the BSL group of companies. BSL has not requested a report from us for its unconsolidated financial statements. We will need individual engagement letters, management representation letters, and independence letters for all of the legal entities we have been asked to work on.

In addition to the engagement considerations for BSL and its subsidiaries, we will need to discuss new accounting policies for the consolidated group, since there have been significant changes in the operations of BSL over the past year. Finally, the owner of BSL has several tax concerns, which we have addressed below as well.

Primary Indicator #1

The candidate discusses planning considerations for both the audit of the consolidated financial statements and the reviews of the individual subsidiary companies.

The candidate demonstrates competence in Assurance.

Competencies

VI-1—Analyzes, evaluates and advises on assurance needs (A)

VI-2.2—Evaluates the implications of key risks and business issues for the assignments (A)

VI-2.3—Determines which rules, standards or policies to apply to the subject matter being evaluated (A)

VI-2.4—Develops guidelines to set the extent of assurance work, based on the scope and expectations of the assignment (A)

VI-2.5—Designs appropriate procedures based on the assignment's scope, risk and materiality guidelines (A)

(CAS Guidance: Candidates applying CASs may discuss the need to assess whether the financial statement framework chosen by the client (current Canadian GAAP) that will be applied in the preparation of the financial statements is acceptable; in other words, whether the preconditions for performing an audit are met by the client (CAS 210) and if the audit fits within general purpose financial statements or specific purpose financial statements (CAS 200).)

(In this case, the financial statements are being prepared to meet the specific needs of the bank. However, the bank has stated that the statements should be in accordance with Canadian GAAP, so they are not special purpose financial statements. The loan agreement should be examined to ensure there are no additional reporting requirements that need to be considered.)

Risks

Engagement Risk Factors — The Entity and its Environment

We will be auditing a set of consolidated financial statements for the first time for this client. Since it will be the first time the client will perform a consolidation, the consolidated financial statements may contain errors as a result of the client's inexperience. We will have to carefully scrutinize the statements to ensure the consolidation has been done correctly. There are two new subsidiaries for which all the intercompany transactions and intercompany balances have to be eliminated. Additional scrutiny to identify the related party transactions will be required. In addition, the treatment of the non-controlling interest will have to be verified. This is the first time BSL has had to account for outside ownership, so there could be errors here as well.

The review engagements are for the newly formed companies: Brennan Transport Ltd. (Transport) and Brennan Fuel Tank Installations Inc. (Tanks). While we are fairly familiar with the nature of the business of Transport, since BSL used to perform these operations, we will need to make sure there have been no significant changes to the business. Tanks, however, is a completely new company and new business area, and it involves new outside ownership: 25% is owned by Sean Piper, whom we have never dealt with before. We will need to gain an understanding of the industry, the business, and management. The nature of the business — fuel tank installation and maintenance — creates an environmental risk, which needs to be considered as part of the engagement planning.

BSL has a new mortgage in place related to the new land and building, and it is substantially more than the old mortgage amount. The bank is most likely using the consolidated financial statements to assess the financial stability of BSL as a whole. This adds additional risk to our audit engagement. We will need to get a copy of the new banking agreement to ensure all conditions and covenants are met, to gain an understanding of the pledge arranged for the assets, and to obtain details that will allow us to properly disclose the nature of the debt in the notes to the consolidated financial statements. We should also obtain copies of the vendor contracts related to the sale and subsequent purchase of land and building as a way of validating the proceeds, etc.

(Most candidates commented on specific new risk factors affecting the current year, using simulation facts to support their comments and concluding appropriately regarding the level of engagement risk. Some candidates did not use case facts to support their risk assessments, and as a result they had a difficult time providing any depth of analysis.)

Review and Audit Engagements

Approach

We will be performing review procedures at the individual entity level and audit procedures at the consolidated level. When designing our procedures, we should ensure that we are performing our work efficiently and avoid duplication of work at the subsidiary and parent levels. We also need to ensure we have met the documentation standards for each type of engagement. There may be ways of performing some of the required review procedures so that they could provide sufficient evidence for the audit level of assurance, and there may be some audit procedures that can also be used for the review engagement. In the latter case, we will need to be careful that we don't give the impression in the review engagement file that we have completed an audit.

(Many candidates did not understand that the review engagements were separate from the consolidated audit engagement and spent time discussing why reviews were not possible, or failed to address the review engagements at all. As a result, their discussions tended to focus on the consolidated audit engagement only.)

Materiality

The audit engagement will need its own level of planning materiality (see AuG-41).

The common range for private companies is 5% to 10% of net income. Although BSL's net income this year is much higher than it was last year, this is mostly due to the gain on sale of the land and building. This is a non-recurring event and it is not appropriate to increase materiality on that basis. I suggest using a materiality that is based on income before other income, which is much lower for the consolidated company. The range would be between \$28,350 and \$57,000 ((income before other income of \$473,000 for BSL + \$44,000 for Transport + \$50,000 for Tanks = \$567,000) × 5% to 10%), noting that none of the intercompany transactions have been eliminated yet. This range is significantly less than last year's materiality of \$70,000 (\$1.1 million × 5% to 10% = \$55,000 to \$110,000).

The audited consolidated statements will be used by both management and the bank. Since the mortgage amount is much larger than the previous year, the bank will likely be relying quite heavily on the financial statements to assess the financial strength of BSL and its subsidiaries. For this reason, materiality should be set at the lower end of the established range; that is, at 5% of net income before income taxes — perhaps \$25,000.

(Many candidates attempted a discussion and calculation of materiality for the audit engagement. However, their analyses often did not consider the significance of the current debt load. In addition, some candidates recognized that materiality should be lower this year, yet their calculations resulted in a higher materiality than the previous year (as their calculations did not remove the non-recurring gains on the sale of equipment and property from net income). Candidates did not step back and assess the results of their quantitative analysis in light of their qualitative comments to ensure that their conclusions were consistent.)

As a result, there may be an issue with the audit of opening balances because BSL was audited to a higher materiality level (\$70,000 per the audit file) for the 2009 year-end. Work will have to be done on the opening balances using the new materiality level, to ensure they are not materially misstated. Based on the nature of the opening balances, it should be possible to do so.

(Few candidates identified the impact a lower materiality level this year has on the opening balances.)

In terms of the review engagements for Tank's and Transport's individual statements, it is not necessary to set a materiality at the planning stage (see Section 8200 of *CICA Handbook — Assurance*). We will evaluate at the end of the work if the errors we find are material. However, it is useful to have an idea of what might be material as a way of guiding our procedures. Since the financial statements are only being used by management, a materiality level at the high end of the range, 10% of net income before taxes (~\$4,000 to \$5,000 based on the financial statements), is a good starting point to help evaluate any potential errors.

(Most candidates who recognized the distinct engagements (audit and review) discussed materiality and significance levels for both.)

(CAS Guidance: Guidance under CAS 315 and 320: Candidates should discuss setting a planning materiality for the financial statements as a whole and possibly setting different materiality levels for particular classes of transactions or account balances, like the intercompany transactions. Candidates may also mention performance materiality and may comment on the fact that it may change once the audit begins.)

The actual calculation discussions would be similar based on the following:

CAS 320 A4 — Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

CAS 320 A7 — Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.)

Specific Risk Areas and Suggested Approach

Intercompany Transactions

It is evident that there are many intercompany transactions. At the review engagement level, we will need to ensure the intercompany transactions and balances are properly accounted for in accordance with Canadian GAAP. Our procedures will need to focus on particular accounts — note receivable, note payable, interest revenue and interest expense, rent revenue and rent expense, due to/from related parties (if any balance exists based on management enquiry), the gain on sale of equipment, etc. Our concern surrounding related party transactions is valuation, presentation, and disclosure.

For each type of transaction, we will need to ensure the client has recorded the transaction properly at either the carrying amount or the exchange amount, depending on the nature of the specific transaction. Much of the review engagement work surrounding this issue will come from talking to management and reviewing related documentation. For example, for the sale of the equipment, we can review the capital asset section prior to the sale using last year's capital asset continuity schedule to ensure opening balances and amortization calculations up to the date of the sale are reasonable.

For the audit at the consolidated level, we will need to ensure the client has properly eliminated all the intercompany transactions that occurred during the year and the balances as at August 31, 2010. Much of the work done at the review engagement level to identify and disclose the transactions will be useful in ensuring these transactions have been eliminated at the consolidated level. We may want to look at some of the specific legal documentation related to the formation of the subsidiaries to make sure that the equity transactions are properly reflected. Journal entry testing using CAATS across the various entities could help identify transactions that have the same or similar amounts, the same dates, and opposite accounts.

(Many candidates identified intercompany transactions as an area of risk for the current year's engagement. When these transactions were discussed, specific simulation facts were used for support, and candidates commented on what additional work would be necessary to cover off this risk.)

Inventory

Quantity

For the first time, BSL has been stockpiling scrap metal inventory. This is because the price of scrap metal is expected to increase. However, BSL does not have a good inventory tracking system in place based on the information Jack provided. Instead, BSL did its best to track the additions to the stockpile throughout the year. They tried to "count" the inventory at year-end using some sort of formula, but management wasn't able to confirm the amount they had logged. They ended up using their initial estimate, as logged by them, to estimate the amount of scrap metal inventory.

Last year's inventory balance of \$10,000 was immaterial, so we likely did not attend the count. We did not attend the "count" again this year, which is a concern from an audit perspective since the inventory amount is now quite significant (\$500,000). The amount of inventory recorded on the balance sheet, and the cost of goods sold amount on the income statement, are therefore not certain. Also, since we did not attend the count and we likely cannot rely on the accuracy of the log (we can't test its accuracy), we may have to qualify our audit report on the consolidated financial statements (scope limitation). Before doing so, though, we should explore alternative ways of gaining assurance about the inventory, if possible. Since it is only 13 days after year-end, a count and rollback might be possible. However, since there is no inventory system in place, we may only have the log as a "system" to rely upon to do the rollback. The log could be used to trace back the amounts that were put in the pile after year-end, but we are not certain it is reliable. In order to substantiate the amounts in the log, we can agree the amounts added to the pile by looking at the receipts issued when the scrap metal was purchased. To determine the amounts coming out of the log, we can look at the sales invoices.

Alternatively, BSL could work with a specialist to get a better estimate of the year-end inventory amount. A specialist might be able to calculate a reliable amount for BSL to use instead of depending on the log, or might be able to help better apply the formula that BSL used so that the differences found between the log and the pile are explained or eliminated.

Note that if BSL uses a specialist, we may be able to rely on that work for our audit. However, we may need to get our own specialist to help us explain how BSL's specialist measured the inventory, depending on the circumstances. We will need to perform the necessary procedures to be able to rely on the work performed by the specialist; for example, ensure he or she has the expertise, assess the independence of the specialist, agree on what can and cannot be communicated, etc. (Section 5049 of *CICA Handbook — Assurance*).

Price

The valuation of the scrap metal inventory is also a potential issue. The market rates are volatile for the different metals. However, there appears to be a “market” for scrap metal, so BSL can likely determine prices for the various metals it has stockpiled. We will need to determine what price BSL used to value its inventory and assess whether the inventory was valued at the lower of cost and net realizable value.

(CAS Guidance: CAS 501 (audit evidence — specific considerations for selected items) addresses how to obtain sufficient and appropriate evidence when auditing inventory, particularly around existence and condition of inventory (see paragraphs 4 to 7, which describe the need to count or to perform alternate procedures, or, if unable to do either, to modify the auditor's opinion).)

(The same discussions would be had with respect to the specialist under CAS, but might be broken down further based on the fact that CASs separate external specialists from those internal to the firm. Note, though, that the case facts do not require a discussion of management's specialist since there isn't one.)

(A key difference when compared with Canadian standards is that the work of a specialist used by a client could be relied upon for audit purposes under Canadian standards if the specialist is judged to meet reliance criteria of independence, etc. Under CASs, this specialist is part of normal audit evidence:

CAS 620 (using the work of an auditor's expert) — An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

CAS 500 (audit evidence) — Management's expert is defined as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.)

(Candidates were able to identify issues relating to inventory and supported their discussions with simulation facts, often recognizing the audit concerns as a result of stockpiling inventory and the issues with respect to the determination of the quantity of inventory held at year-end and verifying its value. Useful procedures to mitigate the level of risk were suggested by most candidates, such as the rollback of inventory and substantiating amounts to supporting documentation. Some candidates automatically jumped to the conclusion that a qualification was necessary, rather than consider the alternative ways assurance could be obtained over the inventory balance. It is important for candidates to think through the issues rather than jumping to the obvious, but not necessarily correct, recommendation.)

Environmental Liabilities

The nature of the fuel tank installation business may add additional environmental risk for Tanks. This risk is shared by BSL because it has guaranteed Tanks' operating license and owns 75% of Tanks. Our search for unrecorded liabilities will need to include a search for potential legal consequences for both Tanks and BSL that could be related to the licence — for example, a fine, a lawsuit related to damage to the environment, or any work required if the company needs to return to a client and clean up a leak. We will need to discuss these potentially unrecorded liabilities with the client at the review engagement level and discuss the need to disclose such information in the financial statements. We should also review the laws and regulations Tanks is required to comply with to assess the risks to both Tanks and BSL.

In addition, we may need to do work regarding an asset retirement obligation (ARO). An ARO is defined as “any legal obligations that are associated with the retirement of a tangible long-lived asset that result from its acquisition, construction, development, or normal operation.” Although BSL has always had inventory, now that it has started stockpiling metal, the amount of inventory may have increased to the point where it is possible that the company has a legal obligation to clean up the land around the stockpile since metal tends to rust, which could contaminate the land.

At the consolidated audited financial statement level, procedures could include discussions with management, discussions with employees, a sampling of the bank activity subsequent to year-end and sending appropriate legal letters. We should find out what sort of obligations BSL may have to comply with now that it has started the practice of stockpiling. We may require the assistance of a specialist to audit the ARO.

(Many candidates did not identify environmental liabilities as a concern. Candidates who did address the issue made only brief comments when discussing the Tanks review engagement and did not provide any plans for reducing this risk. Few candidates discussed the potential environmental risk regarding the stockpiled scrap metal.)

Warranty Provision

We should obtain information as to the type of product and installation guarantee, if any, that is provided with respect to the fuel tank installations line of business, since it is new. It will be important to obtain this information in order to ensure that the liability, if any, is properly accrued.

(This issue was rarely identified by candidates.)

For Primary Indicator #1 (Assurance), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	2.7%
Reaching competence — The candidate identifies several of the new planning issues OR discusses some of the new planning issues.	58.0%
Competent — The candidate discusses the significant new planning issues, recognizing both the audit and the review engagements, OR discusses several of the new planning issues for the audit engagement.	39.0%
Highly competent — The candidate discusses several of the significant planning issues, recognizing both the audit and review engagements.	0.2%

(Candidates were asked to discuss the planning considerations for both the audit of the consolidated financial statements of BSL and the reviews of the individual subsidiary companies. To achieve competence, candidates were expected to discuss, in sufficient depth, the significant new planning issues (recognizing both the audit and review engagements) or discuss several of the new planning issues for the audit. Candidates were directed to this indicator, since the partner asked that CA work on the overall planning for these engagements.)

(Candidates performed below expectations on this indicator. Most candidates were able to discuss, in some depth, general planning considerations for the audit, and applied simulation facts appropriately in their discussion. Candidates also attempted to address one of the significant risk areas (usually inventory or intercompany transactions); however, most failed to communicate or demonstrate in some way that they understood reviews of the subsidiaries were different than audits, which was one of the key elements being evaluated by the BOE.)

(Strong candidates provided greater depth of discussion on the consolidated audit engagement and also discussed the new review engagements. Their responses covered both general planning and several of the significant risk areas in some depth. The application of case facts throughout their discussions was stronger and procedures to address the risks were also provided. In general, the depth of discussion demonstrated by better candidates was stronger, both from a technical as well as an application perspective. Weak candidates addressed general planning issues briefly (often making inappropriate comments regarding materiality and approach), did not address the review engagements, brought few of the specific simulation facts into their discussions, or provided generic solutions.)

(As shown throughout the solution, candidates had the option of applying the new CASs when responding to this simulation. However, few candidates chose to do so.)

Primary Indicator #2

The candidate addresses the accounting issues arising from the changes at BSL during the year.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies

V-2.3 – Accounts for the entity's routine transactions (A)

V-2.4 – Accounts for the entity's non-routine transactions (B)

Accounting Considerations to Consider when Planning the Engagements

Given the changes at BSL during the year, new accounting treatments will be applied. It appears that Jack has incorrectly handled some of the new situations from an accounting perspective. Because the changes typically affect more than one of the companies, they have been discussed from a transactional level rather than an entity level.

Fuel Tank Installation Sales*Revenue — Multiple deliverables*

The revenue generated from selling the installation and maintenance package possibly has three distinct streams of revenue: the revenue related to the fuel tank sale, the delivery and installation service of the fuel tank at the client's site, and the five-year ongoing maintenance contract for the fuel tank. The total revenue that will be derived from the sale of the entire fuel tank package is \$40,000. According to EIC-142 *Revenue Arrangements with Multiple Deliverables*, "If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair values."

In this case, we need to determine if the tank itself, the delivery and installation costs, and the maintenance package represent separate units of accounting. According to EIC-142, the items are considered as separate units of accounting if

1. The item has value to the customer on a stand-alone basis;
2. There is objective and reliable evidence of the fair value of the item; and
3. The items include arrangements with respect to general rights of return (if applicable).

***[Note: EIC-175 (effective January 1, 2011) can be early adopted. This EIC also addresses whether an arrangement involving multiple deliverables contains more than one unit of accounting and is slightly different. Under EIC-175, in an arrangement with multiple deliverables, the delivered item (or items) should be considered a separate unit of accounting if both the following criteria are met:

- (a) The delivered item has value to the customer on a stand-alone basis. That item has value on a stand-alone basis if it is sold separately by any vendor or the customer could resell the delivered item on a stand-alone basis. In the context of a customer's ability to resell the delivered item, this criterion does not require the existence of an observable market for that deliverable.*
- (b) If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.]****

EIC-142 states: “Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value. The best evidence of fair value is the price of a deliverable when it is regularly sold on a stand-alone basis.”

***[Note: EIC-175 contemplates a different method of calculation. EIC-175 states: “Arrangement consideration should be allocated at the inception of the arrangement to all deliverables based on their relative selling price (the relative selling price method), except as specified in the next two paragraphs. When applying the relative selling price method, the selling price for each deliverable should be determined using vendor-specific objective evidence of selling price, if it exists, otherwise third-party evidence of selling price (as discussed in the first paragraph under “Selling price” of this section).”

In this particular case candidates were not given the price of the installation, only of the tank. They would need to come up with the value for each deliverable to meet requirements of EIC-175. Candidates needed to identify that they did not have all the information necessary if they were in the context of EIC-175.]***

Fair value of delivery and installation

Based on the information provided by Jack, Tanks doesn’t sell the tank without installing it. However, other vendors sell the installation separately from the tank, for the same tanks. Therefore, a fair value can be established for the delivery and installation component.

Fair value of maintenance contract

The value of the maintenance package can be calculated as follows: 5 years × \$5,000 per year (fair market value), which totals \$25,000. Therefore, if the total revenue generated from the sale of one tank is \$40,000, \$15,000 should be allocated to the sale and installation of the unit and \$25,000 should be allocated to the maintenance package.

The maintenance contract therefore appears to meet the criteria to be considered a separate unit of accounting and should be accounted for as such.

The value allocated to the maintenance package should be accounted for as deferred revenue. The amounts will be brought into income as the maintenance services are rendered over time (EIC-143).

ASPE

BSL would also have the choice to early adopt the provisions under ASPE. The standards remain the same under ASPE. However, the EICs noted above have been merged into Section 3400. Breaking the sales contract into components and deferring maintenance are discussed in paragraph 11 (replacing EIC-142 and EIC-143).

(Many candidates identified multiple deliverables as an issue and supported their GAAP discussions with the application of relevant case facts, including the value of the maintenance contract. Many of those candidates provided a clear and concise conclusion on the recommended accounting treatment.)

Revenue-Recognition — Delivery and Installation Delays

We also need to consider the fact that delivery and installation are delayed and only happen two to three weeks after the agreement is signed. EIC-141 — *Revenue recognition* says performance should be regarded as having been achieved when all of the following criteria are met: a) persuasive evidence of an arrangement exists; b) delivery has occurred or services have been rendered; and c) the seller's price to the buyer is fixed or determinable.

In this case, there is a signed agreement, but delivery and installation are delayed (two to three weeks later), so Tanks cannot recognize the revenue at the point of signing the contract. It must wait until terms of the contract are fulfilled — in other words, the point of customer acceptance, which in this case is when the tank is installed and working — to recognize the revenue.

ASPE

As noted above, BSL could choose to early adopt the provisions under ASPE. The standards remain the same under ASPE. However, the provisions under EIC-141 related to discussing the timing of delivery are discussed in paragraph 9 of Section 3400 under ASPE.

(Many candidates concluded that revenue could not be recognized when the sales agreements are signed; however, their discussions as to why that recognition would not be appropriate were often limited to commenting that performance had not yet been achieved. More thorough discussions applied simulation facts regarding the delay between signing and delivery and installation.)

Related Party Transactions

There are many related party transactions taking place this year due to the creation of the two new subsidiaries. Upon consolidation, these will all be eliminated (except any profit margin legitimately earned by BSL, if any), but as we are reporting at the individual company level, appropriate accounting treatment is important.

***[Note: *Handbook* Section 1601 can be early adopted and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. An entity adopting this Section for a fiscal year beginning before January 1, 2011, also adopts *Business Combinations*, Section 1582, and *Non-controlling Interests*, Section 1602. Under Section 1601.17, complete elimination of unrealized intercompany gains or losses and adjustments of applicable income

taxes is necessary on the basis that an entity cannot report gains or losses without validation from an external source. There is a view that, where a non-controlling interest exists, a proportion of any intercompany transaction may be considered to have been at arm's length, and that the proportion of the gains or losses relating to the non-controlling interest would be recognized in computing income. This view is inconsistent with the fact that the parent and its subsidiary are related and therefore not operating at arm's length. For this reason, unrealized intercompany gains or losses should be entirely eliminated. However, unrealized gains and losses resulting from remeasuring an asset or liability at fair value after transfer in a related party transaction are not eliminated.]***

The sale of the trucks and trailers to Transport appears to have been handled incorrectly. BSL and Transport have both recorded this transfer, which took place after the subsidiary was set up, at the exchange amount, shown by the \$84,000 gain appearing on BSL's income statement and the \$400,000 of property, plant and equipment appearing on Transport's balance sheet (\$431,000 purchase price less approximately \$31,000 of amortization for the period).

The sale of trucks and trailers by BSL to Transport represents a related party transaction that is not in the normal course of operations for either of these businesses (see Section 3840 of *CICA Handbook — Accounting*), since a sale of a capital asset is not considered to be in the course of normal operations (3840.27). Secondly, because Transport is a 100%-owned subsidiary, the ownership has not significantly changed (3840.33). For these two reasons, the carrying amount must be used to value this transaction. There is no impact at the consolidated level because the transaction would be eliminated.

For Transport, the assets (trucks and trailers) must be recorded at their carrying amount of \$347,000, and the difference between the assets and the note payable of \$431,000 (\$84,000) would be a reduction to equity (see 3840.17).

The other related party transactions between BSL and its subsidiaries (Transport and Tanks), the interest payments and the rent for the property (which are both at fair market value), are in the normal course of business and should be recorded at the exchange amount (3840.18). Jack appears to be handling these transactions correctly. There should be disclosure of the fact that the subsidiaries received free rent from the parent company for the first two months of the year (in other words, the rent agreement for new location started in March, and based on the rental income in the financial statements, rent was free prior to that date).

Management may wish to disclose the guarantee made to the environmental authority by BSL related to Tanks' operating licence in the notes to the consolidated audited financial statements because it increases the overall risk of BSL on a consolidated basis. In Tanks' stand-alone statement, management needs to consider whether it should disclose the fact that Tanks benefits from a guarantee from BSL of Tanks' obligations since it is being provided for free. It is likely that this related party transaction should be disclosed (Section 3840).

ASPE

Under ASPE, the same discussion is relevant. However, the section references are slightly different (because some EICs have been rolled into the revised *Handbook* Section 1600).

(Many candidates identified related party transactions as an accounting issue for the current year, recognizing that several transactions had occurred that must be properly accounted for in the companies. While candidates were able to communicate GAAP for the different transactions, they had difficulty applying it to the specifics of the various occurrences. In particular, candidates did not adequately demonstrate their understanding of the treatment of related party transactions that are not in the normal course of operations (in this case, the sale of trucks and trailers by BSL to Transport) and provided incorrect recommendations regarding the accounting for this transaction.)

Intangibles — Capitalization of Training Costs and Licence

Assets are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. An intangible asset must be identifiable, the entity must have control over the resource, and there must be future economic benefits. If an item does not meet the definition of an intangible asset, it is recognized as an expense when it is incurred.

Tanks has capitalized the \$20,000 of training costs incurred to have Sean Piper certified as a fuel tank installer. While it might be argued that there are future benefits to Sean Piper being certified in order to operate the business and legally earn revenue, training costs are generally not capitalized under Canadian GAAP. It is too difficult to ascertain a) whether there will actually be any benefits (future revenue), and b) if there are, the appropriate period over which to amortize the benefits. In this particular case, the main reason for the uncertainty is that there is no way of guaranteeing that Sean will stay. Even though he owns 25% of the company, he could still decide tomorrow to leave or to stop being an installer. Therefore, there is no way of controlling the use of the asset. Tanks should therefore expense the training costs in the year incurred. The *Handbook* provides examples of expenditures that are not part of the cost of an intangible, and training costs are included on that list, making the recommended treatment option even clearer.

However, we have noted that the value of the licence itself does not appear to have been recorded as an intangible asset in Tanks. There is no indication of the cost of the licence or how long it is good for, but if the amount is large enough and has future benefit to Tanks, management may want to capitalize the cost as an intangible asset.

ASPE

The discussions and analysis under ASPE would be the same had BSL chosen to early adopt.

(Generally, candidates who discussed training costs did so briefly and concisely, pointing out that these costs were specifically prohibited from capitalization by the Handbook and recommending that they should be expensed. Few candidates identified that Tanks' licence was not recorded in intangibles.)

Inventory Valuation

The owners have decided to stockpile scrap metal inventory this year. In the past, scrap metal was not a material amount (\$10,000 on the balance sheet of BSL). BSL is stockpiling the inventory because management expects the price at which they can sell the metal to increase above normal conditions.

In addition to establishing the inventory quantity, BSL needs to ensure it has properly valued its large inventory of scrap metal in order to ensure that the inventory has been accounted for in accordance with GAAP; in other words, at the lower of cost or net realizable value (NRV). The challenge in establishing the NVR of the entire inventory amount is coming up with the quantity. The metal prices should be fairly easy for management to obtain since there is a market for scrap metal.

ASPE

The discussions and analysis under ASPE would be the same had BSL chosen to early adopt. The applicable section reference under ASPE is 3031.10.

(Some candidates were able to identify inventory valuation as an area of concern and recognize that it had to be accounted for at the lower of cost or NRV. However, many of those candidates did not apply the specific case facts to their discussions, failing to recognize that the problem with inventory valuation stemmed from the difficulty in obtaining a reliable estimate of the quantity of metal in the stockpile.)

The Non-controlling Interest (In Consolidated Financial Statements)

The non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent. In this case, there is a non-controlling interest of 25% in Tanks, the portion owned by Sean Piper. BSL will have to properly account for the non-controlling interest when it prepares its consolidated financial statements. Current Canadian GAAP requires the following:

Section 1590, paragraph 16, states: “An enterprise should consolidate all of its subsidiaries.”(unless applying differential accounting (see paragraph 26)).”

Section 1602, paragraph 03, states “In preparing consolidated financial statements, an entity identifies: (a) non-controlling interests in the net income of consolidated subsidiaries for the reporting period; and (b) non-controlling interests in the net assets of consolidated subsidiaries separately from the parent's ownership interests in them.” Paragraph 13 further states “non-controlling” interests shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.”

And, Section 3251, paragraph 04, states “An enterprise should present separately changes in equity for the period arising from each of the following: (a) net income, showing separately the total amounts attributable to owners of the parent and to non-controlling interests; (b) other comprehensive income, showing separately the total amounts attributable to owners of the parent and to non-controlling interests.”

[Note: As discussed previously (under the related party section), BSL would have had the choice to early adopt the provisions of *Handbook* Section 1601, which would also affect the accounting for the non-controlling interest.]

ASPE

Had BSL chosen to early adopt ASPE, essentially the same discussion would apply for the non-controlling interest. However, under ASPE, the preparer has the choice of consolidating or not. (Section 1590, Paragraph 15 states that an enterprise needs to make a policy choice; all subsidiaries must be accounted for using the same method. BSL would need to check with the bank to see if it

would agree to non-consolidated statements.) Section 1602, paragraph 3 says, “*In preparing consolidated financial statements, an entity identifies: a) non-controlling interests in the net income of consolidated subsidiaries for the reporting period; and b) non-controlling interests in the net assets of consolidated subsidiaries separately from the parent's ownership interests in them.*” Paragraph 13 goes on to say, “*if an entity consolidates its subsidiaries, non-controlling interests shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.*” Section 3251, paragraph 4 requires an enterprise to “*present separately changes in equity for the period arising from each of the following: a) net income, showing separately the total amounts attributable to owners of the parent and to non-controlling interests...*”

(Some candidates recognized that Sean’s ownership interest in Tanks would have to be accounted for as a non-controlling interest in the consolidated financial statements that were subject to audit. Most candidates who addressed this issue were able to comment on the appropriate accounting treatment and applied relevant case facts in their discussions.)

Warranty Provision

There may be a need for a warranty provision related to the tank installations. Additional information is required to ascertain if this is the appropriate accounting treatment.

Asset Retirement Obligation

There may be a need to establish a liability related to the stockpile of scrap metal. The large amounts of metal, if exposed to the elements, will likely rust, potentially creating a chemical runoff. BSL would be responsible for either preventing the runoff or cleaning it up.

Depending on the legislative requirements related to the licence held, there may be a contingent liability relating to Tanks’ licence with the environmental authority. An environmental liability may actually need to be accrued. More information is required.

ASPE

Had BSL chosen to early adopt the provisions under ASPE, a similar discussion would apply. Section 3110, paragraph 5 states, “*An entity shall recognize a liability for an asset retirement obligation in the period in which it is incurred when a reasonable estimate of the amount of the obligation can be made. If a reasonable estimate of the amount of the obligation cannot be made in the period the asset retirement obligation is incurred, the liability shall be recognized when a reasonable estimate of the amount of the obligation can be made.*” Section 3110, paragraph 14 goes on to state, “*A present value technique is often the best available technique with which to estimate the expenditure required to settle the present obligation at the balance sheet date.*”

(Few candidates considered the accounting implications of the environmental risks that they had identified in their audit discussions, failing to integrate various aspects of their response. Many candidates who did identify this area provided a brief discussion of their concerns.)

For Primary Indicator #2 (Performance Measurement and Reporting), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	4.2%
Reaching competence — The candidate identifies some of the accounting issues.	55.3%
Competent — The candidate discusses some of the accounting issues in sufficient depth.	39.6%
Highly competent — The candidate discusses most of the accounting issues in sufficient depth.	0.8%

(Candidates were asked to address the accounting issues arising from the changes at BSL during the year. To achieve competence, candidates were expected to discuss some of the accounting issues in depth. Candidates were clearly directed to this indicator through the partner's request that CA discuss the new accounting issues that arose as a result of the changes during the year and evaluate their implication on the engagements.)

(Candidates performed below expectations on this indicator. Most candidates addressed at least one of the significant accounting issues by applying some simulation facts to their GAAP criteria, and often concluded on an accounting treatment. However, the depth of analysis was often insufficient.)

(Strong candidates discussed both of the significant accounting issues thoroughly (multiple deliverables and related party transactions) with a clear understanding of GAAP, and applied relevant simulation facts in their discussions. Those candidates also addressed fewer minor issues, but those they did address were discussed adequately. In general, their responses were well organized, covered significant issues, and were concise. Many weak candidates addressed no major issues and few minor issues, had weak technical knowledge, or did not apply relevant simulation facts.)

(As shown throughout the solution, candidates could have chosen to analyze the above accounting issues in the context of the new Handbook sections (EIC-175, Handbook Sections 1601 and 3400) or under ASPE since these standards were available for early adoption. Had candidates chosen to do so, their analyses and discussions would have been very similar to the existing Canadian GAAP. Very few candidates chose to analyze BSL in the context of these new standards.)

Primary Indicator #3

The candidate addresses Jack's tax concerns.

The candidate demonstrates competence in Taxation.

Competencies*IX-2.3 – Calculates basic taxes payable for a corporation (A)**IX-3.5 – Identifies, analyzes, and advises on tax consequences or planning opportunities associated with certain corporate transactions (B)*

Jack had several tax questions, which I have addressed below.

Sale and Repurchase of Building in BSL — Replacement Property Rules (Section 44, for non-depreciable property, and Section 13, for depreciable property, of the *Income Tax Act*)

Jack expressed concern about the large tax liability resulting from the land and building transaction, and in particular the different classes in which the 1982 building and the 2010 building are allocated. I believe a case can be made that both the new land and building are replacement properties and that the tax liability, both as a result of the recapture and the capital gain (on the land and the building), could be deferred until the new land and building are sold to an arm's length party.

(Some candidates did not recognize that the purchase of the new facility may qualify as a replacement property, and instead focused their discussions on clarifying for Jack the amount of the tax liability that he was facing. Candidates spent time calculating the capital gains for both the land and building, and the recapture for the building. They applied a tax rate and essentially advised Jack to start saving his money for the large tax liability that was looming on the horizon.)

The rules for replacement property may be applied to a “voluntary disposition” of a former business property, if it was owned and used in the course of business, so long as it is replaced within specific time frames (Section 13 is for the deferral of the recaptured depreciation and Section 44 is the deferral of the capital gain). For voluntary dispositions, such as the one at BSL, the old property must be replaced before the end of the first taxation year following disposition. Since the land and building were replaced by BSL in the same fiscal year, it falls within the required time frame. (Note that because the disposition and replacement occurred in the same year, accounting for the transaction as detailed above in the tax return will be considered the proper election; in other words, no other election is required.)

To qualify as a replacement property, the property must meet the following criteria:

- 1) The property was acquired by the taxpayer to replace the former property. This is the case for BSL.
- 2) The property acquired will be used in the same or similar business as the former property by the taxpayer or a related person. The property acquired is being used in a similar business (scrap metal and transportation) by an affiliated person (the subsidiaries of BSL). There may be some question as to whether Tanks' presence in the new building (with its new business of installation and maintenance of fuel storage tank systems) and the new rental income stream puts meeting the criteria in jeopardy. The rules do appear to say that additional activities cannot be undertaken, but that you must continue on with businesses similar to those operating at the former property, which is still the case. However, if the new uses of the building are too significant, the building might not qualify as a replacement property. If BSL starts to rent out space in the new property and also uses it for new businesses, it may not qualify for the replacement property rules. Management may wish to consider this in their decision-making processes.
- 3) If the former property was taxable Canadian property, the new property must also be taxable Canadian property. Both properties are taxable Canadian property, so BSL satisfies this criterion.

(Many candidates who recognized that the new purchase may qualify as replacement property were able to discuss this issue in some depth. Their comments demonstrated their understanding of at least some of the qualification criteria under the tax rules, and they were able to apply case facts to those criteria throughout their discussions. While most candidates seemed to understand that it was a voluntary disposition with replacement within the required time frame, they seemed to struggle with the requirement that the new property must be used in the same or similar business. Strong candidates addressed this issue, and even contemplated that the owners' thoughts of renting some of the extra space to other businesses may affect their ability to have the new purchase qualify as replacement property, which is what the Board hoped they would discuss.)

Subsection 13(4) allows a taxpayer to elect to defer the recapture to the extent that the taxpayer reinvests the proceeds of disposition in a replacement property within a certain period of time. In the case of a voluntary disposition, this is before the end of the taxpayer's first taxation year that begins after the property was disposed of (note that there are special adjustments for short year-ends that may need to be applied here). In this case, BSL purchased a new building worth \$9.0 million, which is much higher than the calculated recapture of \$1.5 million shown below. Thus, no limitation is imposed.

(Candidates with greater understanding of the replacement property rules recognized that the proceeds of sale of the old property should be reinvested in the new property in order for deferral to occur. Many of their discussions referred to deferral on a general principle, rather than specifically to the deferral of recapture.)

Section 44(6) says that on the disposition of both land and a building, the taxpayer may elect in the year of replacement to re-allocate the excess proceeds of disposition (if any) between the two components so that less capital gain or recapture will be reported. In both the case of the land and of the building, the values have approximately doubled with the replacement. Therefore, there is no real benefit to reallocating the proceeds.

Further considerations include the fact that the buildings are in two different classes. The rules in Section 13(5) clearly indicate that the replacement property need not be in the same capital cost allowance class as the original property provided it can reasonably be considered as a replacement of the original property (see Section 13(5) — *Reclassifying of property*).

References : Section 44(1), (5) and (6) for capital gain and 13 (4) for recapture

BUILDING DISPOSAL:

Capital Gain:		Recapture:	
Proceeds of disposition-bldg	\$ 5,250,000	Original Cost	\$ 4,500,000
Original Cost	4,500,000	UCC	3,000,000
Capital Gain	<u>\$ 750,000 (A)</u>	Recapture	<u>\$ 1,500,000 (B)</u>

Class 3 (old building disposal)

Opening balance		\$ 3,000,000
Reduction:		
Lesser of cost or proceeds	\$ 4,500,000	
Less: the lesser of the recapture of \$1,500,000 and the amount reinvested (\$10million less 5million= 5million)	(B) <u>(1,500,000)</u>	<u>(3,000,000)</u>
Closing balance		<u>\$ -</u>

Class 1 (Replacement property)

Opening balance		\$ -
Addition (reduced by capital gain deferral)		
Cost of replacement building	\$ 9,000,000	
Deferred Capital Gain	(A) <u>(750,000)</u>	
Redetermined Cost		8,250,000
Less: Notional proceeds of disposition (equal to recapture here)		(B) <u>(1,500,000)</u>
UCC (before current year amortization)		<u>\$ 6,750,000</u>

LAND (OLD)

Proceeds	\$ 750,000
Cost	<u>500,000</u>
Capital Gain	<u>250,000</u>

LAND (NEW)

New land cost 1million (reduced by capital gain on old)	
Addition:	1,000,000
Capital gain	<u>-250,000</u>
Redetermined Cost	750,000

Jack seems to be expecting a large tax bill. He will be pleased to learn that there will be no tax bill related to the land and buildings.

(Most candidates who recognized the new purchase as replacement property were able to demonstrate their understanding of the tax criteria through their discussions, and applied relevant simulation facts in their analyses of the tax criteria. Some candidates were unable to demonstrate their understanding of the mechanics of the calculation; however, they were able to adequately explain their understanding of replacement property through their discussions.)

Sales of Trucks and Trailers to Transport

In this case, the FMV of the trucks and trailers are lower than the respective UCCs, so the class will simply be reduced by the amount of the proceeds. If these are the last assets in the class, a terminal loss would be triggered this year. Based on Jack's comments, it appears that he believes the losses can be used against operating income. Normally, this would be the case. However, because the transaction was with an affiliated party, the loss would be denied by the stop loss rules. Any remaining UCC would be deemed to be an asset of the transferor and would be eligible for CCA claims by the transferor as long as the asset is used by the transferee in a business with a view to a profit. When the asset is sold to an unrelated third party, the terminal loss can be claimed (see Section 13(21.2)).

(Some candidates recognized that there would be a terminal loss on the sales of truck and trailers to Transport, but many did not explain why such a loss would be available (because they were the last assets in the class), nor did they recognize that stop loss rules would prevent claiming the loss this year. Few candidates addressed treatment of the remaining UCC.)

Other Tax Considerations

Since Jack has admitted his own tax weakness, we may want to remind him of several other tax considerations that will affect the businesses.

The transfer of the transportation operations from BSL to Transport should be discussed with Jack. Was there a rollover performed to transfer the transport business from BSL to Transport? Since the transfer of goodwill or a customer list likely qualifies for an election under Section 85, it isn't too late to complete the transaction this way if it wasn't done as such. We should obtain the necessary information to do so from Jack. The due date for filing the election is the earlier of the two companies' tax return deadlines. Since the subsidiaries have the same year-end (August 31), the deadline would be the end of February.

BSL and the subsidiaries are considered associated for tax purposes, meaning they will have to share the small business deduction (SBD) of \$500,000. This is not as much of a concern for BSL and Transport, but because Tanks has third party ownership, the allocation of this \$500,000 will have to be agreed upon with Sean Piper.

Also, the Small Business Limit of \$500,000 is subject to a reduction based on the taxable capital of the associated group. When the taxable capital is \$10 million, the “grind” of the business limit begins. At \$15 million of taxable capital, the business limit is nil. Based on a quick glance, the taxable capital exceeds \$10 million. It is calculated as retained earnings plus long-term debt (including the current portion) plus bank overdraft, share capital, and a few other items, but does not include regular accounts payable. Intercompany items are eliminated within the group, so the related party note would not be included in the calculation (see tax Section 125 (5.1) for the SBD grind).

(Most candidates who addressed taxation issues were able to identify that the companies would be associated and mentioned the sharing of the small business deduction. Few candidates considered the taxable capital of the associated group and the impact that might have on the SBD.)

The rental income earned by BSL from the subsidiaries is still considered active business income since they are associated companies, but should BSL follow its plan and rent the additional space to third parties, this rental income will be considered property income and will be taxed at the higher tax rates associated with investment income. The rental income can be reduced by the related costs of that income (its share of the property taxes, insurance, and such). The additional tax will increase the refundable tax balance and thus may be recuperated by BSL if it were to pay a dividend to its shareholders at a ratio of \$1 refundable for every \$3 of taxable dividends paid.

(Very few candidates recognized that the plan to rent additional space in the building could change the type of income from active business to property income, and briefly addressed the tax impacts.)

For Primary Indicator #3 (Taxation), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.8%
Nominal competence — The candidate does not attain the standard of reaching competence.	34.6%
Reaching competence — The candidate discusses one of the significant taxation issues.	43.4%
Competent — The candidate discusses one of the significant taxation issues in sufficient depth OR discusses both significant taxation issues.	20.7%
Highly competent — The candidate discusses both of the significant taxation issues in sufficient depth.	0.5%

(Candidates were asked to address Jack’s tax concerns. To achieve competence, candidates were expected to discuss one of the significant tax issues in sufficient depth or discuss both significant tax issues (replacement property rules and the sale of the trucks). Candidates were directed to this indicator by Jack’s email providing details of the vehicle and building sales and the partners’ request for notes on the companies’ tax situation and other relevant issues.)

(Candidates performed below expectations on this indicator. Many candidates did not recognize that the new property may qualify as a replacement property and, as a result, provided weak analysis of the land and building issue. Other candidates who discussed the sale of trucks to Transport were able to recognize the possible terminal loss, but seemed unaware of stop loss provisions. Many candidates were able to discuss association and recognized that the SBD would now have to be shared between companies. In general, the candidates' technical knowledge in these areas was weak. Many candidates would have benefitted from looking up the relevant tax rules in the Income Tax Act.)

(Strong candidates recognized at least one of the major issues and addressed it sufficiently. Those candidates discussing replacement property as an issue demonstrated their understanding of the tax rules for applicability by using case facts in their discussions to support how the new purchase would qualify for deferral of capital gains and recapture. Some of those candidates also addressed the sale of trucks adequately and covered the SBD issues as well. Weak candidates often did not recognize either of the significant issues or discussed few minor issues. Regarding the building, many of them calculated the tax payable on the capital gain and recapture, and advised Jack to start saving for the tax liability that was coming due. Regarding the sale of trucks, they incorrectly calculated the capital gain and a terminal loss, and then suggested Jack transfer the trucks using a S.85 rollover to avoid recognition of the gain.)

EVALUATION GUIDE
BRENNAN & SONS LTD.
SECONDARY INDICATORS OF COMPETENCE

Secondary Indicator #1

The candidate discusses the lack of direction and risk management strategy at BSL.

The candidate demonstrates competence in Governance, Strategy, and Risk Management.

Competencies

IV-2.1 – Understands the entity's strategic plan and planning process (B)

IV-3.1 – Understands the entity's risk management processes (B)

IV-3.2 – Evaluates the entity's risk management program (B)

BSL has made certain strategic decisions regarding its future and plans to make additional decisions about BSL's growth and direction without really considering the costs and benefits of those decisions. There does not appear to be an overall strategic plan, even though the owners describe what they are doing as a strategy.

It is not clear why BSL created a subsidiary for operations it was already involved with (Transport) and which had the same ownership. There was a cost to incorporating each of these new companies, and there will be additional administrative and record-keeping costs, including the review engagements that need to be performed for each of them. There does not appear to be any clear benefits to this arrangement — particularly for tax purposes, since they are associated and must share the small business deduction limit. If the objective was to keep track of the success of the separate divisions, it might have been more practical to simply implement an internal record-keeping system.

The owners of BSL also mentioned possibly setting up another subsidiary if they go ahead with the furniture store. We question the logic of setting up this subsidiary for the same reasons as in the case of the Transport subsidiary.

While the creation of the subsidiary for Tanks makes more sense from the point of view that it is owned 25% by an external party, this was a risky move for the organization. The nature of Tanks' business does not appear to fit with BSL's other businesses, and Sean did not even have the necessary training or certification before jumping into the business venture. It also puts BSL at increased risk since BSL guarantees the licence from the environmental authority for Tanks' operations. BSL is therefore guaranteeing against any mishaps (such as fuel leaks) and will have to deal with any possible litigation, which will affect its reputation.

We should also discuss BSL's latest strategy of stockpiling, with the expectation that the price of scrap metal will increase. BSL is essentially speculating, which is something that it has never done before. BSL needs to consider the possible consequences of this latest strategy. For example, there is a risk that there may be losses associated with the stockpiled metal if the price decreases. The price of scrap metal is considered volatile, so BSL needs to consider this possibility and how the situation will be managed so that it doesn't affect BSL's operations significantly. If BSL decides to continue the stockpiling practice, it should develop a risk management policy with respect to stockpiling to ensure the risk is monitored (maybe set a "maximum loss" policy). In addition, the fact that there is no system in place to help capture the costs adds to the risk. BSL should decide whether to put a system in place as soon as possible.

Finally, I'm concerned about the expansion that BSL has undergone and the further expansion it is considering. BSL is already in the property rental business, the truck rental business, the scrap metal business, the transportation business, and the fuel tank installation business, and is now considering buying land to operate a dump and using part of the building to open up a used furniture business. Not only are the owners moving very quickly, but are also spreading into very different businesses where there are likely very few synergies. We should advise them to slow down and think through their strategy before proceeding any further.

For Secondary Indicator #1 (Governance, Strategy, and Risk Management), the candidate must be ranked in one of the following three categories:

Not addressed — The candidate does not address this secondary indicator.

Nominal competence — The candidate does not attain the standard of competent.

Competent — The candidate discusses, in sufficient depth, the additional costs of incorporating subsidiaries, the risks involved in BSL holding the licence for Tanks' work, the risks associated with speculating, or the lack of direction at BSL.

(To achieve competence, candidates were expected to identify and discuss the potential overall risks to BSL from the decisions that it has made over the past year. Candidates were not directed to this indicator and very few candidates identified any of these critical risk factors associated with BSL.)

(Those candidates who did discuss the high-level risk factors associated with BSL generally limited their discussions to the different lines of business that BSL was contemplating and its rapid expansion plans, noting that these strategies may not be appropriate.)

(Overall, candidates seemed to spend a great deal of time on the assurance indicator on this simulation and provided many detailed planning points for the audit engagement. Many candidates provided extensive discussions of the risk areas associated with the audit engagement but did not appropriately communicate the differences between the audit and the review engagements. Some candidates also appeared to lack the technical knowledge to discuss the accounting issues in sufficient depth and did not use case facts to support their analysis.)

(Candidates very briefly addressed the taxation indicator and in many cases their discussion was technically incorrect. Candidates did not appear to have the appropriate knowledge related to the replacement property rules or the stop loss provisions.)

SAMPLE RESPONSE
PAPER II-1 BRENNAN & SONS LIMITED (BSL)

The following is a candidate response for Paper II-1. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 1

To: Ken Simpson

RE: BSL Audit Planning, Accounting Issues and Tax

Accounting Issues:

Issue: Consolidation and elimination of intercompany gains

- The sale of trucks in January to Transport has been recorded as a gain on sale and a receivable
- Given that these are intercompany transactions, as Transport is 100% owned sub under GAAP, upon consolidation this transaction will need to be eliminated
- The note receivable and payable resulting from these amounts for \$431,000 will also need to be eliminated
- The gain on sale of \$84,000 will also need to be eliminated
- This is consistent with GAAP as in substance BSL controls Transport, so no external sale has occurred
- The gain can only be recorded on a straight line basis as the trucks are amortized
- This means in the consolidated statements the trucks will continue to be recognized at their book values not fair values and no gain will be recorded

2) Revenue recognition of Tanks revenue

- Tank only sells tanks combined with installation and service, which means that multiple goods and services are being sold for a total price of \$40,000
- Since this is a new stream of revenue, we need assess whether it is being properly recognized as one product

Impact on Audit:

- there is a risk of existence of gains as there is a risk that now that BSL is consolidating there will be intercompany gains inappropriately recorded for transfers between the entities

Procedure:

- We should obtain the sale contract/documentation for the gain on equipment
- We should inspect the documentation to ensure that the sale is to a related party
- As this is likely the case given what we are told, we will need to recalculate the gain based on the proceeds specified in the sale agreement documentation
- We will then need to propose an audit adjustment to eliminate the sale on a consolidated basis

Analysis:

- The criteria to consider under GAAP for multiple deliverables is:
 - 1) is there stand alone value for each of the products
 - 2) Is there objective evidence of the fair value of the products
 - 3) Is there a right of return which would preclude the second product from being delivered if the first was returned
- Given that maintenance is completed on a continuing basis after the 5 year term continues, this supports that there is stand alone value to the maintenance component, which would support the concept of multiple deliverables
- However, it could also be viewed that this is one package as the tank could not operate if it was not installed and maintained, thus it is only one single deliverable
- I would conclude that this is in fact a multiple deliverable based on the fact that the maintenance could be completed by another provider and the tanks would have value on their own as a separate good
- However, I suggest that installation is part of the tank revenue component as the tank would not have a separate value if it was never installed, and if there were issues installing the tank would not be functional because it would need to be pressure tested before knowing it was operating properly
- Thus using EIC-142 each component should be valued based on its relative fair value or using the residual value
- Since we do not know the original cost of the tank I recommend using the residual value method
- The maintenance is worth \$5,000 for 5 years for a total of \$25,000 thus the total of \$40,000 less \$25,000 results in \$15,000 allocated to the tank including installation
- Since installation is required for the tank to be operational using the 3 revenue recognition criteria of 1) reasonable assurance of collection 2) substantial performance and 3) reasonable ability to measure the sale revenue should not be recognized until the tank is installed as this is when performance is substantially complete assuming that collections and measurability are reasonably assured

Conclusion:

Revenue for tanks will need to be adjusted as it is currently overstated by including the total \$40,000 for tanks installed as \$25,000 of the total price relates to maintenance for the following 5 years

Impact on Audit:

- given that revenue was improperly recognized this indicates there is a risk of occurrence of revenue as it appears to be overstated for the tanks

Procedure to address:

- We should obtain a listing of the sales transactions recorded in the total \$320,000 revenue amount and select a sample of transactions to test
- For sampled items we should obtain the sales contract and inspect it for the amount of the sale and the date
- We should then vouch the sampled contract to a progress report to ensure that the tank has been installed as this is the point of revenue recognition
- We will have to recalculate that only the \$15,000 has been recognized for the initial sale

Taxation Issues

Gains on land and building sold at Frank Street:

- The building was sold for \$5.25 million which results in a capital gain of \$750,000 over the ACB of the building and a \$1.5 million recapture over the UCC
- The recapture will be taxed as business income while the capital gain will be taxable only on the 50% inclusion of \$375,000
- The capital gain will be taxable at the investment tax rate of 34.67% federally
- The land will have a capital gain of \$250,000 taxable at 50% for a total of \$125,000 which will be taxable at the investment tax rate federally of 34.67%
- These taxable capital gains can only be offset by taxable capital losses
- The fact that a new building was purchased will not reduce the tax liability owing on the disposal of this property as the capital gain and recapture will be calculated on the disposal of the original building
- Given that the trucks and trailers were sold below their UCC value this will result in terminal losses of \$5,000 for the trailers and \$60,000 for the trucks

Other tax Issues

- Assessing association will be important for the three companies as associated companies must share the small business limit which reduces the federal tax rate from 19% to 11% on the first \$500,000 of active business income
- Since both subsidiaries are owned by BSL they will all be considered associated under the ITA which means they will have to share this deduction and for tax purposes will have to be allocated to the three companies
- Given that Sean has a 25% interest in Tanks he will want to ensure that this subsidiary gets its share of the deduction so this will need to be negotiated between the owners

Audit Planning Considerations

Risk for the audit engagement will be assessed as high for 2010 for the following reasons:

- BSL is now consolidating two subsidiaries which means inter-company accounting transactions will need to be considered, and given this is new, will increase the risk of material misstatement
- BSL is now at a consolidated level involved in selling tanks which means as auditors we are less familiar with this line of business so there is increased risk of material misstatement
- The bank requires audited financial statements for the consolidated group which increases the financial information being relied on and thus increases the risk of material misstatement as there is incentive to misstate results for the bank

Approach:

Audit level procedures will be performed on the consolidated statements, however any balance relating to Transport or tank subsidiary, which are material to the BSL consolidated audit, will also need to have audit level work performed even though only review level engagements are being performed for them individually.

We will need to review the prior year files to determine if a combined approach should be taken based on the implementation and operating effectiveness of controls. However, given the issues surrounding a poor inventory system (i.e. multiple formulas were used and there wasn't really an inventory tracking system) a substantive approach will likely be most appropriate as controls appear to be weak.

Other Issues:

BSL has started stockpiling scrap metal but has not come up with an appropriate inventory management system. Inventory is now 50x greater on the balance sheet than it was in 2009 and it is now after year end and we did not perform an inventory count. Since inventory is not being tracked appropriately, as a better system needs to be installed, it may not be possible to perform a count and rollback procedures now. Thus, this could result in a scope limitation for the audit fiscal 2010. See procedures above in accounting discussion

Review Engagements

- Risk will be high for both review engagements as they are new engagements our firm is unfamiliar with
- Also Tanks in particular has engaged in revenue recognition policies which are not in line with GAAP, an indication of a high risk of material misstatement

Approach:

A combined approach is not taken for reviews, enquiry, discussion and analysis procedures will be performed for the review engagement.

Example of procedures to be performed:

1) Amortization - risk of inappropriate amortization policy based on gain recorded on transfer of trucks from BSL to Transport at fair value, thus risk of overstatement of expenses - existence of amortization expense

Procedure:

- Enquire with management what base was used to calculate amortization if it was based on fair value or net book value
- discuss the policy used and if the base used was a result of the intercompany transfer

Paper II - SIMULATION 2 (90 minutes)

Dr. Kate Bolton, OD, an experienced optometrist who runs her own optometry practice, also owns 100% of the outstanding shares of Calibre Lenses Lab Inc. (CLI), which operates a laboratory that makes eyeglass lenses. CLI provides lens-making services to Kate's optometry practice and to several other optometrists. CLI has been successful due mainly to the quality of its lenses and not the speed at which the lenses are made. Unlike many other lens labs, CLI does not offer a same-day service.

Kate has engaged your firm for many years to prepare her personal tax return, compile CLI's financial statements, and prepare CLI's corporate tax return. It is early October 2010 and you, CA, have been called into a meeting requested by Kate to review a draft letter of agreement (Exhibit I) recently signed by her and Dr. J.J. Alkana, owner of QuickLens Lab Ltd. (QLL), another lens-making laboratory.

QLL has been in operation for over 20 years. As Dr. Alkana has little day-to-day involvement in QLL, the bank has requested, for the past five years, audited financial statements. Although QLL's prices are lower than CLI's, QLL does a much higher volume of business than CLI without needing much more staff or equipment. QLL has been successful enough to purchase several other small labs during the past three years.

Kate begins, "I would like you to have a look at this draft agreement with QLL to merge our two operations. Innovation in the vision correction industry has resulted in many lens labs having made large investments in lens manufacturing equipment to stay competitive. Just recently, I lost a customer that represents about 5% of CLI's sales to a local laboratory that has the wavefront technology integrated into its manufacturing processes. I am convinced that any successful lab in the future will have to have wavefront technology (Exhibit II). I looked at the feasibility of CLI acquiring a wavefront machine on its own, but the volume of lenses currently being produced does not justify such a purchase. I am worried that CLI could lose too many customers before it grows large enough. I think the proposed agreement with QLL is the best way to secure the future of CLI. Dr. Alkana also seems convinced that combining our resources is the best way forward, but I would like your opinion. I want to make sure that the deal is structured in a way that is financially fair to me.

"I think it's really important for each prescription to be flawless. Since the lab is next door to my optometry practice, I'm on top of things, and I regularly inspect the assembled glasses before they are shipped to the optometrists. I am a perfectionist, so sometimes I make the lab redo an order I am not satisfied with. I am very excited about this potential deal because the wavefront manufacturing machine will give me access to the latest in lens-grinding technology.

"You already have CLI's statements, and Dr. Alkana has provided audited financial statements from QLL's most recent year-end (Exhibit III). I am also providing you with some information that I think may be relevant to this deal (Exhibit IV). I like the idea of working with Dr. Alkana, but he is definitely not as concerned about the quality of the lenses he produces as I am. He prefers to 'grind them out,' as he puts it! And so far, he has been hard to reach because he's away a lot. Apparently, he and his wife attend many conferences, and they often dine out with QLL's larger customers.

Paper II - SIMULATION 2 (continued)

“Since we started talking about the merger several months ago, the lab managers have had time to prepare a description of the operational workflow now used by each lab (Exhibit V). Assuming we acquire a wavefront manufacturing machine, which of our lab processes would be best suited to the combined operations?”

“I have been talking to my colleagues and I’m confused. Some optometrists I do business with have told me that their accountant optimized their tax situation, for similar transactions, thanks to the rules around something called the Qualified Small Business Corporation. Does it apply to my situation? Should I be proposing something different, from a tax point of view, from what is currently proposed in the draft agreement?”

Paper II - SIMULATION 2 (continued)

EXHIBIT I

EXCERPTS FROM DRAFT LETTER OF AGREEMENT

The proposed agreement specifies that:

- CLI and QLL will merge, effective October 31, 2010, by undertaking a legal amalgamation to form Quick Calibre Inc. (QCI); therefore, Section 87 of the *Income Tax Act* will apply.
- Dr. Kate Bolton and Dr. J.J. Alkana will each receive a 50% stake in QCI.
- Dr. Bolton and Dr. Alkana will each be officers and directors of QCI.
- After October 31, CLI's equipment and staff will move to QLL's premises. CLI will not renew the lease for its premises, which expires December 31, 2010, and will notify its landlord immediately of its intention.

Immediately after October 31, QCI will acquire a wavefront manufacturing machine.

Paper II - SIMULATION 2 (continued)

EXHIBIT II

BACKGROUND INFORMATION ON EYEGLASS INDUSTRY

Optometrists generally perform eye exams by presenting the patient with rows of letters to read. The problem with this method is that it relies on patients to report on their own vision, and many types of vision errors may therefore go undetected. Wavefront represents a significant change in the way vision is corrected using lenses. Wavefront analysis enables the optometrist to “map” the eye better, thus enabling the labs to manufacture a better customized lens using a specialized wavefront manufacturing machine. Wavefront technology greatly reduces visual distortions and improves lens clarity.

Most optometrists already own the reader needed to do the mapping, and many labs have purchased the wavefront manufacturing machine. Current estimates show that, within three years, 75% of all lenses will be produced by labs using wavefront machines.

Despite the popularity of laser eye surgery for vision correction, patients often require corrective lenses within five years of surgery. Labs have been increasing in value, and generally sell for three times their annual normalized earnings before interest, taxes, depreciation, and amortization (EBITDA).

Paper II - **SIMULATION 2** (continued)**EXHIBIT III***EXCERPTS FROM CALIBRE LENSES LAB INC*
*UNAUDITED FINANCIAL STATEMENTS**BALANCE SHEET**As at August 31, 2010**(unaudited - see notice to reader)*Assets

Cash	\$ 91,838
Accounts receivable	98,290
Inventory	45,987
Equipment, net	124,132
	<u>\$ 360,247</u>

Liabilities

Accounts payable and accrued liabilities	\$ 38,252
Income tax payable	27,801
Customer deposits	10,430
	<u>76,483</u>

Shareholder's equity

Retained earnings	283,714
Share capital	50
	<u>283,764</u>
	<u>\$ 360,247</u>

Paper II - SIMULATION 2 (continued)**EXHIBIT III (continued)***EXCERPTS FROM CALIBRE LENSES LAB INC.*
*UNAUDITED FINANCIAL STATEMENTS**STATEMENT OF INCOME AND RETAINED EARNINGS**For the year ended August 31, 2010**(unaudited - see notice to reader)*

Revenue	\$ 1,459,087
Cost of sales	<u>833,171</u>
Gross profit	625,916
Expenses	
Advertising and promotion	5,406
Amortization	18,540
Courier and postage	57,392
Insurance	3,406
Bank charges	1,287
Owner's salary	188,018
Meals and entertainment	1,486
Office and other supplies	31,742
Professional fees	4,232
Property and business taxes	6,534
Rent	32,800
Repairs and maintenance	9,940
Travel and trade shows	2,797
Utilities	14,029
Vehicle	<u>1,543</u>
Income before tax	246,764
Provision for income tax	<u>37,015</u>
Net income	209,749
Retained earnings, beginning of year	<u>73,965</u>
Retained earnings, end of year	<u>\$ 283,714</u>

Paper II - SIMULATION 2 (continued)**EXHIBIT III (continued)***EXCERPTS FROM QUICKLENS LAB LTD.**AUDITED FINANCIAL STATEMENTS**BALANCE SHEET**As at August 31, 2010**(audited)*Assets

Cash	\$ 578
Accounts receivable, net of allowance for doubtful accounts	180,651
Prepaid expenses	7,168
Inventory	178,379
Equipment, net	224,054
Goodwill	125,000
	<u>715,830</u>

Liabilities

Bank indebtedness	\$ 151,009
Accounts payable and accrued liabilities	54,098
Income tax payable	30,102
Customer deposits	21,321
Current portion of long-term debt	24,000
Long-term debt	144,000
Future income tax liability	28,710
Shareholder loan	105,372
	<u>558,612</u>

Shareholder's equity

Retained earnings	157,118
Share capital	100
	<u>157,218</u>
	<u>\$ 715,830</u>

Paper II - SIMULATION 2 (continued)**EXHIBIT III (continued)****EXCERPTS FROM QUICKLENS LAB LTD.**
AUDITED FINANCIAL STATEMENTS***STATEMENT OF INCOME AND RETAINED EARNINGS******For the year ended August 31, 2010******(audited)***

Revenue	\$ 1,743,978
Cost of sales	<u>1,104,556</u>
Gross profit	639,422
Expenses	
Advertising and promotion	58,213
Amortization	23,549
Courier and postage	88,698
Insurance	5,709
Bank charges	10,957
Interest	12,485
Lawsuit settlement	20,000
Owner's salary	57,505
Meals and entertainment	8,290
Office and supplies	97,146
Professional fees	16,300
Property and business taxes	7,098
Rent	48,000
Repairs and maintenance	9,940
Travel	38,143
Utilities	35,987
Vehicle	<u>22,049</u>
Income before tax	79,353
Provision for income tax	<u>23, 923</u>
Net income	55,430
Retained earnings, beginning of year	215,688
Dividends paid	<u>(114,000)</u>
Retained earnings, end of year	<u>\$ 157,118</u>

Paper II - SIMULATION 2 (continued)

EXHIBIT IV

SUPPLEMENTAL INFORMATION

- CLI's receivables are reported from CLI's accounting software, with no allowance made for doubtful accounts. There is no concern about collection, since CLI's customers are mainly Dr. Bolton and other optometrists.
- QLL recently underwent an audit of its last three years' payroll records. The auditor met with Dr. Alkana at the end of the audit to advise him that QLL would be receiving within a week or two a notice of assessment for \$45,000 related to under remitted payroll remittances (EI, CPP, etc.).
- Just before QLL's year end, Dr. Alkana was sued by a client, who claimed that his car accident was a direct result of his new set of lenses being incorrectly produced by QLL. Dr. Alkana explained that frivolous lawsuits of this nature rarely happen to him, but that he has learned over time that it is simpler to pay out the amount being sought rather than waste time arguing the matter in court.
- CLI's and QLL's old equipment (edger, tracer, etc.) will no longer be used once the new wavefront machine is installed. It will be kept and stored in a back area as backup equipment in case of an equipment breakdown. However, both Dr. Bolton and Dr. Alkana have heard that the wavefront machine is very reliable.

Paper II - SIMULATION 2 (continued)

EXHIBIT V

LAB MANAGER OPERATIONAL WORKFLOW REPORTS

CLI

CLI currently uses LabLink version 2.0, a PC-based program developed in 2003 specifically for lens labs to manage workflow. Annual maintenance and licensing fees are minimal, and support from the company has been excellent. The manufacturer has advised CLI that it will stop supporting version 2.0 on December 31, 2013.

Each of CLI's customers (optometrist's office) has a stack of pre-printed, sequentially numbered order forms. The optometrist writes the patient's personal information on the form as well as the information about the lenses, such as sphere, cylinder, type of lens, and coating. The completed form is then faxed or emailed to CLI, which begins the production process.

Once the order is received at CLI, a clerk determines whether the desired base lenses are in stock by checking the physical inventory. If they are in stock, the clerk puts them in a production tray with the order to await the frame's arrival. If the lenses are not in stock, the clerk writes the lens code on a supplier order form. Once a day, a CLI employee calls an order into the lens supplier. The lenses usually arrive by courier the next business day.

Once the lenses and frame are both available, a member of the production staff, each of whom has a unique user ID and a highly secure password, keys the order information into LabLink for the lenses to be customized to the prescription. The job is tracked through cutting (or edging), coating, assembly, and final inspection. An optometrist's office can use the original number on the order form to find out where a particular order is in the production process.

Since the LabLink database is critical to CLI's operations, it is backed up every hour using a web-based service. The service uses 128-bit encryption and claims never to have had a security breach that compromised the data. Fortunately, CLI has never needed to retrieve data from the backup service since the in-house server has never failed.

Paper II - SIMULATION 2 (continued)

EXHIBIT V (continued)

LAB MANAGER OPERATIONAL WORKFLOW REPORTS

QLL

Two years ago, QLL hired a programmer to design and implement a web-based management system. Before the new system, optometrists used to call in their orders to QLL, but that was unsustainable at the volumes QLL does. Now, each optometrist office has its own user identification and password to log on to QLL's website. Orders are submitted online and instantly generate a work order that appears on QLL's lab manager's computer.

The management system searches the inventory for the requested base lenses. If not in stock, the lens code gets added to the reorder list, which is automatically emailed to the suppliers at the end of each day. If the lenses are in stock, a picking ticket gets printed in the warehouse. The picking ticket is taken from the printer, and the lenses are pulled from inventory and put into a production tray to await the arrival of the frame. Once the frame arrives, it is matched with the lens and placed into production for the lenses to be cut.

QLL's management system is integrated with the computers that control the tracing, edging and coating machines, so the system can track an order at any point in the production process. There have been some data transfer problems between the tracer and edger lately, resulting in incorrectly cut lenses. It appears in some cases that the tracer is telling the edger to cut the glass too small, requiring another lens to be cut. Once cut and assembled with the eyeglass frame, the system generates a bill of lading to ship the completed glasses to the customer.

Since the system is web-based, it can be accessed from any computer connected to the Internet. However, since QLL does its own web hosting, on-site access occurs across the local area network. All on-site users currently log in as the administrator to access the system. The original programmer still logs into the system each month to perform routine maintenance on the database and to upgrade components as required. His involvement has become more frequent, and programming costs are beginning to escalate.

Last month, the programmer was on vacation when the SSL certificate, which provides the 128-bit encryption, expired. The encryption feature was turned off, allowing personal customer data to be transmitted over the Internet without protection. Though QLL believes the data was not compromised, the incident may have been a violation of QLL's posted privacy policy.

EVALUATION GUIDE
PAPER II, SIMULATION 2 – CALIBRE LENSES INC.
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source of GAAP.

To: Dr. Kate Bolton
From: CA
Subject: Potential combination of Calibre Lenses Lab Inc. (CLI) and QuickLens Lab Ltd. (QLL)

You have asked me for advice regarding the potential combination of CLI and QLL. The report that follows provides my analysis and recommendations in the following areas:

1. An assessment of the potential combination of CLI and QLL and my opinion on whether the deal is financially fair to you;
2. An analysis of the different business philosophies and other factors that may have an impact on the combination;
3. An assessment of the current processes in use by both CLI and QLL and the processes that may be suitable for the combined operations; and
4. Tax strategies and opportunities that you may wish to consider for this combination.

Primary Indicator #1

The candidate considers the value of each laboratory and analyzes whether receiving an equal share of the newly amalgamated company is reasonable.

The candidate demonstrates competence in Finance.

Competencies

VII-4.2 Estimates the value of the business (B)

VII-5 Analyzes the purchase, expansion, or sale of a business (B)

You have asked me to assess the deal (you receive 50% of the amalgamated company) and determine whether it is financially fair. I believe the best way to answer that question is to consider what you are giving up and whether that consideration is fair in return for a 50% share of the amalgamated company. The approach I will take is to analyze whether CLI and QLL are equal in value in order to judge whether the considerations you are each giving up are worth approximately the same amount. Performing preliminary business valuations will help to determine whether the 50% offer is reasonable.

I have chosen to use one approach only to value each of the companies: the capitalization of normalized earnings approach, which is one particular application of the income approach to valuation. Alternative approaches for performing a valuation are an asset approach and a market approach. In this case, since you are replacing your laboratory equipment with new technology, it could be argued that the old equipment is now obsolete and has little to no value. (You mention that 75% of all lenses will be made using wavefront machines and that you plan on keeping your old equipment as a backup only.) Since, based on a review of both sets of financial statements, there appear to be few additional assets in the business besides the laboratory equipment, there is no reason to look at the underlying asset value. The asset-based value of the business lies more in its future assets than in its historical assets and the ability to generate sales for lenses. The market approach is more suitable to public companies, where one can assess the value compared to other similar businesses based on available market data. Since you and Dr. Alkana own private companies, this approach is also not suitable.

Within the income approach there are various techniques, some of which are based on historical earnings and some of which are based on discounted future cash flows (DCF). You have not provided the information I need to perform a DCF, so I will use historic earnings information as a basis for determining a value for each business. However, because your business operations may change significantly as a result of the purchase of the wavefront machine, you may want to consider the value of the future business earnings (using a DCF), rather than the historic earnings, as a way of measuring the value of what you are getting. Should you and Dr. Alkana decide that you wish to have a DCF prepared, I would be happy to do so.

(Candidates were not required to discuss the various approaches that could be used to perform a valuation. However, the analysis above could have been used to explain why the normalized earnings approach was chosen to estimate the value of each company, and would have been considered in assessing the candidate's performance. Few candidates undertook this discussion.)

Capitalization of Earnings Approach

Essentially, this approach considers the value of the companies in terms of their income-generating values, based on their historic earnings. This approach involves calculating a normalized EBITDA (earnings before interest, taxes, depreciation, and amortization) and then applying a capitalization rate to that amount. Normalization adjustments include adjustments for non-recurring items, such as the purchase or sale of assets, a lawsuit, or an unusually large revenue or expense. These non-recurring items are adjusted so that the financial statements will better reflect the expectations of future performance. In addition, I will consider any discretionary adjustments that should be made due to differences between the two companies that create an imbalance when they are compared. For example, the owner's compensation, benefits, and distributions may need to be adjusted to ensure consistency.

	QLL	CLI
Net income before taxes	79,353	246,764
Amortization	23,549	18,540
Interest	<u>12,485</u>	<u>-</u>
EBITDA	115,387	265,304
Adjustments to normalize earnings:		
Note 1 - Owner's salary	57,505	188,018
Note 2 - Meals and entertainment	8,290	1,486
Note 2 - Travel	38,143	2,797
Note 2 - Vehicle	22,049	1,543
Note 3 - Lawsuit settlement	20,000	-
Note 4 - Payroll audit	(15,000)	-
Note 5 - Loss of key customer (margin)	<u>-</u>	<u>(31,297)</u>
	246,374	427,851
Note 6 - Multiple	3	3
Company value	<u><u>739,122</u></u>	<u><u>1,283,553</u></u>

(Most candidates identified the capitalization of normalized earnings approach as the most appropriate valuation methodology to use. They recognized that adjustments needed to be made to net income to arrive at EBITDA and were able to perform these adjustments adequately. The majority of candidates identified the fact that normalization adjustments were also needed, but many did not attempt them. Therefore, candidates were not able to demonstrate their competence in Finance through these adjustments. Most candidates, in fact, did not make the appropriate normalization adjustments. Candidates should have considered the purpose of the analysis and recognized that certain adjustments were required in order to provide a more meaningful comparison.)

(Many adjustments that candidates did make were done incorrectly. For example, amounts were added instead of subtracted or vice versa. The adjustment related to the payroll audit was often made for the full three-year amount of \$45,000 rather than only one third of the amount, to represent a yearly amount. Many candidates also adjusted for rent in CLI's calculation, claiming that this rent would no longer be required since the lab was moving. However, this was not a valid adjustment; the two companies should be compared on equal grounds for the purpose of their valuation. Taken separately, each of these businesses would need to pay rent to exist on their own. Similarly, an adjustment to bring each of the rents to the same amount is not valid. Unless there was an indication that the rent paid by one of the businesses was below fair market, which was not the case, an adjustment was not required. Candidates' quantitative responses were generally well laid out, but they did not always support their adjustments with appropriate explanations.)

Notes

Note 1: Owner's salary is different for QLL and CLI, with QLL paying \$57,505 and CLI paying \$188,018. Dr. Bolton is more involved in the operations, so her normalized salary may justifiably be higher. It may also be that the form of compensation is different (Dr. Alkana appears to take dividends of about \$114,000). Since we would like to compare the two companies on a similar basis, we will add both salaries back to EBITDA. (Another approach would be to use an industry-average salary amount for both companies.)

Note 2: Personal expenses such as meals and entertainment, travel, and vehicle expenses are much higher for QLL. It appears that some of these amounts could be personal based on your comment that Dr. Alkana brings his wife to conferences and entertains a lot. Any personal portion should be added back to the calculation of value. It may make sense to use the difference between QLL's and CLI's expenses in these categories to calculate the normalization amount. For now, the entire amounts for each company have been added back in order to neutralize the impact.

Note 3: QLL settled a lawsuit for \$20,000, and the amount is reflected in the financial statements. Dr. Alkana has stated that lawsuits rarely occur in his business. In an effort to normalize the business earnings, the lawsuit has been backed out. However, you may wish to gather more information as to how often QLL is actually sued. If it is on a fairly regular basis, then it might make sense to leave the amount in as part of the normal operations of QLL.

Note 4: You will need to obtain more information about the payroll audit at QLL. Based on the information provided, it appears that QLL has under-remitted (and therefore under-expensed) EI, CPP, and other payroll deductions by \$45,000 for a three-year period, or \$15,000 per year. For now, I have made an adjustment to increase the expenses in QLL to reflect the revised payroll expense. However, it may not be necessary, depending on the specifics of the assessment and what QLL's position is with respect to the assessment.

Note 5: The recent loss of a key customer at CLI needs to be considered. If you believe that this customer's earnings cannot easily be replaced, then an adjustment should be made to reduce CLI's revenues to reflect the loss. You have indicated that the loss represents about 5% of sales. I have therefore made an adjustment for the amount of margin that would be lost on the assumption that the customer's sales cannot be replaced ($\$1,459,087 \times 5\% \times 42.9\% = \$31,297$). The margin used is 42.9% based on the August 31 CLI financial statements.

Note 6: I used a capitalization rate of three times EBITDA because you indicated that labs generally sell for three times their annual normalized earnings before interest, taxes, depreciation, and amortization.

Further adjustments could be made to refine the valuation (for example, rent adjustments, normalizing for debt, etc.); however, the above adjustments give you an idea of the two companies' values.

Overall, the preliminary valuations indicate the value of the two companies is not equal; therefore, you and Dr. Alkana are not giving up equal amounts in order to each obtain 50% of the newly amalgamated company. In fact, CLI appears to be worth substantially more than QLL based on the valuations I prepared. If you decide to go ahead with this deal, I recommend that either you receive additional consideration or you end up owning more than 50% of the merged company so that the deal is financially "fair" to you. Based on the estimated values above, it would make sense for you to receive closer to 65% and for Dr. Alkana to receive approximately 35% of the new company.

For Primary Indicator #1 (Finance), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	1.7%
Nominal competence — The candidate does not attain the standard of reaching competence.	15.4%
Reaching competence — The candidate attempts a reasonable analysis of what is being given up as a way of assessing the fairness of the offer.	41.1%
Competent — The candidate recognizes the normalized earnings approach is the appropriate valuation method to use, prepares a reasonable valuation of both companies, and concludes on a preliminary basis on the fairness of the offer.	41.8%
Highly competent — The candidate prepares a normalized earnings valuation of both companies and concludes on the fairness of the offer. The candidate clearly explains that there are areas of judgment that may greatly affect the value (e.g., payroll audit).	0.0%

(Most candidates were able to conclude on the fairness of the deal. Many candidates seemed to have considered the normalizing adjustments as optional and only made the EBITDA adjustments. As a result, not all candidates were able to provide a sufficient number of adjustments to demonstrate their competence in Finance. The Board was disappointed by the number of normalizing adjustments provided by candidates.)

Primary Indicator #2

The candidate identifies that there are different business philosophies, and other factors, that could have an impact on the success of the merger.

The candidate demonstrates competence in Pervasive Qualities and Skills.

Competencies - (Lists all Pervasive Qualities and Skills for the simulation)

III-1.1 Gathers or develops information and ideas

III-1.2 Develops an understanding of the operating environment

III-1.3 Identifies the needs of internal and external clients and develops a plan to meet those needs

III-2.1 Analyzes information or ideas

III-2.2 Performs computations

III-2.3 Verifies and validates information

III-2.4 Evaluates information and ideas

III-2.5 Integrates ideas and information from various sources

III-2.6 Draws conclusions / forms opinions

III-3.1 Identifies and diagnoses problems and/or issues

III-3.2 Develops solutions

III-3.3 Decides / recommends / provides advice

III-4.1 Seeks and shares information, facts and opinions through written discussion

III-4.2 Documents in written and graphic form

III-4.3 Presents information effectively

Based on the information you provided regarding the eyeglass lens industry, there are additional factors I believe you must consider before proceeding with the agreement.

Quality versus Quantity

Wavefront lenses are of superior quality. They will likely become the standard in the next few years, since most labs have already adopted the technology. CLI and QLL appear to have lagged behind and now need to adopt the technology to be able to compete and survive in the industry. The fact that CLI recently lost a client to another lab as a direct result of not having the new technology supports the fact that you need to make this move. In addition, you have made it clear that you cannot grow fast enough to support the new technology, so a merger seems necessary.

However, there are other things to consider before merging the two companies. CLI's emphasis has always been on the quality of the lenses, and quality has been important to your success. QLL seems to focus much more on high volume and low margins. CLI's and QLL's differing business approaches and attitudes do not seem compatible. Together, you will have to decide how the merged company will be positioned: will it focus on high quality or high volume? Personally, you may have to decide if you are willing to move away from your high standards.

(Candidates did well in identifying this issue, and most candidates discussed it in enough depth to demonstrate they understood what was at stake for Dr. Bolton. Candidates were able to compare the business models and conclude that issues could arise in the future from a mix of these two different models.)

Hands-on versus Hands-off Approach

You should discuss with Dr. Alkana what the merged company's business objectives and approach are going to be. Dr. Alkana appears to take a hands-off approach to QLL, whereas you are very involved in the day-to-day operations of CLI. It could be that QLL has strong managers in place and that they are able to function well without him, and that QCI will be able to continue to do so after the amalgamation. Or, it might mean the operations are not well managed, since Dr. Alkana is not very involved in the operations. If you continue to stay intimately involved in QCI, you may want to continue your hands-on approach and manage the new lab, but since it will be a much bigger lab after the merger, it may be hard to find the time.

There is a risk in giving up CLI's lease and moving into QLL's space. Unless you also move your optometry practice, you will not be able to supervise production on a day-to-day basis, as you do now. It may be difficult to maintain your objective of quality lenses if you end up trying to manage both your practice and the lab. On the other hand, this dilemma may in fact present an opportunity for you to learn how to delegate, since you'll be working with Dr. Alkana, and you may be able to free up some of your time. This may be the perfect opportunity to change your management style.

(Most candidates identified this issue. However, not all were able to discuss it enough to show they understood that the different management styles could create conflicts in the future. Some candidates only identified that the management styles were different, but did not explain why that could be a problem after the merger or what the potential consequences could be. Many candidates tried to fix this problem by adjusting the pay level of each of the owners. These candidates did not see the broader issue of potential disagreements between the co-owners and the fact that Dr. Bolton might not be willing to do business with Dr. Alkana knowing that his style is substantially different from hers.)

Risks and Ethics

You should consider Dr. Alkana's attitude towards the lawsuit and determine whether it is consistent with yours. You may want to gather more information from him on the number of lawsuits of this nature he has had. There may be some underlying risk related to the way he does business that you should be aware of (such as the potential for more lawsuits).

The same sort of questioning should be done regarding the payroll audit. You may find some underlying reason for the assessment that relates to his management style and increases the risk to you in your combined operations (for example, allowing late payments).

I also wonder if you are able to leave your current premises as quickly as you propose. You may be required to provide more than three months' notice to your landlord. Further, if the merger does not go as planned and you want out, CLI would have no place to house its operations. As a result, you will want to ensure you have worked through the operational issues before making the deal.

(Candidates did not discuss these minor issues very often. Some candidates identified the issue, but argued that the lawsuit proves that the quality of the lenses made by Dr. Alkana is poor, rather than recognizing that the lawsuit and audit call attention to the risk of doing business with him and that his methods may hurt Dr. Bolton's reputation. The Board was expecting candidates to realize that the association with Dr. Alkana is risky for Dr. Bolton.)

IT Systems

The two IT systems the companies use are quite different. There is some risk in trying to adapt one system to the other business. However, both systems need to be adapted to the new wavefront machine technology, so changes to the processes are inevitable. Since the business appears to be very dependent on technology, whatever changes are made to your processes need to be implemented smoothly, and the new system must allow for a well-run operation or your business continuity could be put at risk.

The current deal is set to take place fairly quickly. If you can afford to wait a bit to purchase the machine, you may wish to consider some alternatives. A delay may not be possible, though, since you are already late in making your move to the new technology. You may not have a lot of choice among other labs that are still looking to move to the new technology, but you may still wish to consider a merger with a stronger lab that is more culturally aligned with yours, if you can find one. Or, perhaps you can form a business arrangement with multiple labs to produce enough lenses and generate sufficient new business to carry the cost of the machine on your own. If your current management philosophy and style are important to you and are to be maintained, then another business partner might be more appropriate than Dr. Alkana.

(Very few candidates identified and discussed this issue.)

For Primary Indicator #2 (Pervasive Qualities and Skills), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.6%
Nominal competence — The candidate does not attain the standard of reaching competence.	8.3%
Reaching competence — The candidate discusses one of the significant differences between the two operations: business model, management style, IT.	46.7%
Competent — The candidate discusses some of the significant differences between the two operations and the potential success of the deal.	44.3%
Highly competent — The candidate discusses most of the significant differences between the two operations and assesses the potential success of the deal, recommending a course of action to the client.	0.1%

(Candidates generally performed well on this indicator. Although this indicator was not directed, there were a substantial number of case facts provided to assist the candidates. Most candidates addressed this indicator from a risk versus opportunity perspective and were able to explain the risks involved and the consequences of the differences in business models and management styles. Strong candidates were able to integrate the case facts, identify the potential problems, and discuss the consequences, while others essentially repeated case facts without any further analysis. Some candidates identified the issues from a financial point of view and did not understand that the business practices of Dr. Alkana could have a pervasive impact on the operations of the combined business.)

Primary Indicator #3

The candidate analyzes the two current processes and recommends processes that would be best suited to the combined operations.

The candidate demonstrates competence in Management Decision-Making (IT).

Competencies

VIII-2.1 Analyzes, selects and implements IT solutions to support processes and management's information needs (B)

VIII-2.2 Evaluates alternative IT solutions (B)

Since you started talking about the merger several months ago, the lab managers have had time to prepare a description of the operational workflow presently used by each lab. You asked me to recommend which one would be the most appropriate process if you merge the two labs, taking into account the wavefront machine. Both LabLink and QLL's IT system appear to work well, although they are very different systems, one being quite automated compared to the other. I have compared the two existing processes below. However, you need to consider how the new wavefront machine will be integrated into either of these processes. I have no information on how the information is collected and sent from the optometrists to the lab. If the wavefront reader collects electronic information and sends that information automatically to the lab, then the lab process needs to be capable of handling the transfer of electronic data. More information needs to be obtained on the wavefront's data collection and transfer processes (from customer to lab) before you can decide which process to adopt.

An assessment of the strengths and weaknesses of each of the processes currently being used is still valuable. You can use the information to determine whether the wavefront technology will fit or whether QCI needs to consider a new process.

(Most candidates failed to consider how the new wavefront machine might affect the choice of processes.)

CLI System — LabLink

LabLink is off-the-shelf software that is used for lens production. It tracks the job order through the lens production process. The software was developed several years ago, so it may not be able to integrate with new technology, such as the wavefront manufacturing machine. There is a significant

issue in that the version of the software CLI has will no longer be supported after 2013. Therefore, the merged company will only be able to continue to use LabLink for a short period of time before a change would have to be made. You should find out from the manufacturer if later versions of LabLink are available that would be suitable for the much larger volumes associated with the merged company and that could integrate with the wavefront technology.

The order process has several manual elements. For example, when the lab receives the faxed or emailed order form, the information is not keyed into the LabLink system right away. A picker physically checks the order against actual lens inventory. If the lens is not in stock, the order is put to the side and not entered into the system. This means that no tracking of back-ordered lenses is being captured in the LabLink system, and there would be no way to easily track an order before its lenses arrive.

On the positive side, LabLink seems to be very secure, with unique user identification and effective passwords. The system support provided appears to be excellent. The software is also backed up every hour, which would minimize lost data in the event of a malfunction. However, since the backup has never been tested, it is not known whether the data could be retrieved quickly.

(Most candidates discussed strengths and weaknesses related to the CLI system. Most discussions were well done and clearly laid out.)

QLL System

QLL's system was custom-designed within the last couple of years and is updated regularly, making it a good candidate for the merged operations. It is also equipped to handle high volumes, which the merged company will need. Since the programmer is still available, changes (such as accommodating the wavefront machine) can be made easily. However, it appears that the programmer is spending more and more time making programming changes and costs are rising, which may reflect a problem with the degree of customization that is required. If the current high level of programming continues to be needed, there may be significant costs associated with choosing the QLL system. An assessment of the degree of customization that would be required to integrate the wavefront machine into the process is required.

The other concern with the system is that it was programmed by a single individual. If something happened to that programmer, it would be difficult to make changes to the system. As a precaution, you should find another person who knows the program, and you should ensure you have access to the source code in case you need to make changes later through another programmer.

The system eliminates the need for fax- or email-based orders and allows customers (optometrists' offices) to enter orders directly into the system in real-time, thereby reducing keying errors. The system is browser-based, so it is easy to grant access to new customers. Unlike the case with LabLink, there is no time when an order exists outside the QLL system, making start to finish tracking easy. QLL's system is fully integrated with the tracing, edging, and coating machines, which reduces data transfer errors that can occur without integration. You will need to find out how this integration would work with the new wavefront machine.

There do appear to be some problems with the QLL equipment and related computer programs. These problems appear to be occurring within the transfer of data between the tracer and the edger: millimetres are being subtracted from random lens measurements. Since the new wavefront machine replaces these pieces of equipment, the current problems may be eliminated with the use of the new machine (although in our discussions you indicated that you plan on using the old equipment as backup equipment). On the other hand, the problem may be with the software. Either way you will need to fix the problem. You should contact the programmer and whoever maintains the tracer and edger equipment immediately to see where the problem lies, if it can easily be fixed, and how much that would cost. If the cost is significant and the equipment or software is only needed as backup, then you will need to re-evaluate the decision to keep the equipment.

Although customers have unique user identifications and strong passwords for accessing the system from outside QLL, internal security could be improved. All the users should not be logging in as the administrator because it may allow them to make unauthorized changes to the system. Each user should have a unique user ID and a strong password restricting access to the system.

The system uses 128-bit encryption, which is a secure form of data transfer used by commercial banks. However, since the programmer allowed this to lapse, data could have been sent unencrypted. QLL should put a procedure in place to ensure that its SSL certificate is always up to date.

(In general, candidates' discussions of the QLL system were well done. Most candidates were able to discuss both the strengths and weaknesses, and did especially well discussing the weaknesses of this system.)

Recommendation

The main issue with CLI's system is whether it can handle the increased volume of business. Further investigation into the newer version of LabLink may be warranted if it can be integrated with the new wavefront machine. However, CLI's current system is too manual to be efficient, even though the controls around it are strong.

Overall, QLL's system seems better suited to the amalgamated company and looks like it might be more easily adapted to the new wavefront technology. The problem of the incorrect measurements, whether it relates to the equipment or the software, should be fixed, assuming the fix is justifiable if the problem is with the equipment. General security improvements should also be made.

However, there may be another option that is better suited to the wavefront technology than either QLL's or CLI's system. I suggest you talk to those already using the wavefront machine to see how they adapted their processes and systems. Then you can decide if it makes more sense to move to a brand new process for the amalgamated company rather than try to adopt and modify QLL's or CLI's processes and systems.

(The vast majority of candidates concluded on which lab process to use. The conclusions made by most candidates flowed logically from their analysis. However, most candidates did not recognize how important it was for the chosen system to fit in with the increased volumes and the new wavefront technology that would be integral to the new combined operations.)

For Primary Indicator #3 (Management Decision-Making (IT)), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.4%
Nominal competence — The candidate does not attain the standard of reaching competence.	3.6%
Reaching competence — The candidate discusses some of the specific strengths and/or weaknesses in each of the current processes or discusses one of the processes in depth.	53.7%
Competent — The candidate discusses some of the strengths and/or weaknesses in each of the current processes, compares them, and makes a recommendation that flows from their analysis, taking into consideration the combined operations.	42.1%
Highly competent — The candidate discusses most of the strengths and weaknesses in each of the current processes and recommends a process, taking into consideration how the new wavefront machine might fit in.	0.2%

(Some candidates only discussed the weaknesses of the systems, identifying their implications and recommending how to fix them. However, in this situation, the candidates were required to tell Dr. Bolton which of the lab processes would be best suited to the combined operations, so strengths were also relevant to the analysis and were a significant part of a good response. Other candidates only repeated case facts and did not sufficiently explain the consequences of the weaknesses or the benefits of the strengths to Dr. Bolton.)

(Although many candidates were able to provide a good analysis of each of the systems, most of them did not realize how important it was for the chosen system to be able to fit in with the combined operations. Because the combined operations would be dealing with a much greater volume of operations and because the new wavefront technology would be integrated into the operations, candidates needed to incorporate these factors into their analysis. Most candidates failed to do so.)

Primary Indicator #4

The candidate discusses the tax strategy available to CLI related to the merger of CLI and QLL (trigger gain).

The candidate demonstrates competence in Taxation.

Competencies

IX-3.5 Identifies, analyzes, and advises on tax consequences or planning opportunities associated with certain corporate transactions (B)

IX-3.6 Analyzes tax consequences of other corporation and partnership restructuring transactions (C)

You mentioned that after talking to colleagues, you are confused with respect to your tax situation. Some optometrists you do business with have told you that their accountants optimized their tax situations by taking advantage of the rules around the Qualified Small Business Corporation (QSBC). You asked whether this applies to your situation. You also asked if you should be proposing something different, from a tax point of view, than what is currently in the draft agreement.

In order to answer your questions, we need to discuss two things: first, whether CLI would qualify as a Small Business Corporation, and second, whether you have optimized your particular situation, considering the description of the transaction provided in the draft agreement. I can also discuss different methods of corporate reorganization so that you have a better understanding of what the draft agreement is suggesting in terms of the structure (in other words, Section 87 amalgamation).

QSBC

To qualify as a QSBC, the corporation must be a Canadian Controlled Private Corporation (CCPC) and have used more than 50% of the fair market value of its assets in an active business in Canada throughout the two years prior to the sale. On the date of sale, the corporation must be a CCPC and use more than 90% of the fair market value of its assets in an active business in Canada. There are also some specific rules regarding the types of shares that qualify for the capital gains exemption, so we should ensure that the shares you own are the right type of shares. Since CLI and the proposed merged company have no non-active or foreign assets, such as vacant land or invested cash, your shares would likely qualify for the capital gains exemption.

(Most candidates identified the need to discuss the QSBC rules. However, some candidates were not able to discuss it in enough depth to demonstrate their competence in Taxation. Most candidates who failed to discuss this issue in depth did not integrate case facts in their analysis. Some candidates only listed the QSBC criteria without applying them to CLI's situation or without concluding whether these criteria were met by CLI. Some candidates were confused and seemed to be analyzing whether CLI met the SBD criteria rather than the QSBC criteria.)

Given that the transaction is described in the draft agreement as being a Section 87 legal amalgamation with each of you taking a 50% stake in QCI, a new corporation, your shares would be disposed of at their adjusted cost base (ACB), and this cost would be deemed to be the ACB of your shares of QCI (the new corporation). So, essentially, if you only receive shares as part of the amalgamation of the two companies, as proposed in the draft agreement, there are no immediate tax consequences to you. Since you and Dr. Alkana are at arm's length, CRA would agree to the values you assign to the shares. Therefore, under the current structure, you will not be triggering a gain against which you can use your capital gains exemption.

However, in order to optimize your tax situation, you may want to trigger a gain on the disposal of your shares and benefit from certain exemptions that are available on shares in a QSBC, since you haven't been able to use these benefits thus far. You have shares that appear to have increased in value (the stated value of the shares is \$50, and the valuation shows a substantial increase in value). Those exemptions are what the other optometrists used to optimize their tax positions. Owners of QSBC shares can claim the capital gains exemption to shelter gains on the sale of those shares, up to \$750,000 in their lifetime. In this way, you will ensure that these gains will not be taxed later should the exemption be taken away.

Depending on how the deal is structured for tax purposes, a gain may or may not be triggered. For example, you could first transfer your shares in CLI to a holding company and trigger a gain as part of that transaction. CLI could then be amalgamated with QLL. There are also a number of other approaches that could be used to trigger the gain. If you do anything that changes the draft agreement, you will need to ensure that Dr. Alkana agrees to the approach, since he could be affected by the changes you make to the agreement for tax purposes.

Note that this discussion is also relevant if you take cash back to deal with the valuation differences. If you do as I suggest and additional funds are paid to you, this would trigger the full gain that would also be exempt as long as it doesn't exceed \$750,000.

(Many of the candidates identified, either implicitly or explicitly, that the deal as currently structured would not trigger a gain. However, most were not able to provide a valid option for triggering the gain. Some candidates proposed options that did not fit with the client's needs. As an example, some candidates proposed that Dr. Bolton sell her shares in order to trigger a gain and use her capital gain exemption, which is not in line with her desire to stay in business.)

Personal Benefits

You should discuss meals and entertainment, travel, and vehicle expenses with Dr. Alkana to better understand the type of expenses he is claiming in his business. If they have a personal component, that portion would not be deductible by the corporation. Also, some types of transactions, such as meals and entertainment expenses, can only be deducted at 50% of the total expense incurred. Dr. Alkana likely already knows this since QLL is audited, but it will not hurt to confirm.

Salary versus Dividend Mix

In light of the fact that you draw a large salary and Dr. Alkana seems to take dividends instead, there may be some benefit to examining the salary and dividend mix that is most suitable once the two operations are merged. I would be happy to meet with you to discuss this issue further.

For Primary Indicator #4 (Taxation), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	2.4%
Nominal competence — The candidate does not attain the standard of reaching competence.	36.9%
Reaching competence — The candidate explains what a QSBC is and how the rules apply to CLI, or identifies the opportunity to trigger a capital gain with a QSBC.	47.3%
Competent — The candidate explains what a QSBC is and how the rules apply to CLI, and identifies the opportunity to trigger a capital gain with a QSBC.	13.3%
Highly competent — The candidate explains what a QSBC is and how the rules apply to CLI, explains the opportunity to trigger a capital gain with a QSBC, and lists alternative methods for structuring the deal.	0.1%

(Candidates performed poorly on this indicator. They were not able to demonstrate sufficient competence in taxation. Candidates showed poor technical knowledge because their analyses included many deficiencies and poor integration of case facts. Candidates did not take into account the client's situation in their proposals of alternative solutions to structure the deal.)

There were no secondary indicators in this simulation.

(Overall, candidates seemed to spend more time on the IT indicator than on any other indicator on this simulation. Many candidates provided a micro-analysis of all of the strengths and weaknesses of each of CLI's and QLL's systems without discussing the key issue, which was the capacity of the chosen system to support the new wavefront technology or the increased volume of operations. Similarly, candidates discussed the differences in business models and management styles from the perspective of making the deal fair to Dr. Bolton and lost sight of the fact that this association with Dr. Alkana might not even work considering the fundamental differences in the styles and business models used by the two doctors.)

(Candidates only very briefly addressed the taxation indicator. Although this was often the last item discussed in their responses, the brevity of the discussions seemed not to have been due to a lack of time, but rather a lack of technical knowledge. It is also unclear to the Board of Evaluators why most candidates did not provide a sufficient number of normalizing adjustments in their finance calculation. Items that needed to be adjusted were presented in the simulation, and candidates should have used case facts to calculate the value of each laboratory.)

SAMPLE RESPONSE
PAPER II-2 CALIBRE LENSES LAB INC. (CLI)

The following is a candidate response for Paper II-2. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 2

To: Kate Bolton

Re: CLI amalgamation with QLL

Overall

You, Kate, should not go ahead with the deal with QLL. You should try and look for other opportunities to amalgamate to get the wave front technology because the current deal is not fair financial. Also Dr. Alkana's strategy is the opposite of yours and appears to be very careless quality wise, resulting in legal liabilities. Combining with QLL will significantly increase your risk as QLL has far more debt than CLI and has been careless with personal information (security breaches with online system) and has caused a legal liability due to a car accident. This means you would be exposing yourself to more risk and not getting compensated for this risk as the value you are receiving for CLI is less than my valuation in exhibit 1 shows.

Financial Assessment

See exhibit 1 for an assessment of the value to you based on keeping CLI versus selling and amalgamating with QLL.

This shows that CLI is worth approx \$1.4 million on its own and the combined entity 50% is only worth \$982,000 this it is not financially fair to receive only 50% in the combined entity.

Risks and Opportunity Assessment of Amalgamation

1) Increase debt load amalgamating

- QLL has bank indebtedness of \$151,000 and a long term debt of \$144,000 whereas CLI has cash of \$91,000 and no long term debt
- This means that amalgamating will increase the financial risk to you and to CLI
- This increases the risk that you will ultimately become responsible for these debts which you have not benefited from and may cause financial strain such as cash flow issues for CLI once amalgamated

2) Conflicting business strategies

- There is a risk that QLL and CLI will not be a good fit strategically based on the current conflicting strategies as you have run CLI as a small but high quality manufacturer with high attention to quality
- QLL on the other hand focuses on high volume and appears to have quality issues based on the lawsuits that Dr. Alkana has mentioned

Recommendation:

You and Dr. Alkana should discuss these differences before agreeing to amalgamate and devise a business plan for the combined business to ensure that you can both cooperate and agree to a unified strategy.

3) Outstanding legal liabilities

- Dr. Alkana has informed us that he has been sued due to a set of incorrectly produced lenses
- Although he says this happens rarely the fact that he has told us that he has "learned over time its simpler to pay out the amounts" indicates he may have been sued more than once
- This is not consistent with your desire for quality and could result in further legal liabilities if his quality becomes the standard in the combined practice which could result in a damaged reputation for you and significant financial costs

Opportunities:

- Combining operations will give you the ability to access the wavefront technology that will allow you to improve quality
- Using this machine will improve quality for both practices and may help deal with the quality issues Dr. Alkana has had in the past which would create an overall good reputation for the new combined practice and should increase profitability as customers will be happy with the product

Assessment of Workflow Reports

CLI Pros:

- the current support from the company has been excellent and fees are minimal which means that Lablink will be less costly which will increase profitability
- Lablink backs up every hour which means that in the event of a failure CLI is very well protected from information losses
- there are strong protection controls with 128 bit encryption and there has never been a security breach which indicates that there is little risk associated with maintaining personal information

Cons:

- Lab link requires manual entry of order information through email or fax which could result in errors and is less efficient
- clerk must check physical inventory to determine if a lens is available
- Overall the system is less automated which will result in a less efficient system and may not be able to handle the larger volumes anticipated once the amalgamation occurs

QLL

Pros:

- orders are submitted online and instantly generate a work order which reduces the risk of errors occurring due to manual entry and requires less effort, thus increasing efficiency of the process
- any out of stock lens code is added to a reorder list which is automatically emailed to suppliers at the end of each day - this automation increases efficiency and reduces error or keying in an order

Cons:

- there is integration between the management system and the tracing and edging and coating so that the order can be tracked at any point, however, this is resulting in errors which is costly because wastage is being generated if the wrong size lens is being cut
- Security is less secure as the system is web-based which increases risk for hacking; also this is an issue because all on site users are logging in as the administrator so there is no way to track and determine accountability for who is in the system- there is a risk that people have access to information they should not which is compromising the confidentiality of personal information in the system

- Also the certificate has expired for the encryption and thus there is not protection for information being transmitted over the internet which again means that hackers could be accessing personal information
- since the personal privacy policy is being violated this will leave QLL open to further legal liability and reputational damage if customers find out, and if this occurs after the amalgamation this will put the CLI name at risk as well

Conclusion:

The QLL system appears to be better suited to the high volumes that the combined entity will have, however, it is showing very serious security issues and errors such as the cutting errors, both of which need to be resolved before the system can be operated effectively. Given that the amalgamation is to happen at the end of October this may not be enough time to fix these issues. If they cannot be fixed, then the CLI system should be selected, as the combined business cannot risk the security and operational issues currently being experienced at QLL. However, this may increase costs and be difficult to administer given the increased volume.

Tax Issues - Use of Qualified Small Business Corporation

A qualified small business corporation can be sold and the owner can use their lifetime deduction of \$750,000 to reduce the tax liability owing on any capital gain which results from the sale of the QSBC.

Thus, instead of structuring the combination of CLI and QLL as an amalgamation it may be more advantageous to structure it as a separate sale of CLI to QLL and then a purchase of the 50% share in the combined entity (QLL) in order for you to utilize your life time capital gain deduction.

The criterion that must be met in order to do this is as follows:

- 1) the QSBC must have been owned by the same or related owners for the last 24 months
- 2) The QSBC must have has 90% of its assets used in earning active business income at the time of the sale

In order for an entity to be a QSBC the following criteria must be met:

- 1) The entity is a CCPC - private corporation owned by a Canadian resident
- 2) 50% of the assets are invested in assets producing active business income - this must hold true for the last 24 months before sale for utilization of the lifetime capital gain deduction

Exhibit 1

Purpose:

To determine the value of CLI to determine if 50% stake in QLL is financially fair compensation

	CLI	QLL	Combined	
Net Income before Tax	246764	55430		Note 3
Amortization	18540	23549		Note 3
Interest	0	12485		Note 3
Depreciation	0	0	0	Note 3
Adjustments to Normalize				
Lawsuit		20000		Note 1
Owners Salaries	188018	57505	0	Note 2
Rent CCL	0	0	32800	note 4
Total Adjustment	188018	77505	32800	note 5
EBITDA	453322	168969	655091	Note EBITDA combined is total for CLI and QLL plus \$32.8k relating to rent for CLI which will no longer be incurred as a combined unit because they are moving to the QLL location
3x EBITDA	1359966	506907	1965273	
At 50%			982636.5	

Conclusion:

Based on analysis above CLI is worth more than 50% of the combined CLI and QLL thus the current deal is not financially fair for you.

Note 1

Assuming that lawsuits do not recur regularly this loss of \$20k should be deduction from the calculation of normalized income

However this will be considered as a risk in risk discussion as it appears QLL has had multiple legal claims

Note 3

Value of business is usually based on 3x normalized earnings before interest, amortization, taxes and depreciation thus interest, amortization and depreciation are added back to the before tax income number reported for 2010 to arrive at a valuation based on this formula

Note 4

For combined EBITDA I have removed owners salaries as I assume that CLI and QLL owners will need to take out a salary because currently each is taking out a different amount compensation will need to be negotiated but I have assumed an average amount of 0 so that the comparative valuation is equal - ie not salary is taken out for the valuation of CLI or QLL

I have assumed this as the owners will need to decide what salary to take out and how much compensation in salary vs dividends

Note 5

I have added back the rent for CCL as the amalgamated business will move into the QLL location.
per the agreement

Paper II - SIMULATION 3 (70 minutes)

You, CA, live in the mid-sized city of Boothville, which has a population of 300,000. You've lived there all your life. Your office is in the small downtown core, but you, like most of Boothville's residents, commute downtown daily from the city's suburbs, where the homes are more affordable. Boothville has extensive urban sprawl. Unfortunately, the public transportation system does not meet the needs of suburban residents, and the service is considered below average. Most residents can't be bothered with the inconvenience of the transit system even if it is a more cost-effective and environmentally friendly alternative than commuting by car.

You are the controller for Gray Hill Apartments Inc. (GH), a private company that owns numerous rental apartment buildings in the suburbs. After another long bus ride into work on Monday morning, you are called into the offices of the owners of GH, Taylor and Peter Waitman, to hear exciting news: they have decided to operate a car-sharing business out of their apartment buildings.

"Businesses like this are thriving in Vancouver, Toronto, and Montreal," Peter explained. "These companies buy several vehicles and set up drop-off spots all over the downtown. People who don't own a car pay to become members so they can have occasional access to a car to run errands or go somewhere the bus doesn't go. They save on the purchase of a vehicle, the maintenance costs, and the insurance. The only difference in our case is that, instead of operating out of downtown, we'll just have a few cars at each of our apartment buildings for our tenants and other people from the surrounding areas to use.

"We haven't done any formal market research, but given the trend nowadays towards eco-friendly choices, we think this is a sure bet. Plus, only about half of our tenants have cars, so we have spots free for these shared cars. We had a few break-ins and car thefts in our parking garages last year but, as you know, we recently put in a state-of-the-art, security-enhanced parking lot system with access cards and video cameras, so the cars will be safe," added Taylor.

Taylor and Peter stated that they believe there are substantial differences in the nature of transactions between their current business (collecting monthly rent payments) and this new business opportunity; therefore, they would like you to advise them on the appropriate accounting policies to employ under current Canadian GAAP.

Paper II - SIMULATION 3 (continued)

To help you, they give you their first thoughts on the pricing schedule and business details (Exhibit I). They also provide some basic ideas of how they think the operations could work (Exhibit II), but they recognize that the manual processes and internal controls they suggest can only be temporary. Peter is eager to automate the controls and to implement some new technology he has read about that is already being used by rental car agencies. A small computer that is integrated with the car's electronic system and engine allows the rental car agency to control access to the vehicle and to track information regarding its usage.

You take the information Taylor and Peter have given you back to your office to look over. While you get to work, you keep in mind that they have always been very open to your suggestions about their business and that they value your opinion. They want to make this new venture a great success.

Paper II - SIMULATION 3 (continued)

EXHIBIT I

PRICING SCHEDULE AND BUSINESS DETAILS

1. Membership plans:

- a) Plan A: Unlimited kilometres – \$8,000
- b) Plan B: 10,000 kilometres – \$4,000
- c) Plan C: 5,000 kilometres – \$2,100
- d) Plan D: 2,000 kilometres – \$900
- e) By individual kilometre – \$0.50/km

Payment is normally due on registration unless the member has arranged to pay on an installment basis. The membership plans are good for one year, at which point all unused kilometres expire. If a member surpasses the number of kilometres allowed for in their plan, they can purchase another plan or choose to be charged the individual kilometre rate.

- 2. A \$500 deposit for the insurance deductible is due when the member signs up. The deposit is fully refundable on termination of membership if no claim has been made.
- 3. A \$10-per-month fee will be charged and placed in a separate bank account to self-insure for accidents that cost less than \$5,000 and that do not involve the police. All accidents with costs at or above \$5,000 or that involve the police must be declared to the insurer. (Note: This fund is intended to keep our insurance rates down. If a member remains in the program for five years and is accident free at the end of that period, we will provide them with a refund equal to 50% of the amount they contributed to this fund.)
- 4. A \$50 administration fee will be charged when a member signs up.
- 5. Members will book vehicles for specific time periods. A \$15-per-hour penalty will apply on vehicles returned later than anticipated.
- 6. Members must return the vehicles with a full tank of gas.
- 7. A flat fee of \$25 will be charged if a vehicle is reserved but the member fails to use it.

Note that we expect to use the vehicles for about three years (or 120,000 km) and then sell them to a used car dealership. We are thinking of recording the vehicles as inventory.

Paper II - SIMULATION 3 (continued)**EXHIBIT II****HOW THE BUSINESS WILL OPERATE**

As with our rental property, we want to make this business as hands-off as possible. We really don't want to incur increased labour costs on account of this venture if we can avoid them. To get up and running quickly, we have made the following decisions:

- A booking sheet will be placed in the lobby of each apartment building so members can sign up for a vehicle for a particular period of time. We expect that if a member returns a car late, the person waiting for that car will report them and the late fee will be charged. In this way, the business will be self-regulating.
- A log book will be placed in each vehicle. Members will be responsible for filling out the beginning and ending kilometres of their trip. If someone forgets, it will be evident how much he/she drove based on the log entries of the previous and the following person. This will also self-regulate. Our bookkeeper will take the log book each month, add up the kilometres used by each member, and reduce their kilometre balance accordingly.
- As non-residents may also be members, the concierge will let these members into the parking garage to access the car.
- Each vehicle will have a punch-code lock system that will allow entry to the vehicle. The key to start the engine will be attached to a cord under the dashboard. The punch code can be reset as often as we wish; however, since we will have only a limited number of members we do not plan to change the code.
- Each car will have an access card in the glove box that operates the parking garage door.
- We know we're going to need a website eventually so that people can check out our business and our rates, can book and pay online, and can email us. We obtained a proposal just to see how much this would cost. The total quoted was \$20,000 and is broken down as follows:

Software purchase and customization	\$ 4,700
Graphic design	4,500
Develop content and populate database	5,500
Register for Internet domain name	100
Register with search engines	200
Training	<u>5,000</u>
	<u>\$ 20,000</u>

EVALUATION GUIDE
PAPER II SIMULATION 3 – SHARE-A-CAR
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source for GAAP.

To: Taylor and Peter
 From: CA
 Subject: Advice regarding proposed car-sharing business

The report that follows provides advice to you on your proposed car-sharing business. The advice can be broken down into the following three general areas:

1. Advice on appropriate accounting policies;
2. Identification of internal control weaknesses within the proposed business and my suggestions for improvements, including automation; and
3. Some further observations and suggestions on your proposed car-sharing business.

Primary Indicator #1

The candidate discusses appropriate accounting policies to implement for the car-sharing business.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies

V-2.2 Develops or evaluates accounting policies in accordance with GAAP (A)

Below, I have outlined the accounting policies I recommend for your proposed car-sharing business, all in accordance with current Canadian GAAP. Where appropriate I have also explained the reasoning behind my recommendation.

Accounting Policy Choices

You have quite a few revenue streams. They are best dealt with individually.

Revenue Recognition Policies — Membership Plans

The critical issue for the revenue associated with the car-sharing business is when the revenue may be recognized. Unfortunately, it is not as simple as recording the money when it is received. Revenue can only be recorded when performance has been achieved and ultimate collection is assured (*CICA Handbook-Accounting* Section 3400.04).

Performance is achieved when (*CICA Handbook-Accounting*, Section 3400.07):

- a) Persuasive evidence of an arrangement exists;
- b) Delivery has occurred or services have been rendered; and
- c) The seller's price to the buyer is fixed or determinable.

You are thinking of offering three different types of membership plans:

- 1) Unlimited kilometres: Plan A
- 2) Set amount of kilometres: Plans B, C, & D
- 3) Per-kilometre fee: Plan E

The timing of revenue recognition may be different for each of these types of plans, so I will discuss the revenue recognition criteria in the context of each type.

Unlimited kilometres: Plan A

There is no way of knowing how much a member will use a vehicle under this scenario. Since there is no limit on the amount of kilometres under Plan A, it is not reasonable to recognize revenue based on the kilometres driven. Plan A essentially provides the member with full-time access to a vehicle for a year. Therefore, the revenue is really earned each month by simply having a vehicle available for their use. In this case, it would be appropriate to recognize the revenue evenly over 12 months ($\$8,000 \div 12 = \666.67 per month).

Set amount of kilometres: Plans B, C, & D

Because plans B, C, and D are set up to equate to a certain number of kilometres driven, it would be most appropriate to record revenue as the members use their allotted kilometres. For example, if a plan B member used 1,000 kilometres in one month, \$400 would be recorded as revenue for that particular month ($1,000 \div 10,000 \times \$4,000$). If, at the end of the year, the individual has not used the full amount of kilometres allowed under his or her plan such that the remaining kilometres expire, the remaining revenue would then be recorded.

This assumes that you are able to track each member's per-kilometre usage. If this is not possible, you may have to defer revenue recognition until the end of the membership period (in other words, when all kilometres expire). Over time, you may be able to use historical data of vehicle usage under these plans to record revenue throughout the year based on typical usage.

Per-kilometre fee: Plan E

Similar to recognition for a set number of kilometres, revenue under Plan E should be recorded as the individual kilometres are purchased and used. However, if members only pay for the actual kilometres used when they return the vehicles, collection issues that would preclude recognition could arise since members could refuse to pay.

Installment plans

It appears that you will make installment plans available to members. You should note that this could represent a potential credit risk if you are not careful about which members you offer the installment payment option to. In terms of revenue recognition, upfront and installment payments are recorded as deferred revenue. If an installment member were to use more kilometres than they have paid for, an accounts receivable would be recorded until the next installment payment is received. If ultimate collection is uncertain, you may need to wait until the cash is received to recognize the revenue.

(Most candidates recognized that revenue from the membership plans was a significant GAAP issue that they needed to consider in their analysis. However, the discussions of most candidates who addressed the issue were weak and tended to reproduce the GAAP criteria presented in the Handbook, with little application to the plans (unlimited, limited, and per-kilometre). Strong candidates recognized the presence of three different types of plans and incorporated that into their discussion of the accounting treatment, clearly recognizing that the accounting treatment may be different for each type of plan.)

Revenue Recognition Policies — Other

Insurance Amount of \$10 per Month

Half of the amount collected from the \$10 monthly charge will be refunded to a member if they remain accident free for five years. The remaining \$5 per month (the 50% non-refundable portion) has no further obligation associated with it, except to cover repair costs in the case of small accidents, so it should be recognized immediately as revenue.

The \$5 refundable portion should be recorded as a customer deposit (liability) until such time as *a)* five years have passed accident-free and the \$300 is refunded to the member; *b)* the member has an accident, and the aggregate of the \$5 per month for that member is moved into other income; or *c)* the member does not renew their membership and as a result the amount is defaulted. Some or all of the \$10 fee may need to be classified separately as restricted cash depending on whether the company is contractually or legally required to set aside the deposit.

Administration Fee

Because we are always trying to record revenue as it is earned, we need to determine what the \$50 administration fee covers and when that work is expected to occur. It appears that the \$50 is meant to cover upfront paperwork to get the member set up and to process their payment. If this is in fact the case, the \$50 can be recorded as revenue at the time the member signs up for the program. If this is not the case, then the amount should be amortized over the average registration period.

Insurance Deposit of \$500

Similar to the refundable portion of the monthly \$10 self-insurance charge, the \$500 refundable deposit cannot be recorded as revenue, but must be shown as a deposit (liability). When the member terminates their membership, if they have not had an accident, the entry will be a debit to liability and a credit to cash for the repayment. If a member has an accident and the deductible must be used to cover the repairs, the deposit will be recognized at that time as revenue and the \$500 (or greater) repair expense will be recorded at the same time.

Minor Issues

Late returns: Late return revenue (\$15 per hour) and the associated receivable should be recorded in the period in which the late return occurred.

Reservation fee: The flat fee of \$25 charged to members who reserve a vehicle but fail to use it should be recorded in the same period the fee is charged.

(Most candidates were able to discuss these revenue recognition issues appropriately and applied their knowledge to the simulation facts when determining whether the revenue recognition criteria were met. Strong candidates recognized that certain fees were partly or fully refundable under particular circumstances and recommended an appropriate accounting treatment to take into account instances when the funds would not be refunded to the member.)

Capitalization of Vehicles

You expect to sell the vehicles at the end of three years, so it is worth discussing whether these assets are capital in nature or whether they are inventory.

They would not be inventory as you are not buying them for the purpose of reselling them at a profit. Because you are keeping the vehicles for a significant part of their useful lives and will then be selling them much below cost, the appropriate accounting methodology would be to treat them as property, plant and equipment. As such, the vehicles should be recorded at cost and amortized to reflect their usage. There will be gains or losses to record at the time of each sale to account for the difference between net book value and selling price.

Amortization Policy

You must put a policy in place for the amortization of the vehicles. It would be a good idea to get an estimate of the expected resale price (residual value) after both three years and 120,000 kilometres for the types of vehicles you are planning to purchase.

One option would be to amortize the vehicles over the three-year expected life $((\text{Cost} - \text{Residual Value}) \div 3)$. However, there is a more appropriate method. I determined earlier in this report that most of the revenue should be recognized as the kilometres are driven, so the vehicles should be amortized on the same basis, since usage of a vehicle occurs in proportion to the kilometres driven. For example, if a vehicle costing \$18,000 with an expected residual value of \$4,000 was driven 25,000 kilometres in one year, the amortization would be \$2,916 $((\$18,000 - \$4,000) \times 25,000 \div 120,000)$.

I recommend amortizing each vehicle based on the kilometres driven during the year relative to the total kilometres of its expected life.

(Many candidates addressed the vehicle issue, and their discussions were generally clear and in sufficient depth.)

Website Capitalization Costs

I agree that you will likely need a website to efficiently run this business with a hands-off approach. I have added a few more uses to the website in my internal control discussion later in this report. From an accounting perspective, some of the costs involved in creating a website would be capitalized while others would be expensed. Section 3064 of the *CICA Handbook-Accounting* — Goodwill and Intangible Assets can be used for guidance. The treatment will likely be as follows; however, we would have to confirm this with a more detailed review of the agreement.

The following items would likely be capitalized:

Software purchase and customization	\$ 4,700
Graphic design	4,500
Content development and database population	5,500
Registration of internet domain name	100
Registration with search engines	<u>200</u>
	\$ 15,000

The following item would likely be expensed:

Training	\$ 5,000
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(Most candidates applied their GAAP knowledge and reached the appropriate conclusion: some of the costs incurred for the website need to be expensed and others need to be capitalized. However, not all candidates were able to provide an adequate discussion to support their conclusions and apply their knowledge to the case facts. Section 3064 is clear on the appropriate accounting treatment for these costs, so the analysis required was not expected to be lengthy.)

For Primary Indicator #1 (Performance Measurement and Reporting), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.0%
Nominal competence — The candidate does not attain the standard of reaching competence.	4.9%
Reaching competence — The candidate recommends suitable accounting policies for some of the accounting issues but their discussion lacks sufficient depth.	42.8%
Competent — The candidate recommends suitable accounting policies for some of the accounting issues and includes an in-depth discussion of revenue recognition.	51.3%
Highly competent — The candidate recommends suitable accounting policies for most of the accounting issues and includes an in-depth discussion of revenue recognition.	1.0%

(Candidates were expected to discuss appropriate accounting policies to apply to the new car-sharing business. To achieve competence, candidates were expected to a) discuss in depth the revenue recognition issue as it related to the various membership plans , and b) recommend suitable accounting policies for some of the other accounting issues (e.g. minor revenue recognition issues; accounting for the vehicles; the website).)

(Candidates performed well on this indicator. Most candidates were able to apply the GAAP criteria to the various items noted in the simulation and recommended appropriate accounting policies for the issues. Strong candidates clearly recognized the variations in the terms of the membership plans and the effect on the related revenue recognition policy they recommended.)

Primary Indicator #2

The candidate suggests ways to automate the manual control processes and discusses the internal control weaknesses that can be eliminated as a result.

The candidate demonstrates competence in Assurance (IT).

Competencies

VI-3.1 Identifies the entity's key operations (B)

VI-3.2 Identifies the role IT plays in an entity's key operational controls (A)

VI-3.3 Evaluates internal control (A)

VI-3.4 Evaluates IT-related elements of internal control (B)

I have reviewed your description of the proposed business processes, and I believe that we could improve upon them. I suggest revamping the proposed manual processes because they currently contain control weaknesses that put the business at risk of lost revenue, additional expenses, fraudulent activity on the part of members, and theft. Below, I have included recommendations on ways to automate controls, and have explained how taking these steps will eliminate the control weaknesses that exist in your proposed manual controls.

Access to Vehicle

The vehicles will have a punch-code lock system that allows entry to the vehicle. The punch code is already an automated feature; however, it is not an effective control unless it is changed frequently, ideally after every rental. If the code never changes, then all previous users will have access to a vehicle at all times, which may result in vehicles not being available to members when promised, as well as lost revenue. It appears that the code can be reset as often as you want, but it is not clear whether it is easy to program a new code. If resetting the code is quick and easy, it should be reset after every rental. If resetting the code frequently is burdensome, you might want to look into the new technology that Peter mentioned that would allow you to better control access to the vehicles.

The keys will be kept inside each vehicle. As the system is currently set up, a thief might be able to get past the punch-code lock system (by breaking the window, for example), find the key inside, and steal the vehicle. Instead of leaving the key inside the vehicle, I recommend that we look into the technology mentioned by Peter. If we are able to connect a computer to the vehicle's engine, then ideally the members would need to enter a personalized code into the computer for the engine to start.

(Most candidates were able to identify the control weaknesses associated with vehicle access. Most candidates also identified the key risks and explained them appropriately. Candidates attempted to suggest solutions for these weaknesses, but in most cases the recommendations were not practical or were not linked with case facts.)

Access to the Parking Garage

Under the proposed system, an access card to open the parking garage door will be kept in the glove box of each vehicle. Most of the members are likely to be tenants and therefore will already have access to the parking garage. For those members who are not tenants, I would recommend modifying the parking system to allow each of them to be provided with their own parking garage access card, rather than keeping the cards in the vehicles. The current setup leaves you open to both theft and fraudulent activity. The recommended change will help prevent theft, since thieves would not be able to get out of the garage without the card (assuming the card is required to exit the garage), and will help prevent unauthorized use of vehicles (each use could likely be traced to a particular access card and a particular individual if we assume the system is sophisticated enough to identify individual cards). The individualized access cards would be recognizable to the parking garage system, so we could identify who is going in and out of the garage. However, you still would not know if they are leaving with a stolen vehicle. The video cameras you have installed will help you monitor the comings and goings of your members.

The individualized access cards will also simplify the process since, under your current proposal, the concierge needs to let non-tenant members into the parking garage each time they want to use a vehicle. With the individualized access cards, non-tenants will be able to enter the parking garage on their own using their card. This will remove the inconvenience for the concierge and the member, and make the process more automated. If it is unreasonable to provide personalized access cards to all non-residents, then perhaps the concierge can maintain and control an inventory of garage access cards for non-tenants. This is not an automated control, but it will be more effective than leaving the cards in the vehicle.

(Candidates recognized and attempted to address the weaknesses associated with access to the parking garage, but struggled to provide relevant, practical solutions incorporating case facts. Many candidates added a long list of additional duties for the concierge or provided inefficient manual procedures. Few candidates were able to discuss automated controls with respect to this issue.)

Tracking Vehicle Usage

Currently, you are proposing that members manually record the kilometres they've driven in a log book inside each vehicle. Instead, I suggest that each vehicle be equipped with a computer that will *a)* recognize each member by a personalized code used to start the engine, and *b)* register the number of kilometres driven by that member. The bookkeeper could take the information from each vehicle's computer to update the kilometre balances and recognize revenue accordingly. The current manual method requires individuals to honestly and accurately populate the log. If a couple of members in a row were to forget to populate the log, there would be no way of knowing how many kilometres each of them drove. Or, the members could collectively agree not to populate the log to avoid being charged. As a result, their kilometre balances would not be up-to-date and they could exceed their allowed plan limits. The automation I've suggested removes these risks.

You do not discuss how you will track gas usage. You have stated that you will require members to return the vehicle with a full tank of gas, but how will you ensure this is done? You could ask the concierge to check the gas gauge when vehicles are returned, but this is just one more thing for the

concierge to do. It will be nearly impossible to automate this type of control. As an incentive for members, and a cost savings for you, when a member returns a vehicle with a full tank of gas, you could consider offering a discount or a bonus; for example, an increase in the kilometres available to the member under their plan — maybe 20 additional kilometres per vehicle returned with a full tank. Of course this would require someone to check to ensure the tank was full which adds an additional manual procedure to the system.

(Candidates recognized that the manual log book had many shortcomings. Most candidates were also able to recognize that automated controls in this area may overcome some of the weaknesses. However, few candidates were able to explain how the automated controls would work in any detail and seldom used case facts to support their analyses.)

Bookings

You propose that bookings will be made through a manual signup sheet kept in the lobby of each building. An easy way to automate the booking system would be to add a section to the website to handle bookings. Each member would have a user name and password so that only he or she could edit his or her booking arrangements. This would also mean that members can book from the comfort of their own apartments or from work, instead of having to go to the lobby of a particular apartment building. The website would populate a database of expected exits and returns of the vehicles to the parking garage. One of the risks this would eliminate is the risk of the signup sheet being altered; for example, under the proposed system, members could remove another person's name and put their own name in to ensure they get a vehicle when they need it. The website bookings would avoid disputes of this nature.

(Candidates were able to recognize that the manual booking system would be an issue for the new venture. Many proposed practical solutions, although many of these solutions were manual. Few candidates integrated the bookings system with the new website.)

Late Returns

The manual system relies on members reporting late returns to management. This may be a difficult part of the process to automate, and it may need to remain manual depending on the level of sophistication of your parking system. If you follow my recommendation to provide all members with their own garage access cards, then it might be possible to track the exact time that vehicles are taken from and returned to the garage. However, even if this is possible, it would be a time-consuming task to cross-reference all the comings and goings of members with the bookings to see if there were any discrepancies. Ideally, the parking garage system would be connected to the same database as the website, and would populate the exits and returns of the members. You could then generate a comparison report that would compare the actual entrances (vehicle returns) to the booking schedule to identify late returns and charge the individuals accordingly. As it is, the manual system may not work properly as there may not be anyone waiting to notice if the individual was late, or the person who witnessed the late return may forget to report it, may not want to "tell" on other members, or may be persuaded by the late member to not report to management. You will likely be unaware of some late returns and therefore not able to charge members for their non-compliance, which will result in lost revenue.

(The weaknesses in the method of monitoring late returns were recognized by many candidates. Candidates attempted to propose solutions in this area, but many of the solutions required cumbersome manual procedures involving the concierge or other additional personnel. While these solutions were not invalid, they tended to be unrealistic from a practical perspective since the costs to initiate these additional procedures would likely have been excessive for an organization of this size.)

For Primary Indicator #2 (Assurance (IT)), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.2%
Nominal competence — The candidate does not attain the standard of reaching competence.	2.9%
Reaching competence — The candidate identifies some of the control weaknesses.	43.4%
Competent — The candidate discusses some of the control weaknesses.	52.5%
Highly competent — The candidate discusses several of the control weaknesses.	1.0%

(Candidates were expected to suggest ways to automate the manual control processes and discuss the internal control weaknesses that would be eliminated as a result. To achieve competence, candidates were expected to discuss some of the control weaknesses they identified. Candidates were not specifically directed to these issues; however, they were part of the proposed operational procedures for the new car-sharing business.)

(Overall, candidates performed satisfactorily on this indicator. Most candidates were able to identify the issues related to the control weaknesses, discuss the relevant risks with reasonable depth, and provide additional insight into the issues by discussing their implications (such as lost revenue) or providing appropriate recommendations or mitigating controls. However, candidates struggled to recommend automated controls, which the Board was ideally looking for candidates to suggest, and often recommended manual controls instead.)

(Strong candidates identified the significant issues, discussed them in the context of the simulation facts, and made appropriate recommendations, generally automating at least one procedure, to alleviate the weaknesses identified.)

Primary Indicator #3

The candidate discusses why it may not be a good idea for Peter and Taylor to go into the car-sharing business.

The candidate demonstrates competence in Pervasive Qualities and Skills.

Competencies (Lists all Pervasive Qualities and Skills for the simulation)*III-1.1 Gathers or develops information and ideas**III-1.2 Develops an understanding of the operating environment**III-1.3 Identifies the needs of internal and external clients and develops a plan to meet those needs**III-2.1 Analyzes information or ideas**III-2.3 Verifies and validates information**III-2.4 Evaluates information and ideas**III-2.5 Integrates ideas and information from various sources**III-2.6 Draws conclusions / forms opinions**III-3.1 Identifies and diagnoses problems and/or issues**III-3.2 Develops solutions**III-3.3 Decides / recommends / provides advice**III-4.1 Seeks and shares information, facts and opinions through written discussion**III-4.2 Documents in written and graphic form**III-4.3 Presents information effectively**III-6 Understands how IT impacts a CA's daily functions and routines*

I know you are both very excited to see this business get off the ground, and while I hope it will be a worthwhile venture for you, I must admit that I have some reservations as to whether it can succeed in Boothville and whether you've considered all that will be involved in this type of venture.

You have based your belief of the success of this business on successes in cities like Vancouver, Toronto, and Montreal. These are the biggest cities in Canada, all of which have populations in the millions and have booming downtown cores where people live and where there is traffic at all times of the day. The car-sharing businesses in these cities operate directly out of the downtown core and have multiple locations all over the downtown areas. It is acceptable for people to take public transportation, and even expected that they will, especially if they work downtown. Many people live in these cities for years without ever owning a vehicle.

In comparison, Boothville is a much smaller city with only 300,000 people. You're planning on operating out of the suburbs, not downtown. It doesn't seem that the eco-friendly movement has hit Boothville to the same extent as in the larger centres. Most people in Boothville own vehicles already because the public transportation available is inefficient. That being said, the market you are targeting may go for something like this service. Over half of your tenants don't have vehicles, and since you are in the suburbs, it must be very difficult for them to get around on the poorly designed public transportation system. They might enjoy the freedom and convenience of driving a vehicle.

You indicate that you haven't done any real market research. Before proceeding, I recommend that you do some formal market research to answer some of the following questions:

- Is the pricing you've chosen based on similar businesses in those big cities?
- Can Boothville support similar prices?
- Are you in the right neighbourhood; in other words, is this the right target market?
- If you have to charge lower rates, is it still worth all the costs incurred to set up the system?

In addition, this new business is outside your area of expertise since it is very different from your current operations. Have you considered the time commitment that will be required? The car-sharing business will likely require more of your time, and involve more administrative time and staff, than your current business. The vehicles will need to be routinely cleaned and serviced. New members will need to be signed up, and this process should involve some sort of background and credit check. And of course, bookings and vehicle usage will need to be constantly managed. You mentioned that you'd like the car-sharing business to be as hands-off as possible, but if you do not want to be involved in all of this, you will have to hire more people to manage the operation. As I mentioned earlier, the most effective controls can only be achieved by installing computerized technology in the vehicles, which will be another added cost. Have you considered what is required to break even once these additional costs are considered? How do you know that the amount you're charging for self-insurance is sufficient? Given the risks involved with this new venture, you may need to obtain additional insurance (theft, damage, liability, etc.), which could end up being a significant cost. I recommend that we sit down and perform a detailed cost and sensitivity analysis of the project to determine how all of these variables might affect the success of the project.

Lastly, have you considered the impact this venture may have on your existing business? You are planning on giving non-residents access to your apartment buildings. This may not only upset existing tenants, but you may actually lose tenants who feel their security is being compromised.

In the end, if you decide to go forward, it would be valuable to try a pilot project in just one of your apartment buildings, instead of trying to operate in all of them at the outset.

For Primary Indicator #3 (Pervasive Qualities and Skills), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	17.6%
Nominal competence — The candidate does not attain the standard of reaching competence.	26.0%
Reaching competence — The candidate questions whether the business model will work.	32.0%
Competent — The candidate discusses reasons why the business model may not work.	23.9%
Highly competent — The candidate discusses reasons why the business model may not work and offers recommendations to the clients on how they should proceed.	0.5%

(Candidates were expected to discuss why it may not be a good idea for Peter and Taylor to go into the car-sharing business as presented in the simulation. To achieve competence, candidates were expected to identify and discuss the reasons why the business model presented by Peter and Taylor might not prove profitable (considering operational, economic, and financial aspects). Candidates had to understand that the preliminary analysis performed by Peter and Taylor was insufficient considering the nature and significance of the car-sharing venture.)

(Candidates performed poorly on this indicator. Many candidates were able to identify the issues such as market research to be completed, no formal budget or cash-flow analysis prepared, etc., but failed to recognize that the overall lack of critical data should lead them to recommend that Peter and Taylor reconsider their decision and not go ahead with their project as currently presented.)

(Strong candidates provided an in-depth analysis of some of the issues and came to a reasonable conclusion from their overall assessment. Weak candidates only identified a few of the issues associated with the incomplete preliminary analysis (the simulation facts) and did not offer any in-depth discussion or recommendation, or they recommended that Peter and Taylor go ahead with the planned business model with some minor modifications.)

There were no secondary indicators in this simulation.

(Overall, the Board was pleased with the quality of the responses on this simulation. Most candidates considered all aspects of the simulation and attempted to address all three significant areas (the indicators) in the scenario. Candidates could have improved their responses by trying to meet their clients' wish to be fully automated and recommending automated rather than manual controls, and by linking the incomplete analysis performed by Peter and Taylor to the unlikely viability of the project in its current form.)

SAMPLE RESPONSE
PAPER II-3 SHARE-A-CAR

The following is a candidate response for Paper II-3. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 3

To: Taylor and Peter Waitman
Re: Proposed car sharing business plan

Overall Issues Identified:

I think you have jumped to quickly to thinking this new business plan will be successful here are some concerns that you should be considering

1) No market research has been completed

- although car programs like this have been a success in places like Vancouver, there has been no research done to know that suburban customers would be interested
- Research should be done with residents of your building through a survey to obtain data such as the amount they drive, the prices they are willing to pay and if they are interested in such a service
- This will give a better base for determining the best membership plans to offer

2) Profitability of Plan A

- given that we have no data as to how much people will drive, allowing for an unlimited plan may result in a negative contribution margin on these contracts as people could potentially drive so much that the \$8,000 doesn't cover the costs such as wear and tear, oil changes, etc that would be associated with so much driving
- this would significantly hurt the profitability of the new venture
- Further \$8,000 a year is very expensive and almost enough for a person to buy a car, so pricing might create little demand for this option

Recommendation:

An unlimited option should not be offered in the first year of operation until GH can assess how much people are driving and if it would be profitable for an unlimited plan to be offered. I will complete a contribution analysis on this once we have the data after the first year.

Accounting Issue Analysis:

1) Revenue recognition

- given the various payment plans, the actual cash will be received under Plan B to D before the car usage actually occurs thus need to assess when revenue can be recognized

Analysis:

- CGAAP requires the following basic criteria to be met before revenue can be recognized
- 1) performance is substantially complete
- 2) collection is reasonably assured
- 3) sale can be reasonably measured

Based on this criterion, the payment will be received upon registration, thus collections won't be an issue and the amount of the sale can be reasonably assured as the payment price is specified upfront for the number of kilometers (km).

- Performance relates to the use of the car, thus, upon registration a customer has not used the car at all, so it is not in line with GAAP to record revenue at this point; thus we need to assess when performance is complete - GAAP allows for two methods
- 1) Completed contract method
- 2) Percentage completion method
- Completed contract is when revenue is recognized at the end of all performance within the contract, thus this would be when the total km have been used up or when the year expires, as there is no longer any obligation once the expiry occurs for GH
- Percentage completion is when revenue is recorded based on a rational and consistent manner of completion of performance - in this case one method would be to base completion on the km used up by each customer of the total km in the plan
- Completed contract may be appropriate if we cannot determine a rational way to recognize revenue, however, in this case the underlying use of the car could be tracked and update monthly thus it would be most appropriate to use percentage of completion.

Conclusion:

For Plans B to D it is most appropriate if revenue is recognized using the percentage of completion method basing completion of the contract on the % of km used by the customer according to the log book (or automated tracking) of the total km specified in the contract. The remaining amount of the payment not completed would be deferred revenue until earned-- in the liabilities section.

Revenue recognition Plan A:

- Plan cannot be recognized in the same way as the Plan B to D as the km are unlimited so there is no total basis for percent complete based on km
- however percentage completion could still be used if we can estimate km in another way
- An alternative to the number of km could be recognizing on a straight line basis over time thus for each month that passes 1/12 of the total \$8,000 will be recognized
- Given that on average people that have the unlimited package will likely drive the same amount because fluctuations with each individual customer will net out to an average this may be appropriate
- However, it could be argued this is not appropriate because certain months such as the winter when people don't want to be outside they may use the car more than in other months

Recommendation:

Given that we do not have any experience as to how reflective the passing of month would be as a basis for using the percentage completion method there is no rational and systematic way to recognize revenue using this method, so I recommend the completed contract method is used for the first year of the business but that usage is tracked so that this basis could be used in future years as a base for estimating the % complete.

Plan E: Km usage

- given that people pay as they use the car there should not be an issue with revenue recognition - as people use the car and pay the revenue can be recorded as it has met the 3 criteria of performance, collectability and measurable as discussed above

2) \$10 fee per month for self insurance

- the fee collected needs to be assessed for its substance as an asset and liability as it is unclear how the self insurance should be accounted for

Analysis:

- given that the cash is being collect for a specific purpose, which is self insurance, this amount would be considered restricted by CGAAP and thus should be classified as a non-current asset because it is not liquid within 1 year of the balance sheet as is the case with most cash balances that are unrestricted
- However it is less clear how the other side of the entry should be recorded as there is no offsetting expense that is being incurred at the time the payment is received
- Since 50% of this fee must be refunded if the member does not make a claim in the 5 years in the program this amount should be recorded as a liability as it meets the definition of a liability
 - 1) there is an obligation that exists or a duty which will reduce resources (cash) – i.e. when the amount must be paid back
 - 2) it is the result of a past transaction - once the cash has been received the fact that the customer has not gotten in an accident would mean that GH has a liability to pay back the amount - thus the obligating event is not getting into an accident
- The remaining 50% should also be recorded as a liability because there is an obligation for GH to cover any insurance claims owing if they occur
 - although this is not a legal obligation, GH would be "self" obligating, but setting up this self-insurance policy for itself, which causes it to meet the definition of a liability
 - it could be argued that there is no liability until an accident occurs and thus the obligation is not met, however, given the fact that the money is being collected with the intention of using it to cover any claims under \$5,000 when they occur they should

Conclusion: The \$10 per month fee should be recorded as restricted cash and a liability based on the discussion above.

Operation Control Weakness Identified:

1) self-regulating log book:

Weakness:

- a self-regulating book will allow customers to manipulate how many km they will actually drive for - although you have said that because the following person has recorded their km and the total will be checked this should ensure the accurate amount is recorded this is not the case
- Given that these cars are in buildings, neighbors may know one another and thus not report each other which would negate the "self regulating" control
- Further, there is the risk that if many people do not accurately record their km driven then it will create a "snowball" effect and none of the km will actually be correct

Implication:

- knowing the usage of the car on both a total and customer basis is key for measuring profitability of the various plans as well as charging customers the correct amounts
- Thus, if this information is inaccurate we will not be able to recognize revenue per customer appropriately, customers may be upset that they are being incorrectly billed and certain contracts may appear more profitable than they actually are

Recommendation:

- I recommend that you automate all the cars so that the trip of each person is tracked. They should have to enter a code that they are provided when they receive their contract registration so that each time they enter the car the computer in the car can track who is using the car and how many km they used such that the information can be uploaded into the accounting system for charging customer accounts.

2) Entry of non-residents into the parking garage

Weakness: This will reduce all controls relating to building safety as the concierge won't know who is not actually a car user and thus should not be allowed in the building. This will give anyone off the street the ability to say they are coming to rent a car and thus get into the building

Implication:

- There were reports of theft and break-ins reported before a new state of the art system was implemented
- Allowing just anyone in will bypass this security system and thus expose GH to the problems of break-ins that were experienced before which will create dissatisfaction for building tenants

Recommendation:

- Each customer should be given an access card which can be electronically activated or de-activated by GH when a customer books a car. This system should record when the customer enters and exits using their access code so that the system tracks when they come and go. This increases accountability and limits access to people so that they can only come into the garages when they have booked a car to limit security breaches and prevent thefts.

3) booking sheet is placed in lobby

Weakness: Self regulating of late returns is not guaranteed to work as people may not report their neighbors in the building

- further it may be annoying to members to have to always be reporting late arrivals as this further inconveniences them
- If there is no one renting the car afterwards the person that has returned the car late there is no way of knowing the car was returned late

Implication:

- Customers will be dissatisfied if their car is not available when they want it because of late returns and thus may not use the service
- Revenue on late return fees will be lost because late returns will go unreported

Recommendation:

The automated system tracking km and time used in the cars should alert GH when a car is being late returned based on the time.

Note the recommendations above are based on the assumption that GH purchases the small computer that is integrated in the car's electronic system and engine which allows tracking information and controls access. Otherwise, these controls would have to be done manually by an attendant at each apartment. Given your expressed interest in technology, Peter, I have assumed you would prefer these recommendations.

THE INSTITUTES OF CHARTERED ACCOUNTANTS OF CANADA



2010 Uniform Evaluation

PAPER III

Time: 4 hours

NOTES TO CANDIDATES:

- (1) *Simulations that require knowledge of the Income Tax Act, the Income Tax Application Rules 1971, and the Income Tax Regulations are based on the laws enacted at March 31, 2010, or in accordance with the provisions proposed at March 31, 2010.*

Provincial statutes, including those related to municipal matters, are not examinable.

- (2) *To help you budget your time during the evaluation, an estimate of the number of minutes required for each simulation is shown at the beginning of the simulation.*
- (3) *Tables of present values, certain capital cost allowance rates, and selected tax information are provided at the end of the evaluation paper as quick reference tools. These tables may be used in answering any simulation on the paper.*
- (4) *Answers or parts of answers to simulations will not be evaluated if they are recorded on anything other than the CICA-provided USB key or the writing paper provided. Rough notes will not be evaluated. You are asked to dispose of them rather than submit them with your response.*

* * * * *

Paper III - SIMULATION 1 (80 minutes)

Central Air Limited (Central) is a regional airline headquartered in Toronto, with service to destinations throughout Ontario and Quebec. It is a small public company that decided to adopt International Financial Reporting Standards (IFRS) two years ago in anticipation of future expansions.

It is now September 15, 2010. Central's Chief Financial Officer (CFO), Patrick Grenier, mentioned to the senior on the audit engagement that he wanted to discuss a potential business opportunity with someone at the firm. The senior contacted one of the partners who specializes in strategic mergers and acquisitions.

Points North Airways (PNA), a regional airline based in Saskatchewan, may be up for sale shortly. Patrick spoke with the Chief Executive Officer (CEO) of PNA, Rodney Pederson, who indicated that Central will need to act quickly if PNA becomes available for sale. Patrick wants assistance in assessing whether the acquisition is a good strategic decision. In addition, he would like to know what investigative procedures could be performed by the firm, on Central's behalf, before the purchase is actually made. Patrick will need to report on these procedures to the audit committee.

You, CA, work in mergers and acquisitions. The partner will handle the broader engagement issues, such as the type of report to be issued. He asks you to prepare the list of investigative procedures for Patrick, providing him with a clear explanation of the purpose of each procedure.

Patrick noted that PNA is a private company that has never been audited. PNA's financial statements are internally generated for the owners, who are the only users. He is somewhat familiar with what accounting policies PNA follows currently, but is more interested in knowing what PNA's accounting policies will be once it is owned by Central and reports under IFRS. He is not interested in a description of the differences between the two companies' policies, nor is he concerned about any implications of IFRS 1.

The partner asks you to draft a separate memo to Patrick responding to the above request. Because you are not part of the audit staff, the partner provides you with the necessary background information on Central (Exhibit I), and notes from Patrick's discussion with Rodney (Exhibit II).

Paper III - SIMULATION 1 (continued)

EXHIBIT I

BACKGROUND INFORMATION ON CENTRAL

Central specializes in short commuter and charter flights within Ontario and Quebec. It focuses on being a low-cost provider and emphasizes its no-frills flights. It has had success with this approach, despite a reputation for poor customer service. However, it operates on a thin margin and has suffered in times of high fuel prices. Central is currently bidding to provide flight service to employees of several mines in northern Ontario and Quebec.

Central has a fleet of 18 small jet-engine aircraft that seat from 30 to 75 people each. Central flies primarily out of major centres and is subject to standard airport security requirements.

Two years ago, Central had a minor incident with landing gear that did not fully deploy. The flight landed safely, but the incident led to a Transportation Safety Board investigation. Central was ultimately cleared, but the media coverage was not positive and resulted in a slight, temporary decline in business.

Most of Central's non-management employees belong to unions, including the Professional Union of Pilots and the Maintenance Engineers Union.

Paper III - SIMULATION 1 (continued)

EXHIBIT II

NOTES FROM DISCUSSION WITH RODNEY

Business Operations

PNA provides commercial and charter service between Regina, Saskatoon, and select northern communities. In the past two years, it has built two new mini terminals on land adjoining the international airports in Regina and Saskatoon, at a cost of over \$2 million each. These mini terminals have been very well received by clients because PNA is not subject to the same security restrictions as airlines going through the international airport terminals. Customers can park for free right at the mini terminals, arrive within 15 minutes of the flight, and board the flight without going through traditional security checks. The time savings have been a significant selling feature and a key success factor. Rodney hopes that the change in ownership will not result in a change in the security requirements.

PNA also regularly services a number of the northern mines. Since many of the mines' employees operate on a one-week in, one-week out schedule, the contracts with the mines have been a steady source of income, reducing the impact of seasonality. The revenue from these flights currently makes up approximately 40% of annual revenue.

PNA was started by CEO Rodney Pederson and two others. Their goal has been "to provide the safest, customer-centred aviation services available anywhere in Canada." PNA has recently won a number of awards locally and nationally, including "Best Saskatchewan Customer Service Company," "Best Saskatchewan Employer," and "Canada's Best Managed Companies."

None of PNA's employees are currently unionized; however, its pilots have recently engaged in discussions with the Canadian Pilots Union, which is known as one of the more aggressive unions in negotiations.

Corporate Structure

The three original owners, who hold 51% of PNA, have been planning an exit strategy. Rodney is the only one of the three still actively involved. He plans to retire once PNA is sold. The remaining 49% of PNA is owned by a group of northern First Nations bands who have been inactive owners for the last eight years. Their investment in PNA was critical in obtaining the contracts for charter service to the northern mines. As part of the mines' agreements with northern First Nations, the mines give priority to those companies that have a connection with First Nations, such as PNA. It is unclear at this point whether the bands will want to sell their investment in PNA or if they would be willing to continue to work with a new owner.

Paper III - SIMULATION 1 (continued)

EXHIBIT II (continued)

NOTES FROM DISCUSSION WITH RODNEY

Assets

PNA operates 22 propeller-driven planes that seat from 8 to 50 people. The larger planes are used primarily for the flights to the mines. A few of the planes are leased, and the lease payments are all expensed. PNA can extend most of the leases for another term at an amount that is substantially less than market rent.

PNA stores its non-fuel inventory and several of its planes in a large hangar, where maintenance of the planes also takes place. The CEO complained that, while the hangar itself is about 20 years old, the large overhead doors, which were last replaced about 10 years ago, had to be replaced recently at a significant cost. This cost was added to the building cost and amortized over the remaining useful life of the hangar of 20 years.

The engines must be overhauled after a set number of flight hours, and the costs are capitalized. For convenience, PNA adds the overhaul costs to the cost of the plane and amortizes them over the plane's estimated remaining service life. On average, PNA has a major inspection of its airplanes done every five years as part of its licensing requirements. PNA amortizes this cost over the life of the airplane based on total flight hours.

The hangar also includes a warehouse that contains items recorded as inventory. Since PNA cannot afford significant downtime for its aircraft, it keeps extras of some of the essential spare items — such as engines, propellers, and tires — on hand at all times.

PNA also owns separate buildings that it leases to rental car agencies. Since these agencies benefit from proximity to the airports, PNA has had a steady stream of supplementary income. The buildings are included at cost in property and equipment in the financial statements and are amortized over 30 years. The fair market value (FMV) of these buildings has increased over the past few years but has now stabilized. The FMV may decline slightly in the near future because the real estate markets in the two cities are expected to correct slightly after a number of years of growth.

One of PNA's fuel storage tanks had a leak a year ago, which was repaired and the land remediated as soon as the leak was identified.

Paper III - SIMULATION 1 (continued)

EXHIBIT II (continued)

NOTES FROM DISCUSSION WITH RODNEY

Other matters

The past two years have proven to be financially challenging. Earnings have been down somewhat because of the poor economy, and fuel prices have been quite variable. One of PNA's biggest customers, a uranium mining company, purchased and paid for 1,000 flight segments for one of its very remote locations; only 200 have been used so far. The company will not be able to use the remaining flight segments at that mine location and has asked if it can transfer the remaining segments to some of its other mines. Rodney is not sure whether he should follow the contract terms and refuse this request on the grounds that flight segment destinations cannot be changed or if he should override the contract and permit the transfer in order to maintain good customer relations. Rodney figures that if he allows the transfer, the use of the segments will then be guaranteed and PNA will recognize the amount in revenue. He told the mining company he would make his decision this week.

There have been rumours that the uranium company may be closing many of its mines because of the high cost of production. Rodney, however, is convinced that the company will remain active in the province for many years to come.

Decreased earnings have put some strain on cash flow management. PNA is in a position, for the first time in a long time, of possibly requiring bank financing to cover small periods of cash shortfall. The bank has indicated that personal guarantees would be required from the owners for any type of financing and that debt covenants would be put in place.

Rodney was reluctant to discuss information not in the financial statements, including management compensation, indicating that it is highly confidential. He said he would wait until discussions have advanced further before deciding to divulge this information to Central.

EVALUATION GUIDE
PAPER III, SIMULATION 1 - CENTRAL AIR
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source for GAAP.

To: Partner
From: CA
Subject: Memo regarding Central Air's requests

You've asked me to draft a memo responding to Central Air's (Central's) requests. First, they want to know if Points North Airways (PNA) is a good strategic acquisition. Attached is my analysis of the risks and opportunities associated with acquiring PNA. Based on my preliminary investigation, the risks are quite significant and should not be ignored. Before making a final decision, Central should proceed with a due diligence, which was in fact Patrick's second request. He has asked which investigative procedures we could perform on the company's behalf before proceeding with the purchase of PNA. As part of the information Patrick requested, I have identified a number of procedures that should be considered as part of the due diligence Central would need to perform prior to the purchase. I have also explained the purpose of the procedures so that the audit committee will understand why they are important. Finally, I have discussed what the accounting issues would be for PNA reporting under IFRS once it joins Central. The fact that its financial statements were never audited results in several suggested adjustments.

Primary Indicator #1

The candidate discusses the strategic decision to purchase Points North Airways through a discussion of the risks and opportunities associated with the purchase.

The candidate demonstrates competence in Governance, Strategy, and Risk Management.

Competencies

IV-2.3 Identifies and evaluates opportunities and risks (A)

The acquisition of PNA would present the following opportunities and risks to Central:

Opportunities

The primary opportunity for Central is the ability to expand into another region of Canada. By purchasing a successful, established company in another area of Canada, it can achieve this goal much more quickly than establishing a satellite operation from scratch.

(Most candidates identified this issue and discussed it appropriately.)

In addition, PNA is a company focused on safety and recognized for its quality management and customer service. Since Central has had issues with its reputation for both safety and customer service, this acquisition would present an opportunity to improve its reputation and enhance its brand. It would also present an opportunity to learn the practices of a successful operation, and to potentially apply these practices throughout its own operations.

(Most candidates identified this opportunity and discussed the fact that PNA's good reputation could benefit Central. Some candidates also discussed the fact that Central's bad reputation could tarnish PNA's reputation after the acquisition, which was also valid.)

PNA has had success in servicing northern mines in Saskatchewan. Central could perhaps leverage this experience to increase its chances of success in its bid to service northern mines in Ontario and Quebec, particularly if the commitment of the First Nations bands can be continued.

(Most candidates identified this opportunity and discussed it appropriately.)

(Overall, candidates were able to identify most of the opportunities and use case facts to support how the points they raised could benefit Central.)

Risks

Business Philosophy

There are some differences in approach between the two companies. For example, Central seeks to be a low-cost, no-frills service provider, while PNA emphasizes customer service. Central will need to determine whether the business model that PNA uses needs to change to fit with its own. Central will need to assess which approach makes the most sense when running the two companies together. If it chooses to focus on low-cost, no-frills service, it may alienate the current PNA customer base. In addition, just as there is the opportunity to enhance Central's brand through the acquisition, there is also the risk that Central's reputation for poor customer service will hurt the PNA brand.

(Some candidates identified the risk related to business philosophy. Most candidates who identified this issue discussed it in enough depth, but others were unclear on the potential consequences of this mismatch between the two companies.)

Operational Difference

The two companies maintain different aircraft. Central uses jet-engine aircraft, while PNA uses propeller-driven planes. This may diminish some of the efficiencies that could be gained between the two companies (for example, they use different parts). Central may therefore not be in a position to benefit from the expertise PNA has in maintenance.

(Few candidates seemed to realize that this could be an issue. However, most candidates who recognized this issue expressed an accurate understanding of the risk involved and discussed the issue in sufficient depth.)

Key Relationships

There is also the risk that those relationships that are critical to PNA's success will not continue in the new entity. For example, the current CEO, Rodney, plans to retire once the sale is completed. There is the risk that he is so critical to PNA's success that his loss may have a significant negative impact on the success of PNA. Central may want to see if Rodney can continue in some role within the company after the sale, even if only in a short-term role to smooth the transition.

(Few candidates discussed this issue. Most explanations of why this could be a risk were sufficient. Strong candidates discussed how this issue could be resolved and proposed potential options to ensure this risk would be mitigated.)

We do not know if the First Nations bands will sell, or if they will continue to work with a new owner. It seems that their involvement is a key component of securing the contracts to service the northern mines. If they are no longer involved, there is a risk that the contracts will either be lost or not be maintained in the long run, leading to the loss of a significant revenue source. Central should seek their continued involvement. The First Nations bands may also be able to assist in securing the contracts to service the northern mines in Ontario and Quebec.

(Most candidates discussed this issue and were able to integrate case facts by addressing the fact that the First Nations investment was critical to obtaining the contracts for the charter service to the northern mines, which accounts for approximately 40% of annual revenue.)

PNA's employees are currently non-unionized whereas Central's are unionized. The fact that PNA's employees are not linked to a union may make the acquisition easier from a human resources perspective. However, the two different work environments may represent a cultural difference between the companies that needs to be addressed. It may also present a challenge in terms of aligning wages between pilots, maintenance engineers, and others within the company, which could result in increased payroll costs.

In addition, it seems that the pilots of PNA are considering becoming unionized, but with a different union than the one Central's pilots belong to. The fact that the unions are different could increase the likelihood that pilots in different parts of the newly combined company will be treated differently, particularly if PNA's union is truly a more aggressive negotiator. Central should question why the employees are considering joining a union if they have always been non-unionized. It may be a sign that the pilots aren't happy, which could create issues for Central in terms of future wage rate negotiations, whether the pilots unionize or not.

(Some candidates identified this issue, and their discussions had sufficient depth. Most candidates discussed it from a financial point of view, addressing the costs related to the potential increase in wages.)

Key Success Factor

Rodney, the CEO of PNA, has indicated that the minimal security in place at the mini terminals has been a key success factor for PNA. Central will need to find out if it can continue this arrangement once the ownership structure changes (in other words, PNA may be subject to normal airport security requirements once they join Central). It might depend on the aviation regulation requirements regarding ownership. Or, Central's strategy and policies may be different and may not support the use of mini terminals. If the security requirements must be changed, this will not only represent a significant additional cost, but may also reduce customer traffic at the mini terminals, since there will no longer be as much time saved by flying with PNA.

The other possibility is for Central to adopt the concept of mini terminals throughout all of its operations since it contributed significantly to PNA's success. In such a case, Central will need to consider the capital investment required to build the mini terminals in Ontario and Quebec, and will need to ensure it meets the aviation regulation requirements for these new operations.

(Most candidates discussed this issue in enough depth to demonstrate their understanding of the risk involved with the mini terminals and security requirements.)

There is the risk that the success Central had in Ontario and Quebec is not transferable to Saskatchewan. It is a different jurisdiction with different laws and regulations that Central will have to become familiar with. There may also be cultural differences between the regions that Central cannot anticipate.

(Most candidates did not recognize this risk.)

Financial Risks

Despite PNA's success in the past, there are some potentially troubling financial developments that should be considered before completing the acquisition:

- Earnings have decreased recently due to the economy and the variability of fuel prices. There is a risk that the purchase is occurring just as this decrease in earnings is becoming a trend. This could diminish the value of the acquisition soon after it occurs. However, this could also result in a better purchase price. The reality of the industry is that there is volatility to contend with, and this needs to be considered when making an offer.
- There is a risk that a significant loss of revenue will result if some of the mines shut down. Since 40% of revenue comes from the mine flights, the company's success is closely tied to the mines. Rodney appears to discount the possibility; however, the fact that one of PNA's largest customers has asked to transfer pre-purchased flights indicates that the situation is likely more than a rumour.
- The possibility of PNA needing bank financing to cover cash-flow shortfalls and of the bank requiring personal guarantees and debt covenants may interfere with the acquisition, particularly if the bank has the right to stop any potential acquisition. It may also limit future capital spending requirements as part of the debt covenant requirements. Just the fact that PNA may need bank financing to get through low periods is a sign that its financial position may be deteriorating.

- The bank said it would want personal guarantees for any new financing to PNA. Central should consider the impact of the owner's leaving and what additional security the bank may request from Central to support any PNA financing.
- There is no information available on PNA management's compensation, which is often at non-market rates for private companies. Thus, we do not know what salaries will be required to retain the services of key staff such as Rodney (if asked to stay) or his replacement.
- An unknown or unrecorded environmental liability may be associated with leakage from fuel storage tanks. It appears that only one tank has leaked so far, over a year ago, and that PNA reacted quickly and appropriately to clean up the leak, but there is a risk of one of the other tanks leaking. This would become the responsibility of Central as the purchaser.
- There are favourable rates on the plane leases, which Central will want to ensure can be continued.
- The possibility of all employees being unionized in the future may result in increased payroll costs.
- The fact that the CEO is considering overriding the clause in the uranium mine's contract could be a concern if the financial situation at the mines is in fact weak. It also raises the question of whether he often overrides contract agreements.
- Since PNA's financial statements have not been audited or reviewed, there is a risk that certain unrecorded liabilities exist that could have a further impact on the financial position of PNA.

(Most candidates discussed at least one of the financial risks and were able to use case facts to support their explanations of the risk.)

For Primary Indicator #1 (Governance, Strategy, and Risk Management), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.4%
Nominal competence — The candidate does not attain the standard of reaching competence.	4.0%
Reaching competence — The candidate discusses some of the strategic risks or opportunities associated with the purchase.	29.7%
Competent — The candidate discusses in sufficient depth several of the strategic risks and opportunities associated with the purchase.	65.3%
Highly competent — The candidate thoroughly discusses most of the strategic risks and opportunities associated with the purchase.	0.6%

(Candidates were directed to this indicator since they were asked to assess whether the acquisition is a good strategic decision. The Board expected candidates to discuss both risks and opportunities to demonstrate competence. The vast majority of candidates discussed the appropriate risks and opportunities in sufficient depth, and most candidates were able to use the case facts to support their assessments of the ones they identified. The coverage of issues was good and most candidates were able to identify both the opportunities and the risks associated with the potential acquisition.)

(Some candidates zeroed in on the issues related to the financial statements of PNA and recognized only the financial risks associated with the potential acquisition, ignoring the other significant risks and opportunities. The non-financial risks and opportunities in this simulation were very important, and candidates were expected to address them to provide a complete analysis.)

Primary Indicator #2

The candidate describes the due diligence procedures that should be performed and explains their importance.

The candidate demonstrates competence in Assurance.

Competencies

VI-2.2 Evaluates the implications of key risks and business issues for the assignments (A)

VI-2.5 Designs appropriate procedures based on the assignment's scope, risk and materiality guidelines (A)

Many of the above risks can be addressed, or at least better understood, by performing a number of specific due diligence procedures on PNA. We are able to offer our services to Central without being in conflict as the mergers and acquisitions group is doing the work, not the auditors. Since PNA is not audited or reviewed, completing investigative procedures is critical. We should ensure that the audit committee has approved the work to be performed before we proceed.

The following is the list of procedures I am suggesting. I have provided an explanation as to why each procedure is important so that the audit committee understands the purpose of each one.

- Contact PNA's legal counsel to inquire about the status and likely outcome of any outstanding lawsuits and legal matters. This may reveal any unrecorded liabilities, perhaps related to the fuel storage tank leakage that occurred a year ago.
- Ask management about the reason for the fuel tank leakage to determine if there is a risk of another leak (of that tank or another tank), and consider engaging an environmental specialist to examine the site to ensure there is no risk of additional leakage.
- Since PNA is not audited, examine the financial statements and discuss them with PNA's accounting staff in an effort to uncover additional information about PNA, including the possibility that the financial statements are not in accordance with GAAP.
- Review the board of directors' and, if applicable, subcommittee minutes. This will reveal items discussed during the year, including any major decisions made by the board.
- Arrange to interview key members of management to better understand such things as how the company operates, the outlook for the future, and key success factors. Obtain any forecasts prepared by PNA that could support management's views.
- Ask about the timing of Rodney Pederson's retirement and assess the potential impact of his leaving on PNA's reputation, revenue generating ability, management of operations, etc.
- Obtain further information about the relationship with the First Nations. Contact the group of First Nations bands to get a sense of their intentions in the event that the purchase proceeds.

- Contact the bank to understand the nature of the covenants that could be imposed and what would be expected of Central in terms of loan guarantees, should they become necessary for PNA to continue to operate (assuming that Central is not in a position or prepared to provide financing).
- Obtain further information about the requirements to run the mini terminals in order to assess whether they can continue to be used once PNA is purchased.
- Examine maintenance records to ensure they have been kept up to date, and have Central's mechanics examine the planes to ensure they are in good operating condition.
- Since PNA has regular inspections performed on its airplanes, obtain copies of those inspection reports from management. This will allow Central to get a better idea of the condition of the planes and whether there are any major issues related to their operation.
- Inspect and assess the value of the buildings owned by PNA to ensure Central is getting the assets it expects as part of the purchase at the value expected.
- Investigate the status of the uranium mines (utilizing publicly available information if available) and discuss with PNA's management to ensure the future viability of this source of revenue in light of the uranium mining company's request to transfer prepaid flights, since loss of this revenue would have a significant negative impact on future earnings. Review the agreement with the uranium mining company to gain an understanding of the flight pass terms and conditions.
- Discuss with management the status of any union discussions, and whether the pilots plan to proceed with unionization, since this may result in increased payroll costs. Consider discussing the situation with some of the pilots directly to get their views on the situation.
- Contact the rental agencies that rent the extra buildings. It is important to establish whether this "steady stream of supplementary income" is at normal levels. Examine the lease agreements they have in place with PNA to validate the value of the leases and determine if there are any other rental buildings in the area to which lessees would have the option of moving.
- For the planes that are leased, review the terms of the lease agreement to understand why PNA is getting favourable lease terms and whether these would continue under new ownership. For the owned planes, have the values appraised.

Central may want to consider performing audit-level procedures on the company's balances if the possibility of errors is suspected based on this initial review.

For Primary Indicator #2 (Assurance), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	12.9%
Reaching competence — The candidate describes some due diligence procedures.	36.5%
Competent — The candidate describes some due diligence procedures and explains their usefulness.	50.0%
Highly competent — The candidate describes several due diligence procedures and explains their usefulness.	0.5%

(To attain the level of Competent, the Board expected candidates to identify and describe specific due diligence procedures that should be performed using case facts to support their analyses. Candidates were further expected to explain the importance of the procedures suggested.)

(Although most candidates identified a sufficient number of procedures to be performed, many candidates did not demonstrate an understanding of the purpose of each procedure. Candidates were specifically asked to provide a clear explanation of the purpose of each procedure. Also, some procedures proposed by candidates were not practical. For example, a number of candidates recommended contacting the uranium company directly to discuss the viability of the mines, when other procedures, such as reviewing publicly available financial information for the uranium company, would have been more suitable in this situation.)

(Although most candidates provided an adequate number of procedures, some candidates had difficulty identifying case-specific procedures that were appropriate in a due diligence context. Although some procedures that would usually be used in a traditional audit could also apply to this due diligence engagement, some other risks that would not usually be part of a regular audit needed to be addressed with a due diligence procedure and should have also been discussed (First Nations ownership, the risk of a future leak, and union discussions are examples of non-standard procedures that should have been addressed in this situation).)

(As well, some candidates provided vague procedures, using the terms “ensure,” “evaluate,” and “determine,” without describing how the procedures should be performed.)

(Many candidates seemed confused by their role and approached this indicator from an audit perspective rather than a due diligence point of view. As a result, generic audit procedures based on assertions were provided without an explanation of why they would be useful in a situation of potential acquisition. Without a purpose for these procedures, it was difficult to determine if they met the needs of the client. For example, procedures relating to the existence of inventory and other assets were suggested; however, without a link to case facts, it was difficult to determine why these procedures would be helpful in this specific situation. Candidates should have provided a link to case facts by explaining that because the purchase price will likely be based on the financial statements, values from the financial statements should be validated.)

(Some candidates addressed the type of report to be issued or discussed an independence issue, despite the fact they were told by the partner that he would take care of the broader engagement issues, such as the type of report to be issued. These discussions were not appropriate in this situation.)

Primary Indicator #3

The candidate discusses the accounting issues that arise when reporting Points North Airways under IFRS.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies*V-2.1 Identifies the appropriate basis of accounting (A)**V-2.2 Develops or evaluates accounting policies in accordance with GAAP (A)*

There are a number of accounting issues associated with PNA's current accounting policies when reporting under IFRS. These issues arise because, up to now, PNA, as a private company, has only ever prepared internal financial statements. We have identified "errors" that have gone undetected or that were perhaps judged to be immaterial in nature by management. Once PNA joins Central, a public company, its financial statements will have to be audited and must meet the high standards required of a listed company.

1. Property and Equipment (IAS 16)**a) Componentization**

IAS 16 requires that significant items of property and equipment be separately identified and amortization rates considered separately for each major component.

[IAS 16, paragraph 43 states *"Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately."*

Paragraph 44 goes on to say *"An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease."*]

Until now, PNA has made conscious decisions to capitalize certain items with other assets of a different life — for example, adding the cost of the hangar doors to the building and amortizing them over 20 years when their actual life appears to be closer to 10 years, and including the engine overhaul costs (which occur after a set number of flight hours) with the cost of the entire plane and amortizing them over the plane's estimated remaining service life. (Note that PNA leases some planes under a lease agreement.) As a result of the decisions made, PNA would not comply with IAS 16.

Since each of these assets has a significant cost and the costs can be broken into significant parts, they should be depreciated separately.

Overhaul costs: The cost of overhauling the engines should not simply be added to the cost of the plane, but rather be capitalized and amortized over the set number of flight hours that relate to the overhaul.

Hangar doors: Amortizing the hangar doors over a reduced number of years increases reported expenses for PNA. The hangar doors should be amortized over 10 years rather than 20 years.

It should also be noted that the engines should be separately amortized, likely based on usage (flight hours) rather than over the plane's remaining life.

Overall, it appears that the breakdown of the plane's components needs to be re-examined. Additional efforts should be made to determine what the significant components are, such as the interior, electrical components, instrumentation panel, propellers, tires, and so on, that should be considered separately and amortized at different rates. The cost of the airframe, once separated from the engine, should be amortized over its remaining useful life. However, there are likely additional components of the airframe with different useful lives that should be further broken down (such as the seats). The cost of refurbishing the interior of the planes could be accounted for separately if it is significant.

Buildings such as the mini terminals and the hangar should be considered in terms of their separate components (for example, the roof, exterior shell, interior improvements, etc.) and separate amortization rates established, as I've recommended above for the hangar doors.

(The vast majority of candidates identified this issue, and most of them discussed it in sufficient depth. However, many candidates did not realize that the key concept of significant costs in relation to total cost was important in distinguishing a component. Instead, they based their decision to componentize on the fact that the useful lives of the components were different and that they therefore needed to be accounted for separately. Strong candidates used the significance of the costs in relation to the total costs, in addition to the different useful lives, to support their conclusion to componentize.)

b) Inspection costs

On average, PNA has a major inspection done on its airplanes every five years as part of its licensing. PNA amortizes this cost over the life of the airplane based on total flight hours. IFRS has a recommended treatment for major inspections, which these appear to be. PNA should recognize the inspection costs in the carrying amount of the airplane, assuming the recognition criteria are met.

[IAS 16, paragraph 14 says “A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.”]

PNA needs to assess the materiality of the inspection costs in determining the accounting treatment. PNA may want to “componentize” the inspection costs, depending on the materiality and the nature of the detailed inspections (for example, is the engine inspection the most critical, material aspect of the inspection?). If so, Central may want to break down inspection costs between the engine versus the airframe, for instance. However, the inspections are every five years, so the timing of the recognition and derecognition is the same whether broken down or not. The cost of the inspection would be amortized over the five-year period it covers.

(Only a few candidates addressed this issue. Among the candidates who did, very few discussed it in enough depth to demonstrate their competence in IFRS. Most candidates did not recognize that the accounting for inspection costs needed to be considered separately from the other costs.)

c) Recognition and de-recognition of assets

PNA has not recorded the transactions related to the replacement of the hangar doors in compliance with IFRS. IAS 16 requires the old asset to be derecognized and the new asset to be capitalized if it meets the recognition criteria for a capital asset. In the case of the hangar doors, PNA added the cost of the replacement to the building cost and amortized it over the remaining life of the hangar (20 years). Under IFRS, PNA would derecognize the old hangar doors and account for the gain or loss of disposal, and then set up an asset for the new hangar doors.

[IAS 16, paragraph 13 states “Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a nonrecurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the de-recognition provisions of this Standard (see paragraphs 67–72).”]

[IAS 16, paragraph 67 further states “The carrying amount of an item of property, plant and equipment shall be de-recognised: (a) on disposal; or (b) when no future economic benefits are expected from its use or disposal.”]

(Very few candidates addressed this issue, and the majority of those who did were not able to demonstrate depth of analysis.)

d) Cost versus revaluation model

Under IFRS, PNA has the option of using the cost or revaluation model. Central and PNA management need to consider whether there is any benefit to applying the revaluation model to assets. There is a significant cost to obtaining the revaluation information needed (appraisals, etc., to justify the fair value of the assets), and the cost of doing so should be weighed against the benefits. Would Central's financial statement users benefit from fair value information? If not, the cost model should be applied.

[IAS 16, paragraph 29 states "*An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.*"]

In addition, PNA needs to consider how its policy choices might affect Central. When preparing the consolidated financial statements, the choice of policy made by PNA will have to be considered since there will be a need to apply uniform accounting policies.

[IAS 8, paragraph 13 states "*An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.*"]

[IAS 27, paragraph 24 states "*Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.*"]

(Most candidates identified the two methods available to account for the assets in the financial statements. However, not all candidates were able to explain the two methods accurately or explain them in enough depth to demonstrate their competence in IFRS. Depth could have been achieved, for example, by explaining the impact on the financial statements of each of the methods and the consequences of choosing one method over the other.)

e) Inventory of major spare parts (IAS 2 and IAS 16)

The warehouse includes the inventory of critical spare parts, such as engines and propellers. IAS 16 says that major spare parts and standby equipment should be capitalized as part of property and equipment, not treated as inventory. Once capitalized to property, plant and equipment, a critical spare part is then amortized at the same rate as the related equipment for which it is a spare part. The impact may be a reclassification from inventory to capital assets, but will also introduce amortization expense, which would not have been the case if the spare parts were treated as inventory. As long as the assets were ready for use, they would be amortized, even when idle. The spare engines would not be amortized, though, because the amortization of engines is based on hours of usage, not years of life.

[IAS 16, paragraph 8 states “Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.”]

(Candidates were unable to demonstrate their understanding of how the accounting for major spare parts would be affected by the adoption of IFRS. Among the few candidates who discussed this issue, many did not understand the change that PNA would have to realize in accounting for the spare parts. Only a few candidates realized that the parts would be amortized as property, plant and equipment. Strong candidates realized that the amortization of the engines would not commence until they were used since the engines are amortized over the number of flight hours.)

2. Investment Property (IAS 40)

PNA owns buildings adjacent to the Saskatoon and Regina airport terminals that it leases to car rental agencies. These buildings are currently included in property, plant and equipment, but would likely be considered investment properties under IAS 40, assuming they are under operating (not finance) leases. Central should first look at the type of leases they are under. Since PNA retains the ownership of the buildings, the leases would likely be classified as operating (see IAS 17).

Under IAS 40, PNA would need to choose to apply either the cost model or the fair value model to these properties. If the cost model is chosen, the fair value, if determinable (which it appears to be since PNA seems to know the values are going up), must still be disclosed in the financial statements. An entity that chooses the cost model shall measure all of its investment properties in accordance with IAS 16’s requirements for that model (paragraph 56).

If the fair value model is chosen, a property is initially measured at fair value, and any subsequent changes in fair value are recognized in the income statement. Since the buildings are currently recorded at cost while the fair market value has been increasing over the past few years, the combined company may wish to record them at their fair value because it is a better reflection of their current worth. However, this would also expose the company to fluctuations in fair values. In particular, given the potential for a market correction in the near future, this could result in a write-down in value after the initial pickup. This volatility may be undesirable, particularly given that this is not a core part of the business.

(Most candidates addressed this issue. However, many of them were confused between the cost versus fair value model and the cost versus revaluation model. A number of candidates incorrectly applied the cost versus revaluation method to the investment properties. For the candidates who identified that the cost versus fair value model applied to the investment properties, many did not discuss the implications for the financial statements of one method over the other. Strong candidates did a good job of explaining the impact on the financial statements and integrated case facts in their analysis, such as the increase in the fair market value of the rental buildings.)

3. Leases (IAS 17) — Operating versus Finance Lease

The leases on some of PNA's aircraft are considered operating leases even though the company has the ability to continue the leases for another term at an amount that is substantially less than market rent. The current classification as operating may change under IFRS. The treatment of those leases should be re-examined. Paragraph 11 of IAS 17 suggests that a lease might be a finance lease where there is an ability to extend the lease at less than market, as appears to be the case based on PNA's description. However, we do not know the other details of the leases. All the terms of the leases should be re-examined to see if they meet the requirements of a finance lease. A reclassification would reduce operating lease expenses while adding capital assets under lease, and a capital lease obligation, to the balance sheet.

[IAS 17, paragraph 8 states "*A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.*"]

[Paragraph 11 says "*Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:*

- a. *if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;*
- b. *gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and*
- c. *the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.*"]

Lessors are required to present the assets subject to operating leases in their statements of financial position according to the nature of the asset. In PNA's case, the rental buildings will be classified as investment properties (paragraph 49). The depreciation policy followed for these buildings should be consistent with PNA's normal depreciation policy for similar assets (paragraph 53). This may be how PNA is currently handling the accounting, so there wouldn't be any change when moving to IFRS.

The income from the operating leases must be recognized in income on a straight-line basis over the lease term (unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished (paragraph 50)).

(Most candidates identified the need to address the accounting issues surrounding the leases. However, many of them were unable to discuss the issue in enough depth to demonstrate their understanding of the appropriate IFRS. When discussing the classification of leases, candidates sometimes missed the last "indicator" under IFRS, which refers to the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent. As a result, it was more difficult for them to integrate case facts to support their discussions.)

4. Revenue (IAS 18)

There may be a revenue recognition issue with the flight passes that were issued to the uranium mining company. Rodney has indicated that he might override the contract clause and allow the flights to be used by another mine. The company has indicated that it cannot use all the flights for that mine location. Therefore, the monies would be forfeited and the revenue would be recognized by PNA. However, if Rodney allows the flights to be transferred, the revenue for the transferred flights should not be recognized. There is no guarantee of the mine's survival based on the information provided, but more importantly, the revenue recognition criteria are not met until PNA delivers the flight service. No revenue should be recognized up until that point.

(Although about half of the candidates addressed this revenue recognition issue, most of them struggled with applying case facts to their analyses. Although candidates were not required to discuss each situation (if Rodney allows the transfer and if he does not), many candidates did not explain the impact of either one. Some candidates concluded that they did not have enough information to make a decision on the treatment, without going further to explain what the treatment would be in each of the situations. Because Rodney had remarked that he would recognize the amount in revenue if he allowed the transfer of the flights, candidates were expected to comment on this statement.)

5. Disclosure (IAS 1)

Disclosure under IFRS is generally significant. For example, key management's compensation must be disclosed under IFRS, but PNA currently considers management compensation to be confidential. Depending on whom the company considers to be "key" management, PNA may have to disclose this information.

(Only a few candidates discussed this issue. Most who did discussed it in light of the fact that Rodney did not want to talk about management compensation, which was a good integration of case facts.)

For Primary Indicator #3 (Performance Measurement and Reporting), the candidate must be ranked in one of the following five categories:	Percent Awarded
Not addressed — The candidate does not address this primary indicator.	0.2%
Nominal competence — The candidate does not attain the standard of reaching competence.	5.2%
Reaching competence — The candidate identifies some of the accounting issues related to reporting under IFRS.	48.0%
Competent — The candidate discusses some of the significant accounting issues related to reporting under IFRS.	46.6%
Highly competent — The candidate discusses several of the significant accounting issues related to reporting under IFRS.	0.0%

(The Board recognized that this was the first year that candidates were required to demonstrate detailed IFRS knowledge on specific accounting issues, and was pleased with the candidates' ability to identify the appropriate IFRS accounting issues.)

(To achieve competence, the Board expected candidates to discuss the PP&E issues in sufficient depth since they were the company's major assets in this case scenario. Candidates did a good job identifying the PP&E issues, but were not always able to demonstrate their competence by discussing these issues in sufficient depth and with technical accuracy. Breadth of coverage of the issues was generally well done. However, some candidates seemed to struggle to apply IFRS knowledge to the specifics of this simulation. Technical knowledge of some sections was lacking, which meant these candidates were unable to provide sufficient depth in their discussions. Candidates also had a difficult time applying theory to particular case facts. For example, some candidates used the criteria in their discussions of the leases, but did not apply any of the case facts to determine whether the criteria were met. Other candidates discussed componentization without applying the theory to the issues (the hangar doors, as an example) provided in the simulation.)

There were no secondary indicators in this simulation.

(Overall, candidates performed well on the Governance indicator, but had a more difficult time with the Assurance (due diligence) indicator and the Performance Measurement and Reporting (IFRS) indicator. Candidates were very good at identifying the risks and opportunities related to the acquisition. However, many candidates were confused about their role related to the due diligence engagement and provided audit procedures rather than due diligence procedures. Some candidates did not seem to understand the difference between a due diligence engagement and an audit. Strong candidates recognized the due diligence context and were able to link their suggested procedures to implications that should be considered by Central's management.)

SAMPLE RESPONSE
PAPER III-1 CENTRAL AIR LIMITED

The following is a candidate response for Paper III-2. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 1

To: Patrick Grenier
Re: Central Acquisition of PNA

Accounting Policies of PNA upon transition to IFRS

1) Recognition and measurement of car rental buildings

- Under IFRS there is a separate classification of assets called investment assets which distinguishes between capital assets used for earning rental income or held for the potential capital appreciation and not used in the regular course of operations or production like traditional capital assets
- Given that these buildings are being leased and used only for the purposes of earning rental income and are not used in any way for production or providing service they would meet the definition of investment property and thus would be classified separately in the balance sheet

Measurement of Investment Property:

- IFRS allows for the choice of use of the revaluation model or cost model for investment property
- if the revaluation model is selected it must be used for all investment property unless an entity is unable to determine the fair value of the property reliably
- Given that there is a choice, PNA would want to assess whether it would be beneficial to adopt the revaluation model which would revalue the building to fair value every time there is a material difference between the carrying value reported and the fair value (i.e. it doesn't necessarily occur at every reporting date)
- Given that the fair value has increased over the past few years it may be beneficial for PNA to increase the value of its assets using the revaluation model option this is particularly a good option because PNA has poor cash management and may be looking to get cash financing so a better balance sheet position would be attractive for the bank
- However, under the revaluation model, gains in value are never recorded in the income statement but are recorded in other comprehensive income (revaluation surplus) and once realized recorded in equity but never go through the income statement
- on the other hand, losses in value must be recognized in income immediately unless there is a revaluation surplus that was previously recorded, in which case the losses offset the revaluation surplus first and then any excess loss is recorded in income for the period
- Given the fact that losses must be recorded in income immediately and I am told that the FMV of the buildings may decline slightly in the near future, this suggest that it may NOT be a good idea to adopt the revaluation model, as the initial gain in FMV that will be recorded will not be recognized as income and the losses will further hurt PNA's income statement

Recommendation:

- I recommend that PNA would use the cost model as the FMV is anticipated to decline for its investment property when IFRS is adopted. I suggest this also because if the buildings are to be used for financing the bank is likely to consider the fair value as collateral even if it is not reported at fair value in the balance sheet.

2) Revenue recognition for 1,000 flight segments at remote location

- Given that Rodney is considering altering the contract with the uranium mining company there are many aspects of this issue that need to be considered

If the contract is not altered:

- If Rodney decides not to allow the uranium company to change the location of the remaining flights and there is reasonable assurance that the company will not use the remaining 800 flights then it appears the three recognition criteria under IFRS will be met - all the risk and rewards of the contract have expired, which would indicate the earnings process (performance) was substantially complete, and assuming there were no collection issues, if Rodney does not give the remaining 800 flights the contract could be recognized as revenue

If Rodney does agree to alter the location:

- if the contract is overridden and the segments can be used by other mines, Rodney is incorrect in thinking that revenue should be recognized because there is a "guarantee" the flights will be used
- if the contract is changed it means that PNA will still retain risk and rewards of performance as their earnings process is not complete because they still owe the uranium company flights
- IFRS does not allow for the use of completed contract thus revenue on the 200 completed flights would be recognized as a percentage of the total segments owing
- Thus PNA would have to estimate the total performance obligation it has in a rational way based on for example total cost, flight hours or km to fly and then estimate the percentage complete as each segment is used in order to apply the percentage to the total revenue contract to recognize revenue
- I would assume that flight hours used would be the most appropriate way to measure the complete of performance as costs such as pilot time and fuel would be correlated with the hours flown

Conclusion:

If Rodney does alter the contract, revenue should be recognized based on flight hours using the percentage completion method of revenue recognition as this is the preferred policy once IFRS is adopted (assuming merger occurs). However, if he does not alter the contract, PNA appears not to have any further performance obligation so the total contract revenue should be recognized.

Risk and Opportunity Assessment of PNA Purchase (strategic analysis)**Risk to be considered:****1) Unionization of PNA work force**

- currently PNA is non unionized but there has been discussion with the Canadian Pilots Union suggesting there may be an attempt to unionize the workforce
- further Central is already unionized by the Professional Union of Pilots and the Maintenance Engineers Union
- This indicates that a change in ownership may increase the pressure to unionize the PNA workforce as there will be increased influence to do so since the parent Central is already unionized

- This is problematic because unions generally increase the cost of labour through wage increases, overtime policies, the costs of contract negotiations etc
 - Also the fact that two different unions may be operating at each entity (PNA versus Central) could cause strife in the workforce
 - Increase wages would cut into the profitability of PNA and may make it a less desirable acquisition
- 2) Significant difference in customer base and flight patterns
- Central is known for operating flights out of large centres in Ontario and Quebec which is its area of expertise
 - PNA however flies out of Regina and Saskatoon which is in line with Central's city centre base strategy BUT the fact that PNA also flies to remote locations such as mines is very different from the strategy that Central has employed
 - 40% of PNA revenue comes from these northern mines, which suggest that if Central acquires PNA it will need to be able to maintain operating these flights as a core competency to keep the profitability of PNA
 - Thus there is a risk that this acquisition is not a good strategic decision because Central does not have expertise in areas that are key to Central's success

Opportunities:

- 1) PNAs strong brand for safe, customer centered aviation services
- PNA has won a number of awards in Saskatchewan for provided good service and being well managed which could be used as a point of leverage upon acquisition
 - Central could maintain the brand of PNA in order to preserve the goodwill associated with PNA's quality service which would give Central a good opportunity to enter a new market (Saskatchewan) to grow revenues without having to first establish itself - especially given the fact it has a poor reputation with customers
- 2) Entry into mini terminal concept and less security restrictions
- PNA has developed mini terminals which have been well received by clients because PNA is not subject to the same security restrictions as airlines in international airports
 - this has been a key success factor (KSF) for PNA
 - There is both risk and opportunity associated with this
 - There is opportunity because it provides an entry point for Central to experiment with managing the smaller airports and use this as a business model for future growth in other provinces which could grow revenues and diversify risk related to meeting safety regulations especially because Central had issues with the Transportation Safety Board already so this could provide from relief from meeting all of these guidelines and lower costs
 - However, this is also a risk because the change in ownership may result in security requirements being heightened because Central generally operates out of larger international centres and has a history of problems with the safety board
 - this would mean that the KSF of the mini terminals of reduced security which increases the convenience (i.e. arriving 15 minutes before the flight) could be lost and thus reduce the profitability of PNA as an acquisition target

Recommendation:

Based on this risk analysis I would advise Central not to purchase PNA as there appears to be serious incongruence in the operational strategies of the two entities. Further, the change in ownership from PNA to Central would negate many of the advantages of PNA such as the mini terminal and a non-unionized workforce.

Investigative Procedures to be completed

1) Fuel storage leak

Risk/Purpose: One of PNA's fuel storage tanks had a leak a year ago; although we have been told the land was remediated as soon as the leak was identified there is potential that the land has been contaminated and thus PNA may have a legal obligation to clean up the land, and assuming the land is land that PNA owns there may be impairment of the value of the land due to potential contaminate - thus to ensure that liabilities are complete the following procedure should be done

Procedure:

- Central should hire a land appraiser and have them come and test the soil at the leak location and surrounding area
- The appraiser should then issue a report to Central providing the results of any contamination and the value of the property based on any contamination found

2) Risk of outstanding obligations to uranium mining company

- There is a risk that PNA will be obligated to fly segments to remote locations if the contract is amended by Rodney, which will obligate Central to continue to provide these flights to the customer, which could be costly and limit Central's ability to make operation decisions not to fly to certain mines going forward until the contract expires, which may not be profitable

Procedure:

Once Rodney has decided on the issue of whether to amend the contract or not, Central should request a copy of the contract from PNA and inspect it for the final terms of service to which it is obligated

- Central should ensure the contract is signed by both parties

3) Risk of losing mini terminal security exemptions

- one of PNA's key success factors is its ability to have lessened security restrictions at the mini terminals
- If Central were to take ownership of PNA it is unclear if this advantage would be lost which would have a negative impact on future expected profitability
- **Thus the following procedure should be performed:**

Procedure:

Obtain the current agreement with the Transport safety board that PNA has and inspect the contract for terms relating to transfer of ownership in order to determine what the outcome would be if ownership change were to occur

If the contract does not specify any clauses relating to transfer of ownership, Central should draft an agreement for the Transport Safety Board and negotiate this being a clause in the acquisition agreement with PNA before the transfer of ownership occurs

4) Valuation of plane fleet

- the fleet of 22 propeller plans will be one of PNA's largest assets on the balance sheet if Central purchases PNA
- thus valuation and existence of these plans is a significant risk that should be tested before the acquisition goes through to ensure the value of the planes Central is paying for is appropriate

Procedure:

Central should hire an aviation appraiser to perform a count of the 22 planes - cutoff procedures will likely need to be implemented as planes will be taking off and landing so need to ensure that planes aren't double counted - this could be done by basing the count on VIN numbers/serial numbers the planes have similar to cars

- The appraiser should inspect the planes for their age, condition (wear and tear) and assign a value based on his experience and the market value for similar planes
- The appraiser should then issue a report to Central citing the total value of the planes which details and valuation amounts for each individual plane

Paper III - SIMULATION 2 (80 minutes)

On April 25, 2010, Don Lowe, CA, died. His widow Jan recently contacted Mike Unick, one of the partners at PPL Chartered Accountants, where you work. Jan is the executor of Don's estate and has asked Mike to assist her in her role as executor. Mike and Don had worked together until he left PPL 20 years ago to start his own partnership, Lowe, Holmes & Henderson LLP (LH&H), with two good friends, James Holmes and Rick Henderson.

Today is May 7, 2010, and Mike asks you to meet with him. He would like you to be responsible for Jan's file and starts to explain what needs to be done. "Let me update you, CA. I met with Jan last week and she asked for our advice on some tax matters, including the tax implications of Don's death and any tax planning opportunities that may exist. I thought that was going to be the extent of our involvement until she called me yesterday.

"Jan received an invoice of \$30,000 for the funeral costs and is somewhat distressed as she is unsure how she is going to pay for this. She also mentioned that Robert, the only CA working at LH&H other than the partners, made an offer to buy Don's partnership interest. Jan has asked me to review the offer (Exhibit I) and provide advice on how to proceed. Here are my notes on my conversations with Jan and LH&H's bookkeeper (Exhibit II)."

Just as you were about to leave Mike's office, he received a call from James Holmes. Here is what he had to say: "The audit of Green Wholesalers Ltd. (Green) is incomplete. The bank, which has provided financing to the company, is waiting for financial statements. The file must be completed and the audit report issued within the next two weeks. I've contacted the bank, but they will grant no further extensions.

"Rick and I are already running behind on our own client work, so we simply cannot complete this engagement, which was one of Don's. We'd really appreciate it if your firm could take this over and issue the audit report. We've already gone ahead and cleared this with Green. I'm happy to send you my notes from my discussion with Rachelle, one of the staff who has worked on this file (Exhibit III), and of course we will give you access to all of Green's audit files." Mike agrees to take over the engagement and hangs up the phone. Mike explains that he will deal with all issues related to the acceptance and terms of the engagement but asks you to let him know what needs to be done before the audit report is signed off.

Shortly thereafter, Mike provides you with all the material he has collected. Mike asks you to sift through everything and to start addressing both Jan's and his requests based on the information gathered so far.

Paper III - SIMULATION 2 (continued)

EXHIBIT I

PURCHASE OFFER DETAILS

Offer received from Robert for purchase of Don's partnership interest in LH&H

Option 1:

- Payment of \$500,000 on acceptance of offer

Option 2:

- Payment of 5% of LH&H's gross revenue each year for five years, plus
- Lump sum payment of \$450,000 at the end of the sixth year

Paper III - SIMULATION 2 (continued)**EXHIBIT II****MIKE'S NOTES FROM DISCUSSIONS WITH JAN AND LH&H'S BOOKKEEPER****Discussion with Jan**

Jan works part-time as a marketing assistant with an annual salary of \$27,000. She has two children, Richard, who is 15, and Marianne, 17. Richard is in grade 10. Marianne starts university next year. As an early graduation gift, her father gave her \$25,000 worth of common shares in several public companies as a start on an investment portfolio. Jan says Don had planned to do the same for Richard when he turns 17 and she would like to make sure this is done. She plans to return to full-time work in five years, but she is concerned about her cash needs until that time. In particular, she wants to finance the kids' post-secondary education, which will cost \$20,000 per year per child. She estimates that her annual living expenses, excluding mortgage payments, are \$42,000.

Jan mentioned that Don had told her she wouldn't have to pay any taxes when he died because he willed all of his assets to her. A list of Don's assets and liabilities, which Jan has prepared, appears below. There seem to be some opportunities for us to help Jan with her cash flows by advising her on the best choices to make in terms of taxation.

	Cost	Fair Market Value
RRSP	\$200,000	\$320,000
Spousal RRSP (contributed by Don in Jan's name)	\$250,000	\$390,000
Non-registered investments		
XC 1,000 common shares	\$80,000	\$12,000
Global Technology 650 common shares	\$54,000	\$ 8,000
Bank account (joint)	\$6,590	\$6,590
Home	\$125,000	\$240,000
Cottage	\$85,000	\$135,000
Antique car	\$30,000	\$45,000
Luxury sedan	\$50,000	\$30,000
Partnership interest in LH&H	\$200,000*	\$500,000

* adjusted cost base as at January 1, 2010

The mortgage on the Lowe's house is \$47,000 and on their cottage is \$60,000 at interest rates of 6% on each. Total monthly mortgage payments equal \$1,000. Jan is planning to dispose of the cars and purchase a compact car for about \$25,000. She doesn't want to sell the house or the cottage, remove any money from the RRSPs, or borrow additional funds.

Paper III - SIMULATION 2 (continued)

EXHIBIT II (continued)

MIKE'S NOTES FROM DISCUSSIONS WITH JAN AND LH&H'S BOOKKEEPER

Discussion with LH&H's part-time bookkeeper

LH&H has operated as a partnership. Don, James, and Rick founded it in 1990 and have been practising for 20 years. Gross fee revenue for last year was \$1.5 million. Because some of the clients were close personal friends of Don, we expect to lose 15% of revenue in the first year following his death. However, Robert is really good at business development, so we expect to grow at 2% a year after the first year.

Paper III - SIMULATION 2 (continued)

EXHIBIT III

NOTES FROM DISCUSSION WITH AUDIT TECHNICIAN

Green has been an audit client of LH&H for about 10 years. It is a private company in which the owner is very involved on a day-to-day basis. Materiality for the current year has been set at \$50,000. Green's year-end is December 31, and the audit for 2009 is essentially complete. The audit report is currently dated April 15, 2010, the same date that the file was reviewed by Don.

Only three issues have been identified as outstanding. The following is information regarding these issues that was obtained by the staff.

1. A legal letter was received indicating that an outstanding lawsuit against Green that arose in 2009 had been settled on April 10, 2010. Green will have to pay \$125,000 plus costs. Following receipt of this letter, the lawsuit was discussed with the owner of Green and he said that they are not going to appeal the judgment. In previous discussions, Don had advised Green's controller that the loss must be recorded and the liability accrued in the 2009 statements. Both Green's controller and owner refused to make the adjustment, because they did not have enough time to adjust the financial statements.
2. The file included a note from Don that Green had requested we not send out accounts payable confirmations to two of the company's major suppliers because of ongoing volume-rebate disputes with these suppliers.
3. Green has set up a receivable of \$500,000 related to inventory destroyed and business interruption losses suffered as a result of a warehouse fire that occurred before year-end. No procedures have been performed on this amount.

EVALUATION GUIDE
PAPER III, SIMULATION 2 – DEATH OF A CA
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source for GAAP.

To: Partner
From: CA
Subject: Implications of Don's death and outstanding issues associated with Green Wholesalers

We have been asked to provide an analysis of the outstanding work that is required to be completed on the Green Wholesalers audit before the audit report is signed off. We have also been asked to review an offer that Jan, Don's widow, received for Don's partnership interest, and have been asked for advice regarding the tax implications of Don's death. My report follows.

Primary Indicator #1

The candidate discusses the issues related to issuing the audit report for Green.

The candidate demonstrates competence in Assurance.

Competencies

VI-2.8 Evaluates the evidence and the results of analysis (A)

VI-2.9 Draws conclusions and drafts a report (A)

Green Wholesalers Ltd. Audit

The Green Wholesalers Ltd. audit needs to be completed as soon as possible. We will have to review the work done to date and resolve the outstanding issues.

Since the bank has set a two-week deadline, the audit will have to be completed before the sale of the partnership interest is completed. Issues that we will have to resolve include

- who will sign the audit report;
- what the date of the audit report should be; and
- how the outstanding accounting issues affect the report.

Reliance on LH&H's Work

In addition to resolving the outstanding issues, we need to make sure we can rely on the work performed by LH&H in all other areas of the audit. It appears that we will have to issue a report under our firm's signature. If we are to sign the report we will need to review the file and the work done to date and satisfy ourselves that it meets generally accepted auditing standards (GAAS). While Don appears to have been a capable CA, the audit risk is high because we are signing off on the audit report and therefore assuming responsibility for the fair presentation of the financial statements. In addition, we are not just relying on LH&H's work for a component of the financial statements but all the

balances, therefore the amounts verified by LH&H are material. Based on these factors, it would appear that we will have to perform a detailed review of LH&H's working papers in order to satisfy ourselves that sufficient and appropriate audit evidence has been obtained. You mentioned that you were taking care of the client acceptance procedures, so I have not discussed reliance on opening balances.

(Most candidates recognized that a review of LH&H's files was necessary. Few candidates addressed this issue from a risk perspective. Responses could have been improved had candidates supported their analysis of this issue with facts specific to the case scenario.)

Date of Audit Report

The current audit report date is April 15, 2010. *CICA Handbook-Assurance*, Section 5404.06 states that "the date of substantial completion of examination should be used as the date of the auditor's report." In this case, there has been an unusual delay, since it is now May 7, 2010. Our review of the working papers does not change the date of substantial completion of the audit. However, if our review of the files or the resolution of outstanding issues makes it necessary to seek new information, the date may change. The key factor is the date the work is substantially complete. If we decide that the work was not substantially complete, we will need to update the file to the date for substantial completion. We will have to perform additional procedures regarding, for example, the search for unrecorded liabilities, a review of the books and records, an inquiry of management regarding commitments and contingencies, etc.

[CAS Guidelines:

According to CAS 700, paragraph 41, "The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements."]

(Note: The references to CAS Guidelines in this report are provided for information only. Candidates were not expected to discuss this case scenario with reference to the Canadian Auditing Standards, although they could have chosen to.)

(Most candidates did not recognize the issue of the audit report date. Those candidates who recognized the issue tended to provide analyses that were brief but adequate to demonstrate an understanding of the issue.)

Outstanding Issues regarding Green Audit

Resolution of the outstanding issues may have an impact on our audit report if they are not adequately resolved.

1. Lawsuit

As highlighted by Don, the correct treatment for the resolution of the lawsuit is to record the loss and accrue the liability in the 2009 financial statements. Both the controller and owner refuse to do so because they claim they do not have sufficient time to adjust the financial statements. However, the bank will be relying on the financial statements, so if the lawsuit liability is not accrued, we will have to qualify our audit report for a departure from GAAP. Per *CICA Handbook-Assurance*, Section 5510.19, “*The auditor should express a qualified opinion when the financial statements contain departures from generally accepted accounting principles with respect to one or more matters unless, in his or her opinion, the departures render the financial statements misleading or virtually useless even when read in conjunction with his report. In the latter case he or she should express an adverse opinion.*” In this case, the issue is an isolated GAAP departure that can easily be explained to the reader of the financial statements. I do not believe this GAAP departure will render the financial statements misleading to the reader, so a qualified opinion seems appropriate.

(The vast majority of candidates recognized and analyzed the issue of the lawsuit, and many candidates discussed the impact it would have on the audit report. Some candidates concentrated their analyses on additional procedures that would need to be performed for the lawsuit. This was not of concern, as the facts surrounding the lawsuit were clear. The issue of concern was the impact on the audit report.)

2. Accounts payable confirmations

The fact that Green had asked LH&H not to send out accounts payable confirmations to two major suppliers will not in itself require us to qualify our audit report. Accounts payable confirmations are not a required audit procedure, but they are a strong source of audit evidence because they are received from a third party. The two balances in question may not even be material, therefore gaining comfort over these two accounts may not be necessary. However, assuming they are material, since they are major suppliers, we will have to gain comfort over the completeness of the accounts payable balance and verify that it is free of material misstatement by performing alternative substantive procedures. For example, we should perform subsequent payments testing to verify that material payments made after year-end were properly recorded (in other words, were included in accounts payable if they related to the 2009 year-end). We could also send out Accounts Payable confirmations for any significant balances other than the two Green mentioned and perform specific procedures for those two accounts; for example, we could look at recent invoices received from those suppliers and determine whether they had been paid by looking at the bank records. We simply need to make sure we can verify that the accounts payable balance is free of material misstatement, and it appears that we can accomplish this through alternate procedures.

Given that Green did not want us to confirm these balances because of ongoing volume rebate disputes with these suppliers, we should investigate the nature of the disputes to determine whether an additional liability needs to be recorded.

[CAS Guidelines:

There are very specific guidelines under CASs with regards to management's refusal to allow the auditor to send a confirmation request. According to CAS 505, paragraphs 8 and 9:

"If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with CAS 260. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with CAS 705."]

(Many candidates struggled to identify appropriate alternative procedures that could be performed with respect to the accounts payable issue (no confirmation sent to suppliers). Some candidates provided audit procedures but were unable to provide support for why these procedures should be applied with reference to specific case facts.)

3. Insurance proceeds from fire

The \$500,000 receivable that Green has set up is material, so we need to verify that this receivable should be recognized in the financial statements and that the amount is accurate. Based on the limited information we have, it is not clear whether these insurance proceeds have been accounted for correctly. We need to determine what the \$500,000 represents. Does this amount relate to proceeds to be received for both the inventory destroyed and the business interruption losses? It is important to understand the breakdown of the amount as it may be appropriate to recognize a receivable for one of these elements but not the other. We should begin by asking Green how the \$500,000 amount was determined. Is this amount based on management's best estimate or has this amount been received from an external party (such as the insurance provider)? If the amount was provided by the insurance company, then a simple confirmation received from the company will likely suffice. If the amount is an estimate, we will need to obtain sufficient, appropriate evidence to evaluate whether the estimate is reasonable. We should begin by reviewing any claims Green has submitted to its insurance company (if available), as well as the insurance policy itself to determine what Green is covered for in the event of a fire.

It might also be necessary to consult police reports to determine the cause of the fire to ensure that Green's insurance policy covers this type of incident. We should also review any documentation available to support the value of the inventory destroyed in the fire. If we are not able to obtain sufficient evidence to support this amount, then the receivable will need to be removed. If the controller refuses to make the adjustment, then we will need to qualify our report because of a departure from GAAP. We should ensure that the use of estimates is included in the representation letter received from management (in accordance with Section 5370.16) and that all the necessary disclosures related to this estimate have been made.

(Although candidates generally recognized the issue of the insurance proceeds and understood it, many candidates did not identify appropriate alternative procedures that could be performed with respect to the receivable for the proceeds. Candidates generally recommended standard audit procedures that could have been applicable to any receivable balance rather than tailoring their procedures to the specifics of the situation.)

For primary indicator #1 (Assurance), the candidate must be ranked in one of the following five categories.	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.6%
Nominal competence — The candidate does not attain the standard of reaching competence.	4.1%
Reaching competence — The candidate discusses some of the issues related to issuing the audit report for Green.	29.2%
Competent — The candidate discusses in depth some of the issues related to issuing the audit report for Green.	64.6%
Highly competent — The candidate discusses in depth several of the issues related to issuing the audit report for Green.	1.5%

(Candidates were asked to comment on what needs to be done before the audit report is signed off. Candidates were expected to discuss the issues related to issuing the report. To achieve competence on this indicator, candidates were expected to provide a discussion of some of the audit issues, including an in-depth discussion of the issues surrounding the lawsuit liability.)

(Candidates performed well on this indicator. Most candidates were able to discuss the significant issues in reasonable depth and provided good audit procedures where applicable.)

Primary Indicator #2

The candidate evaluates the offer received by Jan for the partnership interest and provides advice to Jan based on her cash needs.

The candidate demonstrates competence in Finance.

Competencies

VII-2.1 Monitors cash flow (A)

VII-4.2 Estimates the value of the business (B)

VII-5 Analyzes the purchase, expansion, or sale of a business (B)

Offer for Don's Partnership Interest

To compare the two options, I have calculated the discounted proceeds of each option in Appendix A. I've assumed a discount rate of 6%, the same interest rate as Jan's mortgage, which approximates the risk involved with these proceeds. Based on my calculations, the discounted proceeds of option 2 are \$585,770 compared to the lump sum payment of \$500,000 received under option 1. Therefore, option 2 appears to be the better offer. However, the timing of cash receipts differs between the offers. Option 2 spreads the payments over five years, whereas the entire payment is received up front with option 1. When the timing of receipts is compared to Jan's projected cash outflows, it looks like option 1 might actually be the better option. If Jan goes with option 2, she will run into cash shortfalls in years 3 and 4 when both of her children are at university. Another reason for choosing option 1 is that the proceeds are known. With option 2 there is a potential for the proceeds to vary since they are tied to the gross revenue of the firm. This could result in higher or lower proceeds, depending on the success of the firm. It might depend on how big of a role Don played during the last few years (in other words, whether he was creating most of the business). Therefore, even if we assume that Robert is able to achieve an annual increase of 2%, resulting in discounted proceeds of \$596,085, this will not make up for the shortfall encountered in years 3 and 4.

When deciding which offer to accept, Jan will have to consider the timing of cash receipts and the uncertainty associated with the receipts. If she is willing to accept the additional risk associated with option 2 and believes she will be able to cover the shortfall currently projected for years 3 and 4, then I suggest that she accept this option. It provides the potential for a significant increase in total proceeds. As long as the revenue from the firm does not decline, she will receive at least as much revenue as from option 1. However, if she chooses option 2, Jan may not be able to afford to give Richard \$25,000 in shares as a graduation gift, as she had hoped. This amount is discretionary and, given the projected cash crunch during the next five years, is something she will probably have to postpone until her cash flow improves.

Regardless of what option she chooses, we should warn Jan that she may experience a cash shortfall in the short term. She has already received an invoice for \$30,000 for the funeral, and her only source of funds until the partnership interest is sold will be the proceeds from selling the cars. If Jan is not able to sell the cars immediately or is not able to sell them for as much as she had hoped, then she may have difficulty paying for the funeral without withdrawing funds from her RRSP or borrowing additional funds. Jan should put the cars up for sale immediately and determine whether she has any other funds she could access in the meantime.

One way to improve Jan's cash-flow once she has overcome the temporary shortfall described above would be to start investing in a Registered Education Savings Plan (RESP) for Richard. Since Richard still has two years until he attends university, we should advise Jan to start saving for it as soon as possible by contributing to an RESP. If she starts an RESP to save for Richard's education, a Canada Education Savings Grant (CESG) payment is available at a rate of 20% of the total annual RESP contributions up to \$2,500 per child. The maximum lifetime (up to age 17) grant limit is \$7,200. This will contribute towards her tuition savings for him.

We should also advise Jan to consider going back to work full-time as early as possible because, even if she manages to cover her cash shortfalls, she is still using up the most valuable asset of Don's estate by spending the proceeds from the sale of the partnership.

(Most candidates compared the two options, taking into account the time value of the funds to be received, and attempted to relate the offers to Jan's cash needs. Strong candidates identified the significant components of Jan's cash needs and included them in their cash-flow analyses, while also providing a qualitative discussion of the differences between the two options. Some weak responses did not take into account the time value of money or did not discount Jan's cash-flow needs when comparing them to the options. As well, many weak candidates forgot significant items (such as funeral costs, the kids' tuitions, etc.) when analyzing Jan's cash requirements.)

For primary indicator #2 (Finance), the candidate must be ranked in one of the following five categories.	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.0%
Nominal competence — The candidate does not attain the standard of reaching competence.	10.8%
Reaching competence — The candidate attempts a calculation comparing the offers by assessing both alternatives against Jan's cash requirements.	30.9%
Competent — The candidate prepares a reasonable calculation comparing the offers by assessing both alternatives against Jan's cash requirements and recommends an alternative.	57.8%
Highly competent — The candidate prepares a comprehensive calculation comparing the offers by assessing both alternatives against Jan's cash requirements and provides sound advice to Jan.	0.5%

(Candidates were expected to evaluate the offer received by Jan for the partnership interest and provide advice on which option was most suitable for her based on her cash needs. To achieve competence, candidates were expected to prepare a reasonable calculation comparing the options, assess them against Jan's cash requirements, and recommend an option.)

(Candidates performed well on this indicator. Most candidates compared the two options, taking into account the time value of the funds to be received, and made an attempt to compare the options to Jan's cash needs.)

(Strong candidates identified the significant components of Jan's cash needs and included them in their cash flow analyses. They also provided qualitative discussions of the two options, thereby demonstrating a clear understanding of the case scenario and the significant issues facing Jan.)

Primary Indicator #3

The candidate discusses the tax implications of Don's death and the sale of the partnership interest.

The candidate demonstrates competence in Taxation.

Competencies*IX-1.1 Understands the entity's tax profile (A)**IX-1.2 Identifies and advises on compliance and filing requirements (A)**IX-2.2 Calculates other income taxes payable for an individual (B)***Tax Issues**

There are several tax issues that will have to be dealt with. For now I will identify the issues and provide a preliminary discussion of them.

First of all, it is important to note that a Terminal Return will have to be filed that will include Don's income in 2010 up to the date of his death. The assets that go into Don's estate will then make up what is called a "Testamentary Trust,"² which will require tax filings until the estate is wound up. Another return, called a "rights and things" return, may be available and is discussed below.

Deemed Disposition

When a person dies, they are deemed to have disposed of all of their assets at the time of death. The tax consequences of the deemed disposition will vary depending on the asset and other factors. In this case the assets were transferred to Don's spouse, so the tax consequences may be minimal. When property is transferred to a spouse, the application of paragraph 70(6) of the Income Tax Act (ITA)³ generally means that the property is transferred at the transferor's tax cost, with no taxation at the time of transfer. This will be the case for the non-registered investments, home, cottage, and cars. There is no tax implication related to the joint bank account. The practice and investments will be treated the same as any other assets owned by Don. They can be transferred to his spouse at their adjusted cost base with no tax consequences.

As noted above, the taxation of the gains on the capital property transferred to Jan can be deferred. However, Jan can choose to elect out of the transfer of Don's assets to her at their adjusted cost base. It is important to do some planning so that the maximum advantage can be made of the deferral while maximizing the adjusted cost base to Jan of the assets she inherits.

The following is a list of the assets (other than real estate) transferred from Don to Jan and their respective gain or loss:

² The definition of "Testamentary Trust" at paragraph 108(1) of the ITA includes an estate that arose as a consequence of the death of an individual.

³ In this section of the solution, references to subsection, paragraphs, and subparagraphs are references to subsection, paragraphs, and subparagraphs of the ITA.

	Cost	Fair Market Value	Gain (Loss)
Non-registered investments			
XC 1,000 common shares	\$80,000	\$12,000	(68,000)
Global Technology 650 common shares	\$54,000	\$ 8,000	(46,000)
Subtotal			(114,000)
Antique car	\$30,000	\$45,000	15,000
Luxury sedan	\$50,000	\$30,000	nil ^A
Partnership interest	200,000	500,000 ^B	300,000 ^C
Total			201,000

^A Loss on personal use property (PUP) is deemed to be nil — see discussion below.

^B Based on estimated proceeds from the offer of approximately \$500,000 in total.

^C A capital gains reserve may be available — see discussion below.

If an individual dies, Subsection 111(2) modifies Paragraph 111(1)(b) and Subsection 111(1.1) for purposes of calculating the individual's taxable income for the year of death and the immediately preceding year. Under these modified rules, all unused net capital losses arising in years up to and including the year of death may be used to the extent needed to fully offset any net taxable portion of capital gains for the last two years. After this use (if any) of the individual's net capital losses against the net taxable portion of capital gains for the last two years, any portion of the net capital loss that is still unused must first be reduced by the full amount of all Section 110.6 capital gains deductions claimed by the individual for any taxation year. Any remaining amount can then be deducted in full against any other income for the last two years.

(Most candidates were able to determine that particular rules applied upon death, namely that the deceased was deemed to have disposed of all of his assets; however, they struggled to provide the appropriate rule (spousal rollover rules).)

There are \$114,000 of losses on the assets (excluding PUP), as noted above. A special election can be filed with Don's return so that the losses on those assets are triggered in 2010 and can be deducted against any other income for the last two years. We do not know what Don's income was in the current or prior year, but it is safe to assume that his income from the partnership was probably fairly high and that he would have sufficient income to offset these losses. The other alternative would be for Jan to elect to trigger the gain on the partnership interest to offset the capital losses. It is an all-or-nothing designation; that is, the partnership interest is either deemed disposed of at its ACB or its FMV at date of death. In choosing whether to trigger the gain on the partnership interest, Jan needs to determine the tax cost of triggering the full gain now versus leaving it to be taxed in the estate. If the gain is triggered now, there will be a net gain overall (\$186,000). If, on the other hand, Don has sufficient income in the past two years to offset the losses, and the partnership gain is not triggered, Jan would receive a cash payment for the loss-carryback. This would certainly help Jan, since she is experiencing a cash crunch. In addition, as discussed later in this report with regards to the sale of the partnership, if she chooses option 2 of Robert's proposal, Jan would be able to use the reserve available. As well, Jan may be able to lower the overall taxes further because that reserve may be taxed in the estate at the low marginal tax rates by electing to retain that income to be taxed in the testamentary trust that results from Don's death. Therefore, I recommend that Jan allow the partnership to be transferred at Don's ACB.

If Jan wanted to create a gain from the sale of assets, she could elect to dispose of other capital assets with gains instead of the partnership interest. However, using the partnership interest makes the most sense because that is the first asset that Jan plans to sell that has an inherent gain. If she chose to elect on the house or the cottage, the amount of the increase in ACB for those assets would not be as valuable to her because she intends to keep those assets for as long as possible.

(Many candidates recognized that Jan could elect out of the spousal rollover rules and trigger some capital gains and losses; however, candidates struggled to determine what to do with these gains and losses: namely, apply the losses either against other sources of income for the current year and prior years or against capital gains to increase the tax basis of the properties transferred to Jan.)

Principal Residence Exemption

Jan has the option to designate the home or cottage as Don's principal residence to the date of death in order to increase the ACB of the property for Jan. Since both are currently valued above their original cost, we would have to examine the amount of time that they were owned and ask Jan when she thinks they might be sold in order to determine the most advantageous designation. On the surface, it appears as though the house would be a better choice because the gain on it is higher than on the cottage. Any gain designated for the principal residence exemption will result in an increased ACB to Jan for purposes of any future disposition of that residence.

Sale of the Partnership Interest

It is difficult to determine what the fair market value of the partnership interest is before it is actually disposed of. We can estimate it based on the offer received, but from a practical point of view this should be completed before the final tax return is due and we can use the actual proceeds as the FMV at the date of death.

The sale will be considered to be a sale of a partnership interest, which is a capital asset. The excess of the proceeds over the ACB will be taxed as a capital gain. The ACB of the partnership interest will be equal to:

- the ACB as at January 1, 2010
- plus the income allocated to the date of death
- less any draws Don made from the practice to that date
- plus any gain elected as described above that was triggered to use up the accrued capital losses on property owned at his death.

A capital gains reserve may be claimed for proceeds received after the year-end. The maximum time period for the reserve is five years, even though proceeds are received over six years. Therefore, Jan will be taxed before the final payment is received at the end of year 6. A reserve can only be taken if there are deferred proceeds, so the \$500,000 all-cash offer would not qualify for a reserve and would be taxable all at once. The lifetime capital gains exemption is not available on the disposition of a partnership interest.

(Most candidates identified appropriate tax implications for the computation of the capital gain upon the disposal of the interest in the partnership (adjustments to ACB and possible reserve under option 2); however, many provided information that applied to shares of a corporation and not to units of a partnership (in other words, use of the lifetime capital gains deduction against gains on shares of a QSBC).)

A final return should also be filed for Don for 2010 (to date of death). This will include income earned from all sources up to the date of death. It is due June 15, 2011, although any taxes owing are still owed on April 30, 2011. We will need professional practice statements at date of death to report this income on Don's 2010 tax return.

We could also file an optional return for income from Don's practice for the period from January 1 to the date of death, the so-called rights and things return. This will reduce the tax payable, since additional credits are available on this return (essentially the personal tax credit and access to the lower marginal tax rates on both returns). The rights and things return could also include dividends that have been declared but not paid at date of death.

Income from date of death to sale will be reported as income on Jan's return or a trust return.

We will have to look at the complete tax picture for Don and Jan before we make any final decision on many of these matters.

Registered Retirement Savings Plans

Jan was named as the beneficiary of Don's RRSP. Therefore, a tax-free transfer can be made to her RRSP. The spousal RRSP is Jan's and there are no consequences from Don's death.

Income Attribution

Another tax issue that will need to be addressed is the application of the income attribution rules to the gift of shares Don made to Marianne in 2009. Marianne was only 17 and therefore the attribution rules would apply. Don would have been deemed to have disposed of the shares at market value and a capital gain or loss on shares will have to be reported on his 2009 tax return. Any dividends received in 2009 and up to the time Marianne turns 18 will have to be attributed back to Don and reported on the appropriate return as well, up to the date Don died. If Marianne sells the shares, the gain or loss will be hers because capital gains do not attribute back from children to their parents. The gift to Richard will be from Jan. The same attribution rules will apply to Richard until he turns 18 (in other words, investment income (interest, dividends, etc.) from property gifted by Jan will attribute back to her).

(A fair number of candidates discussed the attribution rules. Most provided relevant tax discussions of the income attribution rules as they applied to the simulation facts (income attributes back to the parent until the child reaches the age of 18; however, capital gains are not attributed back to the parent).)

Filings

When a person dies, tax returns must be filed and optional tax returns may be filed. Don died on April 25, 2010. A return will have to be filed for Don (and for Jan) for 2009. We will need to see if this has been done. If Don's 2009 return has not been filed, the deadline of June 15 is extended to six months after the date of death (October 25, 2010). Jan's return is still due June 15, 2010.

(Most candidates discussed the deadline for filing the deceased's returns; however, most candidates did not recognize the fact that Don earned professional income and that as such his basic filing date was June 15 and not April 30.)

For primary indicator #3 (Taxation), the candidate must be ranked in one of the following five categories.	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	7.5%
Reaching competence — The candidate identifies some of the tax implications of Don's death and the sale of the partnership interest.	44.9%
Competent — The candidate discusses some of the tax implications of Don's death and the sale of the partnership interest.	46.3%
Highly competent — The candidate discusses several of the tax implications of Don's death and the sale of the partnership interest.	1.2%

(To achieve competence, candidates were expected to discuss some of the tax implications of Don's death (i.e., deemed disposal rules, various tax returns to be filed) and the sale of the partnership interest by Jan. Candidates were directed to this indicator, since they were asked to advise Jan on the tax implications of her husband's death and any tax planning opportunities.)

(Most candidates were able to identify that particular rules apply upon death — namely, that the deceased was deemed to have disposed of all of his assets — however, they struggled to provide the appropriate rule (spousal rollover rules). In general, candidates were able to identify the appropriate taxation issues but appeared to lack the technical knowledge to apply the taxation rules to Jan's situation. As a result, many candidates' analyses were superficial and of limited usefulness to the client.)

(Strong candidates identified various tax planning opportunities for Jan, both as a result of her husband's death and subsequently (such as spousal rollover, use of capital losses at death or afterwards, RESP, tuition credits), and also considered the tax implications as they applied to the two options of the offer for the interest in the partnership (computing the capital gain and taking into account the available reserve). Weak candidates struggled with the deemed disposal rules at death and did not mention any tax implications for the disposal of the partnership interest.)

Competencies (lists all Pervasive Qualities and Skills for the simulation)

III-1.1 Gathers or develops information and ideas

III-1.2 Develops an understanding of the operating environment

III-1.3 Identifies the needs of internal and external clients and develops a plan to meet those needs

III-2.1 Analyzes information or ideas

III-2.2 Performs computations

III-2.3 Verifies and validates information

III-2.4 Evaluates information and ideas

III-2.5 Integrates ideas and information from various sources

III-2.6 Draws conclusions / forms opinions

III-3.1 Identifies and diagnoses problems and/or issues

III-3.2 Develops solutions

III-3.3 Decides / recommends / provides advice

III-4.1 Seeks and shares information, facts and opinions through written discussion

III-4.2 Documents in written and graphic form

III-4.3 Presents information effectively

There were no secondary indicators in this simulation.

(Overall, the Board was pleased with the quality of the responses on this simulation. Most candidates considered all aspects of the simulation and provided valuable comments for all three indicators.)

Death of a CA - Appendix A

EVALUATION OF OFFERS

	0	1	2	3	4	5	6
Option 1 - Upfront payment	\$ 500,000						
Option 2 - Discounted CF (rate of 6%)	\$ 585,770	60,142	56,737	53,526	50,496	47,638	317,232
Plus: potential increase in revenues (2% annually)			1,135	2,162	3,091	4,678	3,827
Discounted CF (includes projected increase in rev)	\$ 600,763	60,142	57,872	55,688	53,587	51,565	321,910

JAN'S CASH FLOW

Salary (return to FT work in 5 years)		27,000	27,000	27,000	27,000	54,000	54,000
Income Tax on Salary - 40%		(10,800)	(10,800)	(10,800)	(10,800)	(21,600)	(21,600)
Antique & Luxury sedan (\$45,000 + \$30,000)	75,000						
Mortgage Payments (\$1,000/month)		(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)
Living Expenses		(42,000)	(42,000)	(42,000)	(42,000)	(42,000)	(42,000)
Tuition - Marianne		(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
Tuition - Richard							
Compact car	(25,000)						
Funeral costs	(30,000)						
Graduation Gift - Richard			(25,000)				

Net cashflow before sale of practice

	20,000	(57,800)	(82,800)	(77,800)	(77,800)	(41,600)	(41,600)
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SALE OF PRACTICE

Option 1

Lump sum payment
Income Tax on Capital Gain - 40%

	500,000 (60,000)						
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Net cashflow for option 1

	460,000	(57,800)	(82,800)	(77,800)	(77,800)	(41,600)	(41,600)
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Cumulative net cash flow - Option 1

	460,000	402,200	319,400	241,600	163,800	122,200	80,600
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Interest on Cumulative net cash flow @ 4%

		18,400	16,088	12,776	9,664	6,552	4,888
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Income Tax on Interest @ 40%

		(7,360)	(6,435)	(5,110)	(3,866)	(2,621)	(1,955)
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Cumulative net cash flow - Option 1

	460,000	413,240	329,053	249,266	169,598	126,131	83,533
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Option 2

Gross Revenues

1,500,000

Clients lost (15%)

225,000

Estimate of Gross Revenues

1,275,000

Annual payments based on revenue (5% payout)

		63,750	63,750	63,750	63,750	63,750	450,000
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Lump sum

					(11,000)	(12,750)	(90,000)
--	--	--	--	--	----------	----------	----------

Income Tax on Capital Gain - 40%

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Net cash outflow for option 2

	20,000	5,950	(19,050)	(14,050)	(14,050)	22,150	408,400
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Cumulative net cash flow - Option 2

	20,000	25,950	6,900	(7,150)	(21,200)	950	409,350
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Potential increase in revenues (of 2% annually)

			25,500	51,510	78,040	105,101	132,703
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Jan's portion (5%)

			1,275	2,576	3,902	5,255	6,635
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Income Tax on Capital Gain - 40%

					(1,551)	(1,051)	(1,327)
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Cumulative net cash flow - Option 2 (includes projected increase in rev)

	20,000	25,950	8,175	(4,575)	(18,848)	5,154	414,658
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SAMPLE RESPONSE
PAPER III-2 DEATH OF A CA

The following is a candidate response for Paper III-2. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 2

To: Jan Lowe

Re: Tax planning for Don's Death and Assessment of Robert's Partnership interest purchase offer

Assessment of Offer Alternatives

See exhibit 1 which shows that the second offer presented by Robert will result in a greater value of \$593,000 versus the \$500,000 offer.

Tax Issues to Consider

General tax planning opportunities you should be aware of upon Don's death are as follows:

- filing of three returns - the ITA specifies that upon death three tax returns should be filed including a Rights and Things return which includes accrued income which may not have been realized in cash, a testamentary return and the final taxpayer's return - these returns are due at the later of April 30, 2010 or 6 months after the taxpayer's death
- Since Don died on April 25 you will have 6 months, until October 25th, to file these returns
- The advantage of these returns is that you can claim tax credits on the three returns which allows for overall reduction in the tax liability above what Don would normally be able to claim

Other tax planning issues to consider related to the specific assets you have presented:

- You have said that you plan on not removing any money from the RRSPs - this is a good tax planning strategy as RRSPs are taxable when withdrawn and you would not get that contribution room back once the funds were withdrawn
- Sales of the cars
 - even though the one car is an antique - cars are not on the listed personal property list (LPP) in the ITA which means that it is considered Personal use Property (PUP)
 - PUP as adverse tax treatment on disposal as capital gains are taxable but the capital losses are denied
 - this asymmetric tax treatment results in antique car gain of = \$15,000 (\$45k - \$30k) which is taxable at the 50% inclusion rate = \$7,500 taxable capital gain
 - the luxury car disposal would result in a loss of \$20,000 (assuming no CCA was taken as this is not allowed personally) but because it is LPP will not be allowed to be used to offset the gain on the car
- House and cottage
 - given that you have decided not to sell the cottage and home this will be a tax free transfer from Don to you as you are spouses and the spousal rollover will apply, which means that you will inherit the properties at the ACB (cost) of \$125,000 and \$85,000 respectively and no tax liability is owing until you decide to dispose of the properties

- As long as the cottage meets the ITA requirement of frequent enough use to be considered a primary residence the rules would allow you to designate them as a principal resident for the years you own them which reduces the accrued capital gain that is taxable for each year the residence is designated as the principal residence
- Partnership sale
 - the Partnership would be inherited by you at the ACB of \$200,000, however, given that the ACB of a partnership is based on the profits it will be need to be adjusted for the January 1 date to the date of sale
 - There will be a gain resulting on the sale in the amount of \$500,000 less \$200,000 resulting in a \$300,000 capital gain at 50% inclusion - \$150,000 at 29% = \$43,500 approximately in taxes assuming that you are at the highest tax rate

Given that you are working part time your income is much lower than your husband's was, so your tax bracket will be only 15% assuming your salary of \$27,000 = \$150,000 gain at 15% = \$22,500 in federal tax

- this shows it is better for you to take the spousal rollover on death so that the sale of the partnership is in your income instead of your husband's because his tax rate would result in almost double the tax liability

Conclusion:

See exhibit 2. Based on your current plan you will be able to meet your living needs assuming that you take the second offer on the sale of the partnership.

To: Mike Unick
Re: Green Wholesalers Audit Planning

The following issues need to be addressed before the audit report can be signed off on:

1) Reliance on another auditor - since our firm has not performed the whole audit we will need to establish that we have relied on another auditor's work over the section we did not complete. Reliance on the other auditor is not cited in the audit report as long as the requirements under GAAP are met. We will need to:

- Review the working papers of the other auditor to see that GAAS has been followed appropriately

2) Legal letter adjustment

- given that a legal letter was received on April 10, 2010 this is a subsequent event which is before the date of the audit report of April 15, 2010 (thus it qualifies as a subsequent event under GAAP)
- Since the settlement is more information on an event that existed at the balance sheet date it was correct that Don advised Green this needs to be adjusted for in the F/S
- Since the amount of the liability is \$125,000 and materiality was set at \$50,000 this error cannot go unadjusted by management or it will result in a reservation in our opinion
- We will need to confront the controller about this again and inform him we cannot give an unqualified opinion if this is not corrected

3) There exists risk over the completeness of liabilities since the accounts payable confirmations for the two major suppliers to Green were not sent out

- Although management claimed this was because of volume rebate disputes under GAAS this is not a justifiable reason not to send out confirms
- A/P confirms are not required by GAAP. However, A/R confirms are, so if another viable procedure can give us comfort over the completeness of this assertion we will be meeting the requirement of due care in our audit report
- However, given that Green refused to send these out it would heighten my professional skepticism and I recommend we do send out confirms because other ways of testing completeness, such as a search of payments after year end, may not give us the evidence we need to get comfort over the liability balance - for example there may be no payments from year end to the date of field work so we would not know there was a completeness issue
- If Green's management refuses to let us send out confirmations, this will also result in a qualification due to a scope limitation in the audit report because it is a completeness issue and thus the materiality threshold of \$50,000 is not relevant as we don't know by how much the balance is incomplete, thus we must assume it is over materiality and qualify the audit report

Exhibit 1

Purpose: To assess which offer is more beneficial for you from Robert and will give you greater value

Offer 1

NPV = \$500k

Note: NPV is the same as the current value of the offer since the payment will be received on acceptance of the offer there is no discounting necessary because there is no time value of money being lost

Offer 2	2010	2011	2012	2013	2014	2015	
Gross Revenues Projected	1275000	1300500	1326510	1353040	1380101		Note 1
5% of Gross Revenues	63750	65025	66325.5	67652.01	69005.05		
Lump Sum Payment						450,000	Jan would receive this lump sum payment at the end of 6 years
Total Cash Received	63750	65025	66325.5	67652.01	69005.05	450000	
Discount Factor	<u>0.94</u>	<u>0.89</u>	<u>0.84</u>	<u>0.79</u>	<u>0.75</u>	<u>0.7</u>	Based on 6% interest rate
Discount Cash flows	59925	57872.25	55713.42	53445.09	51753.79	315000	
Net present value of offer 2						593709.5	

Conclusion:

Based on the net present value of both options, option 2 is actually more valuable by \$93k however this will require you to factor the timing of payments into your budget.

Note 1

Gross revenues are based on \$1.5M current revenues reduced by 15% in 2010 assuming that "we expect to lose 15% of revenue in the first year following his death" referred to the first year end after Don's death which will be December 31, 2010

This amount is then increased by 2% for each year from 2011 until 2014 to account for the projected growth in the remaining 4 years you would receive 5% of gross revenue from Robert

Exhibit 2:

Purpose: To provide a budget you should follow in order to meet your future needs

Budget	2010	2011	2012	2013	2014
<i>Cash Inflows</i>					
RRSPs	0	0			
Bank	6590	0			
Home	0	0			
Cottage	0	0			
Antique car	43875	0			
Luxury Car	30,000	0	0	0	0
Cash from Partnership	63,750	65025	66325.5	67652.01	69005.05
Marketing Salary	<u>27,000</u>	<u>27000</u>	<u>27000</u>	<u>27000</u>	<u>27000</u>
Total Inflows	171,215	92,025	93,326	94,652	96,005
<i>Cash Needs</i>					
\$25k for Richard	12500	12500	0	0	0
Annual Living costs	42,000	42,000	42000	42000	42000
Kids Education	20,000	20,000	40,000	40,000	40,000
Tax liability on Partnership	22500	0	0	0	0
Mortgage on House	2820	2820	2820	2820	2820
Mortgage on Cottage	3600	3600	3600	3600	3600
Total Outflows	<u>103420</u>	<u>80920</u>	<u>88420</u>	<u>88420</u>	<u>88420</u>
Net Cash	67795	11105	4905.5	6232.01	7585.05

Conclusion:

Based on the above budget Jan will have enough cash in her budget if she follows her plan of not selling the house and cottage

Assume not sold per your request
 Assume not sold per your request
 Assume the car is sold for \$45k FV less tax on capital gain of \$7.5k
 (see tax discussion) at 15% tax (assuming lowest tax bracket) since your salary
 Assume sold at \$30k, a loss of \$20k results but loss denied
 0 Assume a 0.5 See exhibit 1
 69005.05
 27000 Assume you continue to work part time for next five years
 96,005

0 Assume save half of desired \$25k investment each year until son is 17
 42000 Given as requirement for each year
 40,000 Assume 20k required per child for 2 children in 2 years time
 0 See tax discussion
 2820 6% of total mortgage of \$47k
 3600 6% of total 60k mortgage
 88420
 7585.05

Paper III - SIMULATION 3 (80 minutes)

Dry Quick (DQ) is a medium-sized, private manufacturing company located near Timmins, Ontario. DQ has a June 30 year-end. The Chief Financial Officer (CFO) believed DQ had outgrown its audit firm and asked your firm, Poivre & Sel (P&S), to perform the annual audit.

It is now August 2, 2010. P&S performed the necessary client acceptance procedures and is currently working on the year-end audit of DQ. However, the senior on the engagement has recently become ill and will be unable to complete the file. You, CA, have been asked to take over the senior role on the audit. The following information has been provided to help you familiarize yourself with the client: information on DQ (Exhibit I), a draft income statement prepared by management in accordance with Canadian Generally Accepted Accounting Principles (GAAP) (Exhibit II), notes from your firm's meetings with management and the Board Chair (Exhibit III), and excerpts from the current year audit file (Exhibit IV).

The following week, the audit partner on the file calls you into his office, "Now that you've had the audit file for a week, can you let me know what issues you've identified and what is left to be done, including a list of outstanding audit procedures. In addition, the Board Chair is curious to see what our management letter is likely to contain, so please prepare a first draft for me."

Paper III - SIMULATION 3 (continued)

EXHIBIT I

INFORMATION ON DRY QUICK

DQ manufactures portable heating and drying units. The units include heat exchangers that heat and circulate dry air, making them useful on construction sites. The technology was invented by Yuda Mann, the current Chief Executive Officer (CEO). DQ holds a number of patents and is protective of its proprietary technology. Seed capital was provided from the sale of shares to Yuda's friends, family members, and employees, as well as through bank financing.

As the company grew, Yuda recognized the need for a CFO, particularly since he is more involved with research and development and manufacturing operations. Since it was difficult to recruit someone to come to Timmins, Yuda decided to recruit someone with the right skill set, regardless of location. Two years ago, DQ hired Randy Wall, a CA located in Toronto. Randy works out of Toronto and spends about one week per month in Timmins. The bookkeeper, Melanie Beech, works in Timmins but reports to Randy. Despite the fact that Randy was hired as the CFO, he really enjoys sales and marketing. Randy has been instrumental in DQ's rapid sales growth because he is willing to travel extensively throughout North America to meet potential customers. With Randy involved in sales, Yuda says he thinks of himself as more of a Chief Operating Officer (COO) than a CEO. Yuda says that he completely trusts Randy, and defers most decisions other than those related to manufacturing to him.

A venture capital firm, VC Ventures (VC), obtained a 20% interest in DQ about three years ago. Yuda owns 40% of the outstanding common shares of the company, while Randy holds 15%. The remaining shares are held by Yuda's friends, family members, and DQ employees. Two directors of VC sit on DQ's Board, along with Yuda, Randy, and one other member of DQ's management. The Board also functions as the audit committee.

VC and DQ's management have been actively pursuing a buyer for the company. In the past year, DQ engaged in negotiations with one company; however, the deal was not completed and is no longer being pursued. A second potential buyer has now been identified and has started some preliminary due diligence. The current year's earnings are expected to be a key part of the determination of the purchase price.

Paper III - SIMULATION 3 (continued)**EXHIBIT II****DRAFT INCOME STATEMENT PREPARED BY MANAGEMENT**

DRY QUICK
INCOME STATEMENT
For the year ended June 30, 2010
(unaudited)

Sales	\$ 16,973,450
Cost of sales	<u>7,012,495</u>
Gross profit	9,960,955
Administrative expenses	6,123,560
Selling and marketing expenses	487,988
Interest on long-term debt	624,333
Amortization of fixed assets	369,421
Amortization of intangibles	<u>48,709</u>
Earnings before income taxes	2,306,944
Income taxes	<u>647,065</u>
Net earnings	<u><u>\$ 1,659,879</u></u>

Paper III - SIMULATION 3 (continued)

EXHIBIT III

NOTES FROM MEETINGS WITH MANAGEMENT AND BOARD CHAIR

Bookkeeper: Melanie Beech – Melanie has been cooperative, but since Randy has asked that all requests go through him first, she has needed to check with him before giving us information. With Randy often on the road, this correspondence is typically by email which can be slow when Randy does not reply promptly. At one point, Melanie provided us with a schedule supporting the sales commission expense accrual of \$150,000 prior to Randy's review, which showed a commission rate of 5%. This was higher than the rate accrued in the general ledger of 3%, which was supported by a schedule prepared by Randy. Melanie didn't know which percentage was correct because she can't seem to find a written agreement with the salespeople. In addition, the final version of the financial statements, and much of the supporting documentation, is on Randy's hard drive and not accessible to Melanie.

Board Chair: Nathan Cole of VC – The Board has not met regularly as a group for most of the past year because Randy has been unavailable. Nathan has also not received the monthly reports promised to him by management. Nathan finds Randy difficult to contact and has given up trying to obtain information from him. Nathan has asked the audit partner to update him weekly on the audit status. He thinks it will be easier than trying to get an explanation from Randy.

CEO: Yuda Mann – Yuda is proud of the products DQ produces and the business he has built up; however, he prefers dealing with product development and is grateful that, except for manufacturing, Randy has taken over almost everything, including sales. DQ is not only selling more products, but its gross margin which was around 50% has increased. With these results, Yuda is happy to continue to focus on the products and to let Randy deal with everything else.

CFO: Randy Wall – Randy has indicated that he has achieved increased sales due in part to the new Early Order Program, which provides a 15% discount to buyers committing to purchases in advance. Any purchase orders that were placed by June 15 and accompanied by a 10% deposit were eligible for the program, with delivery of the units to occur within four months. The program was highly successful, resulting in total sales of \$1.5 million being recognized related to these bill and hold arrangements.

In addition, DQ sends demonstration units to customers (demos) which they have the option to return within six months if they are not satisfied with performance. Demos with a total sales value of \$400,000 were delivered to customers fairly evenly throughout the year. Based on his estimate of returns over the past two years, Randy has recognized 80% of the items as sales.

Randy was not happy to hear that the Board Chair was contacting us directly. He has asked that we deal directly with him and save the reporting to the Board for the final audit meeting.

Paper III - SIMULATION 3 (continued)

EXHIBIT IV

EXCERPTS FROM THE CURRENT YEAR AUDIT FILE

Preliminary audit work included the following:

Board minutes –No Board minutes were available for review because the Board met only once during the year, and no secretary was appointed to take the minutes.

Accounts receivable confirmations – Sample size was calculated based on a preliminary materiality of \$80,000, which represents 5% of net earnings. A number of confirmations received were initially returned with discrepancies. One customer indicated that a total of four of the units confirmed, worth approximately \$25,000 each, were demos and would be returned. For other outstanding confirmations, Randy followed up with those customers, and the confirmations were received by him shortly thereafter. He also dealt with confirmation discrepancies related to the Early Order Program, as customers seemed unsure whether or not to include these purchases in the amounts confirmed. Accounts receivable includes approximately \$1,350,000 related to the Early Order Program.

Inventory count – A junior audit team member attended the inventory count in Timmins on June 30, 2010. A few discrepancies were noted. In some instances, the junior noted that there were more items on the floor than were reported on the inventory listing. This finding may be due to the Early Order Program because those units remain on site with the rest of the inventory. During the count, the staff noted some returned demos that were included as part of the new inventory. Randy recorded the returned units at the same value as new units.

Inventory overhead testing – We still need to test the overhead allocated to inventory. Per Randy, other than some of the specific percentages noted below, he generally allocates 60% of administrative costs to inventory because most of DQ's operations are ultimately about production. Some items in overhead include:

- 100% of the depreciation related to manufacturing
- 60% of the depreciation related to the head office building
- 60% of the advertising costs
- partial allocation of several employees' salaries, including 75% of each of the following salaries: CEO, CFO, and administrative staff

Journal entry review – We asked Randy for a listing of the general ledger journal entries. He has provided us with a sample of journal entries that he has selected from the first half of the fiscal year. No work has been performed to date on them.

Paper III - SIMULATION 3 (continued)

EXHIBIT IV (continued)

EXCERPTS FROM THE CURRENT YEAR AUDIT FILE

Merger & acquisition costs – DQ has capitalized \$350,000 of costs related to legal and other expenses for the first offer to purchase. While the first offer is no longer active, much of the work done on the first offer can be leveraged for future offers. Most of the costs incurred related to preparing the company for purchase, thus greatly improving its marketability.

Subsequent disbursements – The disbursements subsequent to year-end that were selected for testing include commissions to a salesperson of approximately \$37,500 (related to \$750,000 in sales during the last quarter of the 2010 fiscal year) and \$26,420 for one of Randy's expense reports. The expense report had not been approved by anyone other than Randy. It appeared to be for expenses incurred subsequent to year-end, and therefore was appropriately not accrued.

EVALUATION GUIDE
PAPER III, SIMULATION 3 – DRY QUICK
PRIMARY INDICATORS OF COMPETENCE

The reader is reminded that the solutions are developed for the UFE candidate, therefore all of the complexities of a real life situation may not be fully reflected in the following solution. The UFE Report is not an authoritative source for GAAP.

To: Partner
 From: CA
 Subject: Memo regarding accounting, audit, and other issues related to Dry Quick (DQ)

Attached is my memo summarizing the accounting, audit, and other issues related to our ongoing audit of DQ. Given the number and nature of the issues, their potential impact on the financial statements, and the difficulty associated with resolving them via email, we should inform Nathan Cole, the Board Chair, and Randy Wall, the CFO, of the status as soon as possible.

Primary Indicator #1

The candidate discusses the accounting issues arising from the audit.

The candidate demonstrates competence in Performance Measurement and Reporting.

Competencies

V-2.3 – Accounts for the entity's routine transactions (A)

V-2.6 – Prepares or evaluates financial statement note disclosure (A)

The following are accounting issues that we noted from the information we reviewed.

Early Order Program

The Early Order Program is a new program whereby deposits of 10% are received prior to year-end for deliveries that would occur within four months. The total sales recognized prior to year-end under this program were \$1.5 million. Generally, revenue recognition criteria would suggest that this revenue should not be recognized because delivery of the products has not occurred, indicating that the risks and rewards of ownership have likely not transferred. However, the CFO believes that these should be recognized as bill and hold sales.

EIC-141 sets out seven criteria that must be met before bill and hold sales can be recognized as revenue. While these sales meet some of the criteria, a few criteria are problematic for DQ:

- The criteria require that the buyer, not the seller, must request that the transaction be on a bill and hold basis, and must have a substantial business purpose for doing so. This program was an offer made by DQ to its customers to increase sales, and the incentive for the buyers seems to be to obtain the discount, which is not a substantial business purpose.

- There must be a fixed schedule for delivery. It is unclear whether this criterion has been met, but it is unlikely since the program simply says delivery would occur within four months.
- The ordered goods must have been segregated from the seller's inventory. This does not appear to be the case based on our inventory count observation that some count overages were due to the Early Order Program.

Based on our audit confirmations, even the customers seem to be unclear as to whether a sale has occurred. As a result of the above deficiencies, the sales do not qualify as bill and hold sales and revenue has been overstated by \$1.5 million.

We will also need to understand how the related inventory and cost of sales were accounted for to ensure the entries are appropriately reversed. Based on inventory count observations, it appears that the bill and hold inventory items were not included in the original inventory count listing, but since the sales should be reversed, these items must now be returned to inventory. The 10% deposits that were received should be recorded as deferred revenue.

ASPE

If the company chooses to early adopt ASPE, we would look to *CICA Handbook — Accounting (Part II)* Section 3400.05 for further guidance. The *Handbook* indicates that in a transaction involving the sale of goods, performance is regarded as having been achieved when the following conditions have been fulfilled (provided that at the time of performance, collection is reasonably assured):

(a) the seller of the goods has transferred to the buyer the significant risks and rewards of ownership, in that all significant acts have been completed and the seller retains no continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership.

Therefore, we need to determine whether the risks and rewards of ownership have transferred to the buyer. Additional guidance is provided in Paragraph 14, which states: *“Assessing when the risks and rewards of ownership are transferred to the buyer with sufficient certainty requires an examination of the circumstances of the transaction. In most cases revenue is recognized on passing of possession of the goods.”* In this case, delivery of the goods has not occurred. In addition, DQ still maintains control of the goods, since they are still in its possession. As a result, it appears that the risks and rewards have not been transferred to the buyer.

(b) reasonable assurance exists regarding the measurement of the consideration that will be derived from the sale of goods, and the extent to which goods may be returned.

In this case, the amount of the consideration is known because the contract has established the sales price.

It is questionable whether collection of these amounts is reasonably assured because the accounts receivable confirmations had some discrepancies relating to the Early Order Program (customers were unsure whether to include these purchases in the amounts confirmed).

Since the criteria for recognition of revenue have not been satisfied, the revenue from these transactions cannot be recorded.

(Most candidates were able to provide an adequate discussion of the Early Order Program (EOP), supporting their technical knowledge with some application of simulation facts throughout their analysis. Candidates generally concluded appropriately on the recommended treatment for EOP sales and used the appropriate criteria to support their analyses.)

(Candidates unfamiliar with the EIC attempted to address the issue using basic revenue recognition criteria or early adoption of ASPE. While this was possible, most of those candidates were not as thorough in their analysis because they did not apply the relevant case facts in their discussions or did not appropriately contemplate all criteria.)

Demo Units

Demo sales also appear to be overstated. The CFO indicated that 80% of the \$400,000 of demo sales, or \$320,000, has been recognized as revenue. It could be argued that the company's history of returns supports recording this amount of revenue. However, EIC-141 indicates that when the seller delivers a product to a customer for trial or evaluation purposes that is subject to customer acceptance, even if only by the passage of time (in this case six months), the revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse. Therefore, revenue can only be recognized for those demo units that have been outstanding for more than six months as of year-end, unless earlier acceptance of the product has occurred. Revenue is, therefore, likely overstated for at least a portion of the demo units, particularly given the confirmation response disputing a portion of accounts receivable as relating to demo units. Further investigation will be required to determine the appropriate amount to record. However, given that the demo units were delivered to customers throughout the year, it is probably reasonable to recognize approximately half of the demo sales, since those delivered in the first half of the year would have been outstanding for more than six months.

(Most candidates who were aware of EIC-141 and its applicability to the demo units performed well on this issue because they were able to apply the case facts appropriately in their discussions. Other candidates focused their discussions on the adequacy of the 20% return provision and whether that percentage was appropriate. Many of those candidates did not recognize the acceptance provision in their discussions and the impact it might have on revenue recognition. As a result, their analyses were often insufficient in depth.)

Any demo units that are on customer premises but have not been outstanding for at least six months should be recorded as inventory and disclosed as consignment inventory. DQ will need to ensure that these demo units, as well as those that have already been returned by customers, are properly valued. Section 3031 of the *CICA Handbook — Accounting (Part V)* requires inventory to be measured at the lower of cost and net realizable value. The demo units have been used, so their value has probably decreased. The issue with regards to these units is whether their net realizable value (NRV) is lower than their cost and, therefore, whether a writedown is necessary.

(Many candidates recognized that the returned demo units may not be in the same condition as the new units that are for sale, questioned their valuation, and considered whether a writedown was necessary. Their level of discussion on this issue was appropriate, and they incorporated simulation facts into their analyses as required.)

ASPE

Again, the company has the option of early adopting ASPE. Similar *Handbook* guidance (in Part II) as used above (Section 3400) would apply to the demo units. In addition to collection being reasonably assured at the time of performance, there would be a requirement that the risks and rewards have transferred and that there be reasonable assurance regarding the measurement of the consideration. In this case, the last condition is an issue. Because the demo units are in the possession of the buyer, the risks and rewards have likely transferred to them. However, the last condition will be harder to meet because it requires reasonable assurance regarding the extent to which goods may be returned.

The buyers are allowed to return the demo units within six months of purchase; therefore, there is a significant risk that the units will be returned. The CFO has recognized 80% of the sales based on his estimate of returns over the past two years; however, we do not know how he came up with this estimate. According to HB 3400.21, “revenue would not be recognized when an enterprise is subject to significant and unpredictable amounts of goods being returned...” Therefore, for DQ to recognize any of the revenue related to these transactions, it must be able to accurately predict the amount of returns. Otherwise, the entire amount should be deferred until units have been accepted.

(Very few candidates applied the ASPE criteria to the demo units issue.)

Overhead Allocation

Section 3031 of the *CICA Handbook — Accounting (Part V)* addresses costs that can be included in inventory. In general, the costs should relate to “bringing the inventories to their present location and condition.” It is appropriate to include depreciation of the manufacturing facilities in inventory overhead because these facilities are most likely used for the production of goods for sale to customers. It is unlikely that the depreciation related to the administration building and the administrative salaries could be allocated to inventory, unless it can be established that these costs were related to bringing inventory to its present state and condition. Randy indicated that he generally allocates 60% of administrative costs to inventory. These costs are also unlikely to be able to be included as inventory overhead, unless it can be established that they are linked to bringing inventories to their present state. However, it may be possible to allocate some of the other salaries to inventory overhead to the extent that it can be argued the work performed by those staff relates to inventories. For example, given that the CEO’s role is actually related more to production and operations, it may be appropriate to have 75% of his time allocated to inventory overhead. It may be more difficult to argue the same for the CFO, given his high involvement in sales and accounting. Selling costs, such as advertising, cannot be included in inventory overhead. As a result of these adjustments, inventory is likely overstated and cost of sales understated. We will need to investigate further to determine the appropriate amount to record.

(Most candidates recognized inventory overhead as an issue for discussion; however, their analyses were often superficial. Their comments were generally phrased as conclusions, identifying what should be excluded from the overhead without providing reasons for the exclusions. Had candidates taken more time to understand the nature of costs included in the overhead allocation, they may have been able to provide more support for exclusions or to provide reasons for inclusions (such as the CEO's salary).)

Merger and Acquisition Costs

DQ has capitalized \$350,000 of costs related to the first offer to purchase DQ by an outside party. In order for these to be capitalized, they must meet both the definition of an asset and the recognition criteria. According to *CICA Handbook — Accounting (Part V)*, Section 1000.30, assets have three characteristics:

- a) *They embody a future benefit:* DQ believes that these costs do embody a future benefit because most of them were incurred to prepare the company to be sold. DQ is still hoping to be purchased, and another potential buyer is currently performing due diligence work. Therefore, it can be argued that the costs incurred have improved DQ's marketability and have improved its odds of being purchased.
- b) *The entity can control access to the benefit:* While DQ does not have ultimate control over whether it receives another purchase offer, it has already started negotiations with another buyer, so it seems probable that it will eventually be purchased and stands to benefit from these costs.
- c) *The transaction or event giving rise to the entity's right to, or control of, the benefit has already occurred:* DQ has already incurred these costs, and they will not need to be incurred again for future purchase offers.

Paragraph 44 of the same section outlines the recognition criteria:

- a) *The item has an appropriate basis of measurement and a reasonable estimate can be made of the amount involved:* The costs have already been incurred, therefore the amounts are known.
- b) *For items involving obtaining or giving up future economic benefits, it is probable that such benefits will be obtained or given up:* This issue is debatable. DQ will only receive a future benefit from these amounts if the second purchase offer or an eventual purchase offer is successful. Therefore, we will have to perform additional work to determine just how probable it is that DQ will obtain a future benefit from these costs. It may be that part or all of the \$350,000 originally deferred would need to be expensed.

(Many candidates performed poorly on this issue. Often, they misinterpreted the simulation facts, thinking that Dry Quick was the acquirer and, as a result, concluded that the costs should be expensed since the deal had been unsuccessful. Many of the candidates who did discuss whether the costs could be considered an asset provided brief, superficial analyses with little application of case facts to the few asset characteristics they identified. Some candidates discussed this issue from an intangible asset perspective without considering whether these costs first represented an asset.)

Commissions Expense Accrual

Subsequent to year-end, a commissions expense of \$37,500 was paid related to \$750,000 of sales in the last quarter of the year. Because the commissions were paid after year-end, this amount should be accrued at year-end. The payment reflects a rate of 5%, but the general ledger only includes commissions at a rate of 3%. The year-end accrual should reflect the actual rate paid. To the extent that any of the sales relate to the revenue recognition issues outlined above, the commissions should also be adjusted accordingly.

(Many candidates did not integrate the subsequent disbursement finding to the commission accrual and, as a result, were unable to provide sufficient discussion on this issue. Those candidates who did integrate the simulation facts appropriately questioned the rate used for the year-end accrual of commissions.)

For Primary Indicator #1 (Performance Measurement and Reporting), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	9.6%
Reaching competence — The candidate identifies some of the accounting issues arising from the audit.	49.5%
Competent — The candidate discusses some of the accounting issues arising from the audit in sufficient depth.	40.5%
Highly competent — The candidate discusses several of the accounting issues arising from the audit in sufficient depth.	0.3%

(Candidates were asked to discuss the accounting issues arising from the audit. To achieve competence, candidates were expected to discuss, in sufficient depth, some of these issues. Candidates were not directed to this indicator, since the partner asked that CA let him know what issues CA identified, and provided several exhibits that contained information on these issues.)

(Candidates performed below expectations on this indicator. Most candidates were able to discuss, with some depth, a single issue related to revenue recognition (EOP or demo units) and one other issue. Most attempted to use technical knowledge in their discussions, and most made reasonable conclusions based on the results of their discussions. However, many candidates failed to support their analyses with relevant case facts, instead discussing the Handbook requirement in general terms. Therefore, their discussions were often superficial.)

(Strong candidates provided greater depth of discussion on the revenue recognition issues (by applying the applicable EICs correctly in their discussions) through a well-suited application of case facts to the GAAP criteria, and they provided clear conclusions. Most of those candidates addressed additional accounting issues in their discussions, thereby achieving breadth as well as depth of discussion, further demonstrating their knowledge of accounting. In general, the depth of discussion demonstrated by the better candidates was stronger, both from a technical as well as an application perspective, and they covered more issues. Weak candidates identified issues, but did not address any of them in depth. Many weak responses restated GAAP, did not apply case facts, and provided very little analysis, as well as an inadequate conclusion or no conclusion at all.)

(As noted throughout the solution, candidates had the choice of answering this simulation using either Canadian GAAP (Part V) or ASPE (Part II) of the CICA Handbook. Most candidates chose to apply Canadian GAAP.)

Primary Indicator #2

The candidate discusses the outstanding audit issues and suggests additional audit procedures.

The candidate demonstrates competence in Assurance.

Competencies

VI-1 – Analyzes, evaluates and advises on assurance needs (A)

VI-2.5 – Designs appropriate procedures based on the assignment's scope, risk and materiality guidelines (A)

VI-2.7 – Documents the results of procedures performed (A)

VI-2.8 – Evaluates the evidence and the results of analysis (A)

There are a number of audit issues outstanding that will require further investigation.

Accounts Receivable Confirmations

We should re-evaluate whether our sample size was sufficient given the impact of the errors noted on materiality. We will likely need to send additional confirmations or perform other procedures. In addition, we will need to follow up with the confirmations showing discrepancies by performing additional work, such as having DQ provide us with a reconciliation of any differences with supporting documentation. Reconciling items should be vouched to original records, such as sales invoices and shipping documents. In addition, we could perform subsequent receipts testing by examining payments received from customers (from bank deposit slips and remittance advices) and tracing those back to sales invoices outstanding at year-end.

(While many candidates recognized that additional audit work would have to be done to follow up on confirmation discrepancies, few candidates contemplated the impact of the errors on the initial sample size. Many candidates were able to explain why additional work should be performed and specified what that additional work entailed.)

It would be inappropriate for Randy to follow up and obtain the confirmations. As auditors, we should maintain control of the confirmation process to ensure there has been no tampering with information or results. Therefore, we need to reconfirm or perform alternate procedures (such as subsequent receipts testing and direct contact with customers to determine the accuracy of the original confirmation) for those balances on which we received the confirmation from Randy rather than directly from the customer, since the reliability of these confirmations has been compromised.

(Some candidates stated that Randy should not have intervened with the confirmations, but did not explain why Randy's actions were problematic. Many candidates who addressed this issue recommended specific audit procedures to deal with his intervention in the confirmation process.)

Early Order Program

We should obtain a listing of all Early Order Program sales at year-end and verify, by examining adjusting journal entries, that they have been reversed from sales, accounts receivable, and cost of sales, and then reinstated to inventory. We should also examine the Early Order Program agreement between customers and the company to ensure that the terms are as Randy has indicated.

(Some candidates recommended audit work that should be done in this area and were able to explain why this work was necessary. Most of these candidates demonstrated good integration with their accounting analysis.)

Demo Sales

We should confirm the demo inventory held off-site at customers' locations and compare it to all demo sales recorded. We should also trace these units to shipping records to determine the shipping date. Those that were shipped more than six months prior to year-end and have remained at customer premises can be recorded in sales. Those that were shipped less than six months prior to year-end and have not been formally accepted by the customer should be removed from sales, accounts receivable, and cost of sales, and then reinstated to inventory. We should ensure that the client adequately records this as consignment inventory by examining journal entries.

We will also need to perform some work on the valuation of the demo units that are sitting in inventory at year-end. As mentioned earlier, these units need to be recorded at the lower of cost and net realizable value. DQ will have to provide us with documentation to support that it has recorded these at an appropriate amount; for example, by providing us with sales invoices for recently sold similar demo units (to establish the fair value) and providing details of costs incurred to sell these units (such as delivery and freight invoices), which may have an impact on the NRV determination. We will need to agree a sample of these invoices to the shipping documents and the receipts journal to verify that the transactions did occur and that the amounts are accurate.

(Most discussions regarding demo units related to NRV with respect to the returned units. Many candidates recognized that these units would have a lower value than new units, but often provided inappropriate procedures to achieve their valuation objective, not comparing the findings regarding NRV to the inventory cost of the item. (In other words, we should examine subsequent sales invoices for both new and used units and compare them — essentially a fair-market-value to fair-market-value comparison.))

Inventory Overhead

We should obtain a schedule of all inventory overhead costs and verify that all costs prohibited by Section 3031 are removed through adjusting journal entries (such as advertising). For costs that may be valid but are subject to allocation, we should test the reasonableness of the allocation through discussions with various management or employees. For example, Randy should provide an explanation supporting why 75% of his time and wages relate to inventory. This explanation should be corroborated with others familiar with his work.

(Most candidates who addressed this issue were able to provide relevant audit procedures related to substantiating amounts that had been included in the inventory overhead allocation.)

Journal Entry Review

It appears as though the previous senior had planned to perform this testing because he or she had requested a listing of the general ledger journal entries. However, Randy has only provided us with a sample of journal entries that he himself has selected. In addition, the sample of journal entries covers only the first half of the fiscal year. The review of journal entries is performed to respond to the risk of management override of controls. Therefore, it is inappropriate for Randy to be selecting the sample of journal entries that we will review, since he is the one with the greatest ability to manipulate the accounting records. It is also inappropriate for us to review journal entries from just the first half of the year.

The *CICA Handbook — Assurance* provides some guidance in this area, stating:

The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries and other adjustments are often made at the end of a reporting period, the auditor ordinarily selects journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, the auditor considers whether there is also a need to test journal entries and other adjustments throughout the period.

Given the lack of internal controls and the high risk of manipulation present at DQ, I believe we should review journal entries both made at year-end and throughout the year. To do this, we will need to obtain a complete listing of all general ledger journal entries from Randy, since the sample he provided us with is not sufficient.

(Many candidates struggled to identify the problems with the journal entries Randy had selected. Their discussions did not sufficiently communicate their concerns — that Randy had chosen the sample and that it covered the first half of the year only — and they could not adequately explain why this concerned them in terms of the audit. Some candidates' outstanding audit procedures in this area were vague and incomplete and did not address the underlying issue: that they needed to get entries for the other half of the year from Randy.)

Merger and Acquisition Costs

We should obtain a detailed schedule of the costs included in this account. We should agree a sample of these costs to invoices and verify the amounts, as well as determine the purposes of the costs. We need to then determine whether the costs were actually incurred to improve DQ's marketability to potential buyers. We also need to determine how likely it is that DQ will eventually be sold, since these costs have no benefit if no sale occurs. We could discuss these issues with DQ's legal counsel. If the costs deferred are not applicable to the second offer, or the offer does not seem likely to result in a sale, we should verify that they are written off by reviewing journal entries to remove these costs from the account.

(Many candidates who addressed this area provided specific procedures that were outstanding in the verification of merger and acquisition costs, and explained why these procedures were necessary.)

Commissions Expense Accrual

We should determine what the agreed upon rate is for commissions. If no documentation supports the rate, we should look at prior year commission expense to determine what rate has been used historically. We could also contact the relevant salespeople and question their understanding of the commission rate. We should then recalculate the proper amount to accrue.

(Most candidates who proposed procedures to support the rate for commissions were able to explain why those procedures were required and clearly communicated how those procedures would be performed.)

Inventory Count

The junior noted instances where there were more units of inventory on the floor than were listed on the report (overages). These count discrepancies need to be resolved. We should ask management whether these units relate to the Early Order Program, as the junior suspects. If management cannot adequately explain these discrepancies, we will have to perform additional procedures in this area. For example, we may need to perform additional test counts now and compare them to the current inventory listing to determine whether any discrepancies continue to exist, or to extrapolate the error from the original count done at year-end over the total inventory balance.

(Few candidates addressed this area.)

Materiality

We should require the client to adjust for all of the accounting errors we have identified. However, even if this is done, we still need to revisit our materiality calculation because the accounting errors noted earlier — specifically, the overstatement of revenues related to the Early Order Program — have reduced net income. Assuming we use net income as a basis for materiality, our revised materiality will be lower and will likely result in a need for us to perform additional procedures to gain comfort in the significant account balances.

In addition, a new user of the financial statements has been identified (the second potential buyer) and has started some preliminary due diligence. We should consider this user when reassessing our materiality level.

[CAS Guidelines:

According to CAS 320, Paragraphs 12 and 13: “*The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.*”]

(Few candidates integrated the results of their previous discussions in the areas of accounting issues and outstanding audit procedures to consider the overall impact on the audit engagement to date. They did not step back to question the impact on the initial materiality calculation. Many of those candidates who did pull together the various parts of their discussions and other case facts (such as the second potential buyer) were able to provide useful discussions and make appropriate suggestions with respect to materiality.)

For Primary Indicator #2 (Assurance), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.1%
Nominal competence — The candidate does not attain the standard of reaching competence.	9.5%
Reaching competence — The candidate attempts to provide valid audit procedures.	37.4%
Competent — The candidate discusses valid audit procedures.	52.4%
Highly competent — The candidate discusses several valid audit procedures.	0.6%

(Candidates were asked to discuss outstanding audit issues and to suggest additional audit procedures. To achieve competence, candidates were expected to discuss valid audit procedures to address the issues identified. Candidates were directed to this indicator through the partner's request for a list of outstanding audit procedures.)

(Candidates performed adequately on this indicator. Candidates provided some audit procedures; however, some did not provide specific, valid audit procedures that should be performed, and instead suggested vague or incomplete procedures. Some candidates did not explain why their procedures were necessary. For the most part, candidates were able to address outstanding procedures related to the accounting issues as well as the incomplete audit work.)

(Strong candidates provided clear procedures and discussed why the specific procedures they suggested were necessary. Their responses were better organized than those of weak candidates and, consequently, covered more issues. Weak candidates tended to provide vague procedures, and their discussions did not explain why the procedures were necessary. Many weak candidates failed to identify the specific procedures required to address incomplete audit work.)

(As noted throughout the solution, candidates had the option to respond to this simulation using the guidelines provided under CAS. Very few candidates chose to do so.)

Primary Indicator #3

The candidate prepares a draft management letter.

The candidate is demonstrating competence in Assurance.

Competencies

VI-2.10 – Prepares information for meetings with stakeholders (A)

VI-3.1 – Identifies the entity's key operations (B)

VI-3.3 – Evaluates internal control (A)

I-1.3 – Identifies and evaluates the audit committee's role in governance (A)

You have stated that the Board Chair is curious to see what our management letter will contain. Below is a first draft of the findings to be included in our letter:

During the course of my audit of DQ for the year ended June 30, 2010, I identified matters that may be of interest to management. The objective of our audit was to obtain reasonable assurance on whether the financial statements are free of material misstatement. Since an audit is not designed to identify matters that may be of interest to management, these items are discussed separately.

The matters we identified are as follows:

Lack of segregation of duties — There is currently a significant lack of segregation of duties as a result of the various roles Randy plays within the company. Although Randy was hired as a CFO and is responsible for supervising the accounting area for DQ, he also appears to have taken on the primary responsibility for sales. This represents poor segregation of duties since having access to both the sales and the accounting records gives Randy the opportunity to both generate sales and potentially manipulate the recording of those sales. It also allows him to record fictitious sales. We recommend that these duties be separated, or, at a minimum, that Randy's work be reviewed closely by Yuda to ensure that only valid transactions are recorded.

(Many candidates were unable to identify the concern with segregation of duties: that Randy has access to accounting functions and also to sales records. Instead, their discussions focused on Randy's geographic absence from the Timmins plant, and they suggested that Randy should move closer. This suggestion did not resolve the actual problem that exists with Randy's incompatible functions.)

Financial statement and document control processes — The master copy of the financial statements and much of the supporting documentation is located on Randy's hard drive, which creates a likelihood of error since the financial statements are not linked to the general ledger. This also makes the information inaccessible by others, and creates an increased risk of loss of information since it is not stored on a server. Significant documentation should be stored on the company's server to decrease the likelihood of loss of information in the event that Randy's computer malfunctions or, assuming it is a laptop, it is lost. Storing the documents on a central server would also be more efficient since other employees, such as the bookkeeper, would be able to access necessary files directly rather than going through Randy.

(Many candidates approached their discussions of this issue from an audit perspective; in other words, addressing the delays that the auditors would experience because Randy alone had the information. As a result, few candidates considered the impact on the company and its control processes in their analyses.)

Expense reports — Subsequent disbursement testing identified an expense report of Randy's that had not been approved by anyone other than him. While the reimbursement appears to be for valid expenses incurred subsequent to year-end, it raises a concern with respect to controls over approval processes within the company. Randy should not be approving his own expenses because he could make inappropriate or inflated claims for reimbursement that would have a negative impact on cash flow and would artificially increase company expenses. Randy's expense reports should be approved by a higher level of management, such as by Yuda, to ensure that they are legitimate and supported by proper receipts.

(Many candidates recognized that Randy had approved his own expense report and were able to explain the implications of this to the company. Those candidates concluded their discussion by providing a useful recommendation to address this control weakness.)

Documentation of terms — The lack of documentation related to sales commissions, and the confusion surrounding the contract terms related to both the Early Order Program and the demo units, increases the likelihood of error and of misunderstandings in business dealings, which could lead to disputes and potential losses. We recommend that all significant transactions be well documented, with the terms agreed upon by DQ and the counterparty as evidenced by relevant signatures.

(Some candidates recognized that the need to ensure that proper documentation supporting various items was necessary, were able to explain what impact the lack of such documentation could have on the company, and advised on what needed to be put in place to rectify this omission.)

Inventory — Inventory controls need to be improved. In order for DQ to properly safeguard its assets, it needs to be aware of exactly what it has in inventory at all times. The units related to the Early Order Program, as well as the returned demo units, should be physically segregated from the rest of the inventory. By physically segregating this inventory, it will be easier for DQ to maintain accurate inventory records and to ensure inventory is properly valued.

(Few candidates were able to identify the weaknesses associated with the inventory controls.)

Board minutes and frequency of Board meetings — There is a lack of documentation related to Board meetings, which increases the likelihood of misunderstandings between the Board, management, and others, since significant discussions and decisions are not well documented. In addition, it reduces accountability for ensuring decisions and action plans are implemented, since they are not clearly documented. A secretary should be appointed and minutes taken for all Board meetings. These minutes should then be circulated to all Board members to ensure that they agree that they accurately represent the decisions made and the action items agreed to at the meeting.

The Board's role in the company is not currently being adequately fulfilled. The Board has not met regularly throughout the year, so it would be difficult for the Board to keep apprised of matters related to the company, particularly given the dysfunctional relationship with Randy. We recommend that the Board meet regularly throughout the year, preferably at least quarterly, so that informed business decisions are made. The roles of the Board and management should also be more clearly defined, including their relationship with the auditor.

(Most candidates were able to identify these issues, clearly explain the implications to the company, and make specific recommendations for improvements. Some candidates linked their discussions to the impact on the audit engagement (in other words, if there are no Board minutes, the firm cannot complete its audit work) rather than raising the point in the management letter so that the company could make improvements to its processes and controls.)

Timeliness of reporting — The Board (Nathan) has noted that its members are not receiving timely information from Randy. Timeliness and relevance of information are closely linked; if the Board members are not receiving timely information, then the information they receive may no longer be relevant and they are not adequately informed to perform their role. We recommend that the Board establish clear timeframes and expectations that would meet their information requirements, and communicate them to Randy.

Board independence — DQ's Board is not independent, since most members are also members of DQ management. The Board is composed of Yuda, Randy, one other member of management, and two representatives from VC, so three of the five members are employed by DQ. The Board must be independent in order for it to act as an oversight committee for the well-being of the company. If the members are not independent, they will be reluctant to critically judge the decisions made by management. New members should be added so that the majority of members are independent.

Audit committee composition — The Board also acts as the audit committee. It is not clear whether the audit committee members possess the necessary finance and accounting skills to sit on such a committee. Ideally, an audit committee should be made up of a separate group of people with finance backgrounds but, at the very least, the CFO should not be part of the audit committee. Otherwise, the audit committee may be biased by the CFO's opinions.

This communication is prepared solely for the information of management and is not intended for any other purpose. I accept no responsibility to a third party who uses this communication.

(Many candidates combined their discussions of the independence of both the Board and the audit committee. This approach was not always successful, since comments relating to the audit committee (that management should not be involved) were not necessarily problematic for the Board (where the issue was that the majority of members were management). In addition, many candidates did not fully appreciate the scenario of the simulation (a medium-sized, private company) and felt that it was inappropriate for both management and shareholders to sit on the Board. Most discussions that combined the issues concluded with only one recommendation that may have been suitable for the audit committee but was usually unsuitable for their Board discussions.)

For Primary Indicator #3 (Assurance), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.4%
Nominal competence — The candidate does not attain the standard of reaching competence.	20.3%
Reaching competence — The candidate identifies some of the points to be included in the management letter.	49.9%
Competent — The candidate discusses some of the points to be included in the management letter.	29.2%
Highly competent — The candidate discusses several of the points to be included in the management letter.	0.2%

(Candidates were asked to prepare a draft management letter. To achieve competence, candidates were expected to discuss some of the points to be included in the management letter, including both internal control deficiencies as well as Board and governance concerns. Candidates were directed to this indicator by the partner's request that CA prepare a first draft of the management letter.)

(Candidates performed below expectations on this indicator. Candidates were able to provide some general comments on the Board issues, sometimes recognized control concerns, and made recommendations to address those issues; however, many did not sufficiently discuss the implications of the deficiencies on the company and its operations.)

(Strong candidates provided a well-organized response that identified the weakness or problem, discussed the implications, and made a recommendation to address the deficiency. Those candidates clearly saw how these issues would affect the company and explained the impact in their specific recommendations, demonstrating that they understood the nature of the problem. Weak candidates identified issues but did not attempt discussions to demonstrate their understanding of the implication of the issue, and provided weak recommendations. A small number of candidates attempted to provide a management representation letter rather than a management letter, misunderstanding the required.)

Primary Indicator #4

The candidate recognizes the high degree of control the CFO has and the potential impact on the company.

The candidate demonstrates competence in Pervasive Qualities and Skills.

Competencies – (lists all Pervasive Qualities and Skills for the simulation)

III-1.1 – Gathers or develops information and ideas

III-1.2 – Develops an understanding of the operating environment

III-1.3 – Identifies the needs of internal and external clients and develops a plan to meet those needs

III-2.1 – Analyzes information or ideas

III-2.3 – Verifies and validates information

III-2.4 – Evaluates information and ideas

III-2.5 – Integrates ideas and information from various sources

III-2.6 – Draws conclusions / forms opinions

III-3.1 – Identifies and diagnoses problems and/or issues

III-3.2 – Develops solutions

III-3.3 – Decides / recommends / provides advice

III-4.1 – Seeks and shares information, facts and opinions through written discussion

III-4.2 – Documents in written and graphic form

III-4.3 – Presents information effectively

III-6 – Understands how IT impacts a CA's daily functions and routines

To: Chair of Audit Committee (also Chair of Board)
From: CA firm

We would like to bring the following issue to your attention directly, rather than include it in the management letter, because it is a sensitive issue.

Currently, Randy Wall, the CFO of DQ, has a wide range of responsibilities that give him a great deal of autonomy and opportunities for manipulation. The CEO is also deferring many of a CEO's traditional responsibilities to Randy, which gives him a great deal of control over the dealings of the company. During our audit we noted the following examples of cases where Randy has exerted control that may present him with an opportunity to manipulate the records without anyone noticing.

The first example is that the bookkeeper must check with Randy before providing information to the auditors, and Randy has asked that all requests go through him. Secondly, during our audit we noted a discrepancy in the commission rates that needs to be investigated and might relate to Randy's excess control of those records. Further evidence of him having taken undue control is that he is able to have his expenses paid out without his expense reports being review by anyone else. In addition, you seem to find it easier to get information directly from the auditors rather than from Randy, and your doing so upsets him.

While there is no overt evidence of fraudulent behaviour at this time, there is a consistent bias in the recording of transactions to positively affect earnings. As a shareholder in the company, Randy stands to benefit from the sale of the company. In particular, since the earnings results may be a key part of the determination of the purchase price, he has an incentive to manipulate earnings positively. With the amount of control Randy has over the records, he appears to have the opportunity to manipulate the earnings should he choose to. It is understandable for Randy to want to maximize earnings, since it will benefit not only him but all of the shareholders. However, if he has been overly aggressive and the end result is that the financial statements are misleading, DQ runs of the risk of being sued by the purchaser of the company.

There appears to be some early evidence of aggressive accounting practices. This includes the recording of the Early Order Program and demo unit sales, the aggressive allocation of costs to inventory, and the deferral of costs related to an inactive deal. While these may simply be due to aggressive accounting, Randy has the autonomy in his various roles within the company to manipulate the earnings, and there may be inadequate review to detect manipulation. This is particularly true since he has the complete trust of the CEO, the bookkeeper relies on him, and the Board has been relatively inactive in its oversight role. Before the situation develops into something more significant, we thought it should be brought to your attention.

(Many candidates repeatedly expressed their concerns about Randy and his activities and actions, and on occasion, were able to provide simulation facts to support their positions. Most candidates felt that Randy was committing fraud rather than merely being aggressive in the selection of accounting policies, and made extreme recommendations to deal with the perceived fraud. Other candidates focused extensively on Randy's distance from Timmins as the problem, and their suggested solution was to replace him. Some candidates focused solely on Randy's impact on the firm's ability to complete the audit work, without considering the impact on Dry Quick.)

Some of the problems may be the result of a lack of clarity in the roles of management within DQ. It may be unclear who is responsible for certain areas of the organization, and as a result it might be difficult to hold each person accountable for their actions since the roles are mixed.

We recommend that the roles within the organization be more clearly defined to ensure that responsibilities are properly allocated and that there is appropriate accountability. For example, if Yuda's role is more that of a COO, it may be appropriate to give him that title instead of CEO, particularly given that he allocates many CEO responsibilities to Randy. Randy's role as CFO should be more clearly defined. Since sales are not typically a CFO's primary focus, it may be more appropriate to either allocate sales responsibility to someone else, or to call Randy the head of sales and marketing and hire an on-site controller. It may also be more appropriate to have an on-site finance person who is accessible and is able to keep up with day-to-day operations.

Overall, Yuda and the Board have exposed themselves to a great deal of risk by putting too much faith in Randy. He has an inordinate amount of control over the company and his actions require significantly greater oversight.

(Few candidates were able to step back from their detailed analyses of Randy to consider the issue as it related to the company overall. Strong candidates were able to tie their discussions of the issue back to Randy's influence, to step back and consider Randy's high degree of control, and to bring the issue to Yuda's attention. They also recognized that Randy's actions or intentions may not always have been harmful or intentional, and provided useful recommendations to resolve some of these concerns in the short term.)

For Primary Indicator #4 (Pervasive Qualities and Skills), the candidate must be ranked in one of the following five categories:	<u>Percent Awarded</u>
Not addressed — The candidate does not address this primary indicator.	0.7%
Nominal competence —The candidate does not attain the standard of reaching competence.	26.2%
Reaching competence — The candidate identifies the CFO's high degree of control.	52.1%
Competent — The candidate discusses the CFO's high degree of control and the potential impact on the company.	21.0%
Highly competent — The candidate thoroughly discusses the CFO's high degree of control and the potential impact on the company, and recognizes that this has been facilitated by the CEO's hands-off approach.	0.0%

(Candidates were expected to recognize the high degree of control the CFO has and the potential impact on the company. To achieve competence, candidates were expected to discuss Randy's control and to support their discussions with simulation facts. Candidates were not clearly directed to this indicator, but were provided with hints from Exhibit I: Information on Dry Quick regarding Randy's widespread functions, the communication of information, and the possible sale of the company.)

(Candidates performed below expectations on this indicator. From their earlier accounting or audit discussions, some candidates raised concerns about Randy's actions from a fraud perspective and supported those comments with case facts. Most candidates did not step back to consider the issue from a broader perspective, and focused on Randy's distance from Timmins as the problem or considered the impact on the firm's ability to complete the audit work.)

Strong candidates stepped back and assessed Randy's level of control on an overall basis, in addition to making links to Randy's control throughout their responses. Those candidates also escalated the issue to Yuda or the Board and recognized that further investigation should be done. Weak candidates talked about Randy's geographic absence as a problem, failed to link Randy's control to simulation facts to address the impact on the company, or made unsupported conclusions that Randy was committing fraud. Candidates must ensure they do not only see the issues they want to see (like fraud) or address issues that seem obvious, without considering whether there is a bigger or related problem to address. In this case, the geographical location was not the issue, although it might appear to be so on the surface. Candidates needed to dig deeper to get to the real source of the problem.)

There were no secondary indicators in this simulation.

(Overall, many candidates seemed confused by Randy's high degree of control in this simulation and, as a result, their analysis of the accounting and assurance indicators was tainted. The focus of many responses appeared to be founded on the basis of Randy committing fraud. For example, many candidates:

- concluded that Randy was deliberately making incorrect journal entries in an effort to improve the financial results of Dry Quick. This led to a superficial analysis of the accounting issues;*
- identified additional procedures to determine if Randy was committing fraud but in doing so missed some additional key audit procedures for the riskier areas of the audit; and*
- focused their management letter concerns on areas where they believed Randy was overriding controls in an effort to defraud the company. As a result they often missed additional management letter comments unrelated to Randy.*

While a discussion of the possibility of fraud was certainly warranted in these circumstances, additional areas should also have been discussed by the candidates for each indicator.)

SAMPLE RESPONSE
PAPER III-3 DRY QUICK (DQ)

The following is a candidate response for Paper III-3. Whereas the evaluation guide presents all the elements of a complete response by indicator, this sample response shows how the case facts are integrated into an analysis and how the competency areas are addressed in an actual response. It demonstrates the degree of depth that can be achieved in an exam setting.

Question 3

To: Partner of P&S
RE: Audit of DQ

Overall: Manipulation of Financial Statements

- It appears that there is manipulation of the financial statements occurring by Randy the CFO for the following reasons:
- The board shows weak oversight controls and Randy sits on the board and the board will not meet without him, meaning that no one is reviewing or questioning his work
- The accounting issues we identified show a bias in that they all overstate income either by overstating sales or understating expenses
- In addition to the bias, there is an incentive for Randy to do so because he is a shareholder of 15% of the shares and DQ is looking to get bought out - we have been told that that the current year's earnings are expected to be a key part in the determination of the purchase price thus there is significant incentive for Randy to misstate earnings for 2010 so that the price is higher and he gets more money when he sells his shares
- Randy won't allow auditors access to documentation without his involvement which suggest he may be manipulating support and thus the financial results

We should discuss this issue with Yuda to determine further steps that are appropriate to address the issue.

Issues Noted In Audit Work

High level of Risk for DQ in 2010 because of the following reasons:

- DQ shareholders are looking to sell and a key determination of the purchase price is this year's earnings which gives the owners - particularly the CFO incentive to overstate earnings
- Controls appear to be weak in the accounting department as the CFO is rarely in the office and focuses largely on sales and the only other accounting staff is a bookkeeper who does not appear to have the expertise or authority to question the CFO as we have noted accounting errors - see below
- This is our first year auditing the client thus we are unfamiliar with the business, which increase the risk of detection of errors

1) Revenue recognition on bill and hold

- Orders that were made by June 15th were recorded in revenue for 2010 as Randy said these should be considered bill and hold arrangements thus we need to assess if this is appropriate

Analysis:

EIC-141 requires that specific criteria are met for sales to be considered bill and hold and thus recognized as sales before delivery occurs:

- 1) risks of ownership have passed to customer - not met
- 2) there is a fixed schedule of delivery for products - there is no evidence of such schedule thus not met
- 3) the products are ready for delivery - it is unlikely inventory for 4 months ahead has all be completed thus criteria is not met
- 4) The buyer has requested the bill and hold transaction and has legitimate business reason for doing so - the buyer has not requested this transaction; they have just placed orders ahead of time to get a discount
- 5) the seller does not retain any performance obligations - not met as DQ still has to deliver goods and no evidence ready for sale and inventory, thus still obligation to manufacture and have ready for sale
- 6) The inventory is segregated and not used to fill other orders - some items may have been segregated based on inventory count results, but it was unclear if this was the case or not as these items were not on the inventory listing at all

Based on the criteria above, DQ has not met this criteria as there is no evidence that the buyers requested bill and hold transactions and there has been transfer of risks to the customer as DQ is still liable to ensure delivery occurs in 4 months if for example there was a fire or theft in the mean time

Conclusion:

This means it was inappropriate to record the revenue on these sales thus the \$1.5 million that was recorded as revenue should be deferred if the cash was received – i.e. the amount that related to the 10% deposit required and \$150,000 and the amount relating the accounts receivable should be reversed as no receivable should be recorded and no revenue should be recognized for the \$1.35 million

Audit Procedure:

Risk = based on above analysis, risk is over occurrence/existence of revenue recorded with especially high risk relating to orders close to year end

- I will have our staff obtain a listing of all revenue transactions recorded in the last quarter of 2010 and have them select a sample of revenue transactions to test
- the sample items will then be vouched to the order forms, shipping documentation if it exists, and sales invoice relating to the sample item
- If no shipping document or sales invoice exists or the document relates to a shipment after year end this will indicate that the revenue was likely prematurely recorded based on Randy's bill and hold logic which was demonstrated to be incorrect above
- items which are appropriately recorded should have a shipping document and invoice showing that the sale and delivery occurred before June 30 year end

Inventory overhead testing

- GAAP requires that inventory is recorded at the lower of cost and net realizable value
- GAAP does allow for allocation of overhead costs relating to production in the determination of cost, however allocations of administrative costs are not usually appropriate
- Thus, in assessing the overhead that DQ allocated it appears only one cost would potentially be appropriate which is the depreciation relating to manufacturing; however, need to assess if this in accordance with GAAP as amortization of manufacturing equipment could be reasonable as it is considered to assist in bringing inventories to their current location and condition
- Administrative costs, however, are clearly disallowed by GAAP, thus the 60% allocated of the head office building, advertising costs and salaries of the CEO, CFO and admin staff is inappropriate
- These costs should be expensed as incurred in the period

Conclusion:

An adjustment needs to propose to reduce the value of inventory for the costs noted above.

Procedure:

Risk: Valuation of inventory appears to be overstated based on the discussion above, thus we should perform the following procedures:

- obtain the general ledger details from the inventory account
- select a sample of journal entry allocations made which have the description of administrative allocations
- The sample of allocation entries selected should be agreed to the journal entry prepared and from there to the supporting documentation of the expenditure - for example if it related to depreciation, the continuity schedule calculating the amount should be inspected, and for salaries the employment contract should be obtained and then recalculate to see the 75% allocation
- If these items agree we will see that they were inappropriately capitalized to inventory and we must make an adjustment for these items in inventory

Work still to be completed:

In addition to the procedures to be done as described above the following needs to be done:

1) Discrepancies that have been noted

a) accounts receivable has had discrepancies come back which means that more testing needs to be done as a result of the errors found to ensure that total errors in the accounts receivable population are not greater than materiality. Once the further testing results are complete the errors found must be extrapolated over the population and an adjustment needs to be proposed based on these errors to management.

b) Inventory discrepancies noted - completeness of inventory

- given the bill and hold discussion above and the results of the count it appears that inventory is understated by the value of the bill and hold sales
- The inventory items which were recorded in cost of sales as a result

2) Accumulation of errors:

- All of the errors found in testing must be recorded and accumulated to determine on both a qualitative and quantitative how many balances are materially misstated.

- Any adjustments that are materially misstated must be adjusted by management or a qualified audit report must be issued. Given the pervasive nature of errors in revenue, expenses, accounts receivable and inventory an adverse opinion may be required.

Management Letter Control Issues:

1) Composition of the board

Weakness

- The board is made up of the CEO, the CFO and VC
- The CFO should not be included on the board as the purpose of the board is to provide management oversight and protect shareholders

Implication

- Having the CFO on the board compromises the objectivity/independence of the board and impairs its ability to provide strong oversight which would contribute to the control environment at DQ because one of the main board members which seems to have a strong influence on the board is essentially reviewing himself
- There is no one else with a financial expertise on the board to critique his work and thus provide independent oversight

Recommendation: Another CA that is not a management team member should sit on the board and Randy should not be re-elected to the board.

2) Expense review policy - Randy reviewing his own expenses

Weakness: Randy is reviewing his own expenses without anyone else looking at them which means he could approve any amount and have it paid because no other level of review is occurring

Implication: This gives him the opportunity to submit false expenditures and then misappropriate DQ cash to himself

Recommendation: Randy should have to obtain approval from Yuda on all of his personal expenses and the cheques to him should be signed by Randy. All cheques should have to have two signatures - at least one being Yuda's

3) The board meets infrequently

Weakness: The board has not met regularly according to Nathan Cole and monthly reports have not been received

Implication: This means that timely decision cannot be made and again this limits the board's ability to perform proper oversight duties of management because they don't have the reports to review and base decisions on that they need

Recommendation: The CFO should be required to submit reports on time and if he cannot live up to this duty should be replaced. Further, the other board members should meet regardless if Randy can make the meetings and should meet on a monthly basis.

TABLE I**PRESENT VALUE OF \$1 RECEIVED AT THE END OF THE PERIOD**

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

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

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

TABLE III

**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%
Class 50	55%
Class 52	100%

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 IV
INDIVIDUAL FEDERAL INCOME TAX RATES

<u>Taxable Income</u>	<u>2009 Tax Rate</u>
\$40,726 or less	15%
\$40,727 to \$81,452	\$6,109 + 22% on next \$40,726
\$81,453 to \$126,264	\$15,069 + 26% on next \$44,812
\$126,265 or more	\$26,720 + 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	\$10,382
Spouse or common-law partner amount	10,382
Net income threshold for spouse or common-law partner amount	NIL
Child	2,101
Age 65 or over in the year	6,446
Disability amount	7,239
Infirm dependants who reach 18 in the year	4,223
Net income threshold for infirm dependants 18 and over	5,992
Basic amount for:	
Age credit and GST credit	32,506
Child tax benefit	40,970
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 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>
2010	3	3		
2009	4	3	3	3
2008	6	6	5	5
2007	7	7	7	7
2006	5	6	6	7

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.

For more information

The CA qualification process prepares future CAs to meet the challenges that await them.
For more information on the qualification process, the uniform evaluation, and your province's specific education requirements, contact your regional education director.

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