

CPA Common Final Examination

BOARD OF EXAMINERS' REPORT

PART A — The Day 2 and Day 3 Report

September 2021 Examination

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THE BOARD OF EXAMINERS' REPORT ON THE SEPTEMBER 2021 COMMON FINAL EXAMINATION

OBJECTIVES OF THE REPORT

The objective of this report is to explain the Common Final Examination (CFE) process and to assist the profession in improving the performance of candidates on the CFE.

The report sets out the responsibilities of the Board of Examiners, the methods used for guide setting and marking the CFE, and the results of the marking process. The report also includes recommendations to candidates from the Board of Examiners.

The September 2021 CFE Report is presented in two parts: Part A is the Day 2 and Day 3 report and Part B is the Day 1 report.

The appendices provide more detailed information on the design, guide setting, and marking of the CFE, as well as the board's expectations of candidates on the simulations. Readers are cautioned that the marking guides 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 CFE report is not an authoritative source of GAAP.

RESPONSIBILITIES OF THE BOARD OF EXAMINERS

The Board of Examiners (BOE or the board) comprises a chair, two vice-chairs, and sixteen members appointed by the provincial bodies.

The board's responsibilities, as set out in its terms of reference, include the following:

- Setting the CFE in accordance with the *CPA Competency Map* (the *Map*) and other directions from the Professional Education Management Committee;
- Submitting the CFE and the marking guides to the provincial bodies for review;
- Marking the candidates' responses and recommending to the provincial bodies the pass or fail standing that should be given to each candidate; and
- Reporting annually on the CFE to various CPA committees and the provincial bodies, in such form and detail and at such time as is satisfactory to them.

The chair is responsible for the supervision of the evaluation process. A CFE subcommittee, made up of nine members of the board, is actively involved in the preparation of the CFE simulations, the preliminary marking guides, and the setting of the initial passing profile. The members of that subcommittee participate in the Preliminary Evaluation Centre where the marking guides are tested against candidate responses and finalized, and in the start-up of the marking centre. The BOE chair and vice-chair provide oversight throughout the entire marking process, consulting with subcommittee members as required. The full board is responsible for equating the difficulty of the examination to prior years' examinations and establishing the passing standard.

THE CFE

Preparation and Structure of the CFE

The board staff works in conjunction with authors to ensure that simulations presented to the board achieve the overall intent and design objectives set by the board, while adhering to the competencies and the proficiency levels specified in the *Map*.

The full board provides guidance as to the content and nature of simulations to be included on the examination. The CFE subcommittee reviews and refines these simulations that make up the three-paper evaluation set.

Nature of the Simulations

The CFE comprises a set of simulations that are both essential and effective in evaluating the candidates' readiness to enter the profession:

Day 1 – The first paper is a four-hour examination consisting of a single simulation that is linked to the Capstone 1 group case. There are two versions of the linked cases. Version 1 is linked to the most current Capstone case and is written by first time writers and by repeat writers who chose to attempt the new case rather than Version 2 of the previous Capstone case. Version 2 is written by repeat writers and candidates who deferred and are writing Version 2 as their first attempt. The two versions of the exams are calibrated to ensure the difficulty of both is comparable.

As a result of Covid-19, there have been adjustments made, that have resulted in a version 3 of some Capstone cases.

Day 2 – The second paper is a five-hour case, with four different roles and requirements. Additional information tailored to each role is provided in four separate appendices.

Day 3 – The third paper, is a four-hour paper, consisting of three multi-competency area simulations.

Assessment Opportunities

The board applies competency-based marking procedures that enable it to decide which candidates demonstrate readiness to enter the profession.

Assessment Opportunities are designed to answer the question, “What would a competent CPA do in these circumstances?” To attain a pass standing, candidates must address the issues in the simulations that are considered significant.

Appendix A contains a comprehensive description of the evaluation process.

Marking Guides

Marking centre leaders and assistant leaders provide valuable input during the testing and setting of the marking guides, before live marking begins. The vice-chair, selected member(s) of the CFE subcommittee and senior evaluations staff hold meetings with the leaders and their assistants during both the guide-setting and the marking processes. See **Appendix B** for the Day 1 simulations that appeared on the 2021 CFE and **Appendix C and D** for the Day 2 and Day 3 simulations and marking guides. The marking results for Day 2 and Day 3, by Assessment Opportunity, appear in the statistical reports found in **Appendix E** of this report. See Part B of the CFE Report for details on Day 1, Distinct Hotels Corporation Version 1, Version 2 and Version 3, which was offered as a result of the May 2020 CFE being cancelled).

Day 1 – The marking guide is designed to assess the candidate on the stages of the CPA Way: 1) situational analysis; 2) analysis of the major issues; 3) conclusions and advice; and 4) communication. Based on these four summative assessments, the candidate’s response is then holistically judged to be either a passing or a failing response.

Day 2 and Day 3 – Marking guides are prepared for each simulation. Besides identifying the Assessment Opportunities, each marking guide includes carefully defined levels of performance to assist markers in evaluating a candidate’s competence relative to the expectations set out by the board when developing the passing profile for a competent CPA.

Five categories of performance are given for each Assessment Opportunity. The candidate’s performance must be ranked in one of the five categories:

- Not Addressed
- Nominal Competence
- Reaching Competence
- Competent
- Competent with Distinction

Setting the Passing Standard

The board chair and vice-chair in charge of the examination monitor the live marking. Near the completion of the marking process, the CFE subcommittee satisfies itself that the markers applied the marking guides as intended by the board.

In determining which candidates pass the CFE, a candidate is judged in relation to the board's pre-established expectations of an entry-level chartered professional accountant. Any changes to the initial profile that were made throughout guide-setting and the marking centre are ratified by the full board. In setting the passing profile, the board considers the following:

- The competency area requirements described in the *Map*
- The level of difficulty of each simulation (set using a scale: Easy, Easy to Average, Average, Average to Hard, or Hard)
- The level of difficulty of each Assessment Opportunity (set using a scale: Easy, Easy to Average, Average, Average to Hard, or Hard)
- The design and application of the marking guides
- Comments from leaders and assistant leaders regarding any marking difficulties encountered or any time constraints noted
- Possible ambiguity of wording or of translation
- Input on critical decision factors from an independent board (i.e., those BOE members not on the CFE subcommittee and therefore not directly involved) who review the fair pass package

The Decision Model

The purpose of the CFE is to assess whether candidates possess the competencies required of an entry-level CPA through a written evaluation that is common to all CPAs. Each day of the CFE is unique and is designed specifically to assess different skills:

- Day 1 is linked to the Capstone 1 group case work. It assesses the candidates' ability to demonstrate professional skills. It is independent from Day 2 and Day 3.
- Day 2 is the **depth** test. It assesses technical **depth** in one of four unique roles (that reflect the four CPA elective choices) and provides **depth** opportunities in the common core competency areas of Financial Reporting and/or Management Accounting. Candidates pre-select one role and respond from that role's perspective.
- Day 3 supplements the **depth** test in the common core areas of Financial Reporting or Management Accounting. It is also the **breadth** test for all common core competency areas.

Candidates must pass all three days in order to qualify for entry to the profession. Those seeking licensure must obtain depth in Financial Reporting and in the Assurance Role.

Day 1

Day 1 is assessed independently from Day 2 and Day 3. A pass or fail decision is made based on a holistic assessment of the candidates' performance in applying the CPA Way to demonstrate essential professional skills.

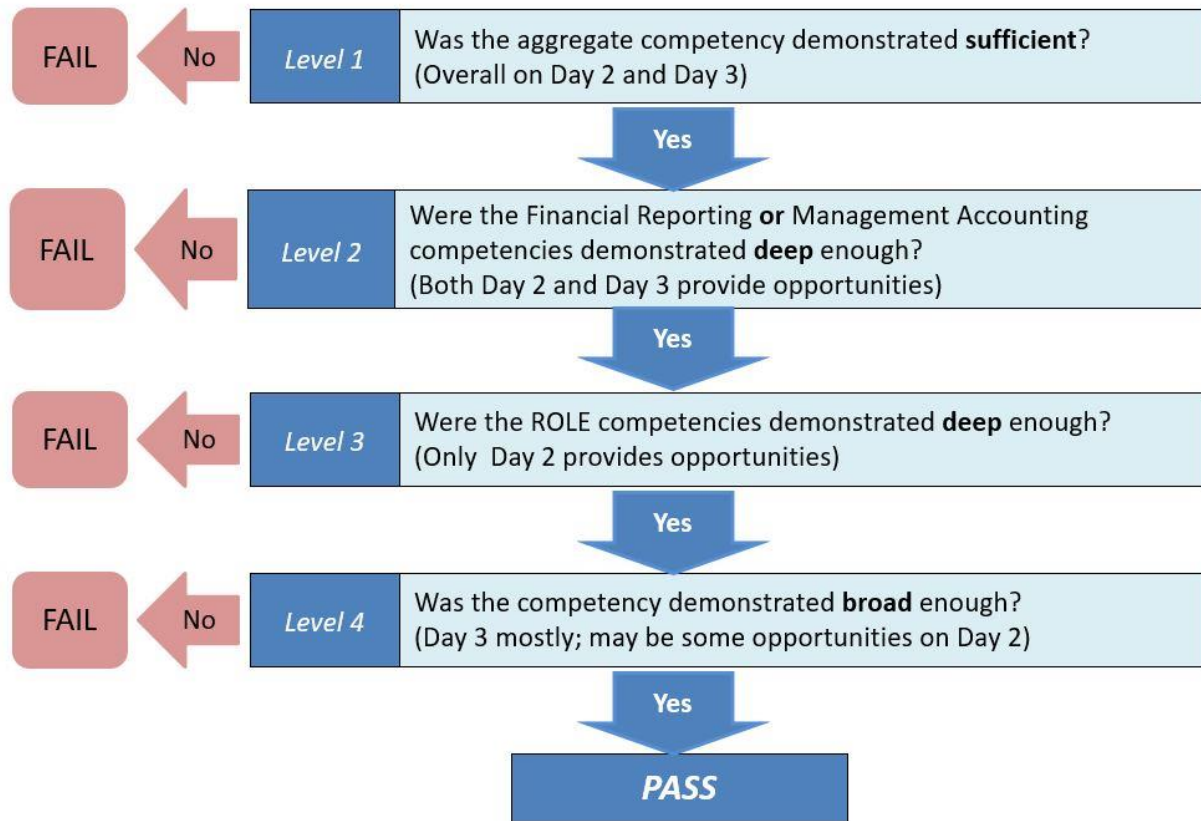
Day 2 and Day 3

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

1. The response must be **sufficient**; i.e., the candidate must demonstrate competence in the Assessment Opportunities presented on Day 2 and Day 3 (Level 1).
2. The response must demonstrate **depth** in the common core area of Financial Reporting or Management Accounting (Level 2).
3. The response must demonstrate **depth** in the pre-selected elective role (Level 3).
4. The response must demonstrate **breadth** across all competency areas of the *Map*, at a core level, by not having avoided a particular technical competency area (Level 4).

The BOE is responsible for equating the results from one examination to another to ensure that candidates have an equal chance of passing whichever examination they write. The BOE uses the factors listed above under setting the passing standard, in order to equate the examinations.

EXHIBIT I
DAY 2 AND 3 PASS/FAIL ASSESSMENT MODEL



Approving the Results

The CFE subcommittee reviews and approves the marking results for each simulation. Day 1 is assessed separately from Day 2 and Day 3.

Day 1 – The CFE subcommittee discusses the profiles for both the marginally passing and marginally failing candidates to confirm that the board's pre-established passing profile has been appropriately applied by the markers.

Day 2 and Day 3 – As part of the development process, the CFE subcommittee sets preliminary requirements for the three levels (tests of depth and breadth) being assessed on the Day 2 and Day 3 simulations. After the marking is completed, the board reviews and finalizes those requirements. The board establishes the Level 1 (sufficiency) requirement for the combined Day 2 and Day 3 simulations.

During the approval process, the board continues to consider whether the results could be affected by any inconsistency in the evaluation or the board's processes.

Reporting

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 reports the following information by candidate number:

- Overall pass/fail standing and pass/fail standing for each of Day 1 and of Day 2 and Day 3 combined.
- A pass/fail standing for Day 1.
- A pass/fail standing for Level 1, Sufficiency. A decile ranking is provided for failing candidates.
- A pass/fail standing for Level 2, Depth in Financial Reporting or Management Accounting.
- A pass/fail standing for Level 3, Depth in Role.
- A pass/fail standing for Level 4, Breadth in all technical competency areas.

Thank You

All board members wish to express their warm and sincere appreciation for the outstanding energy, support, and commitment of the Board of Examiners 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 the provincial reviewers, markers, authors, translators, and editors. 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. Everyone's commitment to the quality and fairness of the process is appreciated.

A handwritten signature in black ink, appearing to read "Jordan Oakley", with a long, sweeping underline that extends to the right.

Jordan Oakley, CPA, CA
Chair
Board of Examiners

A MESSAGE TO CANDIDATES

To attain a pass standing, candidates needed to achieve a “Pass” on Day 1, and on Day 2 and Day 3 combined, demonstrate sufficient competence in all areas and meet the two depth standards and the breadth standards.

Introduction

The September 2021 CFE Report, Part A and Part B combined, presents detailed information on all candidates' performance for all the examination cases, except for the Day 1 linked case, WDI Version 2. Detailed commentary on the performance of candidates on the WDI cases (Version 1 to Version 3) will only be available after WDI Version 3 is written in September 2022.¹ The simulations, marking guides, marking results, and Board of Examiners' (BOE) comments on the Day 2/Day 3 portion of the examination are found in Part A of the CFE Report. Similar information on Day 1 DHC simulations (Version 1 to Version 3) can be found in Part B of the CFE Report.

The intent of this message from the BOE is to help candidates improve their performance on future CFEs by drawing their attention to the most common detracting characteristics observed in candidate responses to the September 2021 CFE. The BOE's comments are based on the feedback of the marking teams, who see the entire candidate population, and reflect the broad themes noted by the markers that apply to all candidates who wrote this sitting of the CFE. More detailed AO-by-AO commentary on candidates' performance can be found in the BOE's comments in Appendix F of Part A, or Appendix J of Part B, of the CFE Report.

Nature of the CFE

The design of the CFE is such that each day of the examination allows candidates to demonstrate a different skill set. Day 1 allows candidates to demonstrate their high-level professional skills, such as analysis that is relevant and critical to strategic decision-making, professional judgment, and ability to synthesize. Day 2 allows candidates to demonstrate their technical competence in the common Financial Reporting and Management Accounting competencies and in their chosen role, which is tied to one of the four elective areas. Day 2 typically, but not always, directs candidates to the work to be done and is not designed to be time constrained, allowing candidates to demonstrate depth. Day 3 allows candidates to demonstrate depth in the common Financial Reporting and Management Accounting competencies and provides multiple opportunities to demonstrate breadth in all the core technical competency areas. Day 3 is typically time constrained, requiring candidates to prioritize the issues and manage the amount of time spent on each issue. Both Day 2 and Day 3 require candidates to integrate the information found in the simulation in order to demonstrate competence. All three days require candidates to clearly communicate their thought process.

¹ The profession will offer Version 3 of WDI on the September 2022 CFE.

Strengths and Weaknesses

There were two noticeable areas of improvement on the September 2021 CFE. The first was better time management on the part of candidates. The second was fewer unrelated discussions. However, overall, the BOE observed some of the same patterns in the responses as seen in candidates' performance on recent CFEs, and has therefore highlighted these areas of overall weakness.

Time Management

None of the exam days on the September 2021 CFE was time constrained, although Day 3 required time management on the part of candidates to ensure all three simulations were completed within the four hours allowed. Candidates generally managed their time well, which allowed them to attempt the majority, if not all, of the AOs. The BOE was pleased to see evidence of candidates consciously and deliberately managing their time. Markers observed that the discussion for one required would often end abruptly, and another would begin, suggesting the candidate had spent their budgeted time on that AO and moved on to the next required, to ensure that, overall, they addressed all the requireds. This was observed on Day 2, between the common AOs and the role AOs, and on Day 3, between simulations. Overall, on Day 2 and Day 3, only a few candidates mismanaged their time, and these were generally the weaker candidates who either spent too much time in their quantitative analyses or had difficulty identifying the relevant issues. Day 2 Common noted that the last AO (AO#6 – Operational plan) and Day 2 Finance noted that the last AO (AO#13 – Logistics proposal) had higher percentages of Not Addressed compared to other AOs, but they were not significant percentages. These AOs were considered difficult, and it appears that some candidates simply were not sure how to address them, rather than not addressing them due to mismanagement of time.

For both Day 1 simulations, generally, the amount of time candidates devoted to their situational analysis and their issue analysis was well balanced. However, not all candidates addressed the underlying strategic issues. This was not due to time constraint, but rather a failure to do the necessary step-back to see the broader issues (see later discussion).

Candidates are reminded that the CFE has a minimum sufficiency score that must be obtained, separate from the requirements that are set for the depth and breadth tests. The BOE continues to encourage candidates to take time to identify the relevant issues and attempt a discussion of all the requireds, since their sufficiency score is affected by AOs they do not attempt. The Board also encourages candidates to continue to use the suggested times on each simulation as a guide to help manage the time spent per AO.

Unrelated Discussions

Although done much less frequently on the September 2021 CFE, some candidates inserted discussions that were not relevant, because of either misinterpreting or misreading the requireds or neglecting to consider the specifics presented in the simulation. This often appeared to be the result of applying a templated approach and failing to consider the differences in the facts presented compared to similar issues tested on past exams. Candidates appeared to be trying to fit the answers from their practice exams into the current year's exam, rather than addressing the case facts as presented. The following are some examples of where candidates either misinterpreted the requireds or provided irrelevant discussions:

On Day 3, Simulation 1, AO#2 (Management Accounting – New revenue model – qualitative), some candidates brought in irrelevant points, such as whether the contractors would be considered employees. These discussions were not relevant to the overall analysis, since there was nothing in the case to suggest this was a pertinent issue.

On Day 3, Simulation 1, AO#7 (Strategy and Governance – U.S. expansion), some candidates defaulted to providing management advice. For example, many explained that it would be harder for the Moons to manage an operation in the U.S., given the geographical distance. Others were concerned that foreign exchange would make the accounting more difficult. These discussions did not address whether the expansion met FenceCo's strategic objectives, which is what the required asked candidates to address.

On Day 3, Simulation 3, AO#1 (Financial Reporting – PP&E accounting Issues (IFRS)), there were a multitude of issues to contend with related to the scooters and bikes. Many candidates focused on the wrong issues, believing the discussion revolved around whether the scooters were inventory or capital assets or whether the bikes and scooters met the definition of a capital asset. There was no information in the simulation to suggest these were relevant issues. A few candidates also addressed potential foreign exchange accounting issues, having noted that there was a U.S. supplier; however, there was no accounting issue related to foreign exchange, since there were no case facts to indicate that the accounting treatment was incorrect. Foreign exchange was tested on recent CFEs, though, and candidates appear to have been searching for similar issues.

The BOE reminds candidates that while it is good to practise writing cases and know different approaches to use, they should not automatically assume the task is the same as in previous years. The facts presented are unique to each case and require integration of the pertinent case facts to fully understand what the relevant issues are for a particular case and to decide what form of analysis is appropriate. Rarely is an issue identical to a prior one. Candidates are encouraged to pause and take the time necessary to ensure they have clearly identified what issues and analyses are most relevant, based on the set of circumstances presented, before beginning their response.

Technical Ability

Generally, there were fewer unusual and complex AOs for candidates to contend with on Day 2 and Day 3 than on the September 2020 and September 2019 CFEs. Therefore, unlike on recent CFEs, where some candidates avoided the harder and more complex AOs entirely, candidates generally attempted all the AOs. As has been the pattern for the past few CFEs, candidates generally performed better on the straightforward and commonly tested issues presented throughout Day 2 and Day 3, although that was not always the case, as noted below. Candidates also appeared to perform better compared to recent CFEs on the quantitative AOs, generally showing a better application of the fundamentals, like break-even analysis, WACC, NPVs, and taxable income calculations.

Candidates generally performed well on Day 2, Common, AO#2 (Financial Reporting – Revenue recognition) and AO#5 (Management Accounting – Breakeven); Day 2, Assurance role, AO#7 (Risk assessment) and AO#12 (Internal controls); Day 2, Finance role, AO#8 (New product line NPV); Day 2, Performance Management role, AO#7 (SWOT analysis); Day 2, Taxation role, AO#8 (Taxable income – quantitative); Day 3, Simulation 1, AO#1 (Management Accounting – New revenue model – quantitative); and Day 3, Simulation 2, AO#3 (Assurance – Audit procedures).

However, on certain of the remaining AOs, there was more variability in the quality of the responses, with some candidates demonstrating a very poor understanding of the required technical knowledge.

In Financial Reporting, for example, on Day 2, Common, AO#1 (Investment in LOB), some candidates appeared to confuse the concept of significant influence with that of control and incorrectly concluded that consolidation was an acceptable accounting policy choice, when in fact only equity or cost were viable options based on the case facts. Others incorrectly suggested that the cost method was the only policy choice available to FFTY, or concluded that there would be a greater impact on FFTY's net income under the cost method due to the dividends, failing to identify the proportionate income inclusion under the equity method.

On Day 2, Common, AO#3 (Sale and leaseback), some candidates concluded that the lease was an operating lease despite the case facts clearly indicating it was a capital lease, and many did not discuss how to account for the gain on the sale part of the transaction, despite the amount being significant.

On Day 2, Common, AO#4 (Non-monetary transaction), an AO that was rated a higher difficulty by the BOE to reflect the fact that the *Handbook* section is difficult to interpret, most candidates demonstrated performance that was similar to what was seen on the September 2020 CFE, despite the current transaction being a more straightforward exchange of goods (food) and services (web design). Most identified that the transaction was a non-monetary transaction and knew that ASPE section 3831 applied. However, as was the case in September 2020, candidates were confused as to how to apply the section. Many concluded that the transaction lacked commercial substance, but they continued to use the fair values despite the guidance suggesting the use of carrying value, or they concluded there was commercial substance without any further supporting discussion, seemingly not knowing what to provide as support. The impression left on the BOE, based on the analyses observed, was that many candidates did not know how to interpret the requirements of the section or how to apply them to the facts presented.

On Day 2, Performance Management role, AO#12 (Proposed supplier contract), the candidates were asked to assess a proposal for a new long-term supplier contract. Many candidates struggled with the quantitative component of this AO. These candidates were unable to perform a meaningful comparative analysis of the costs for the two options (status quo versus the new proposed contract). Their calculations lacked structure, and the purpose of the calculation was often unclear. The impression left on the BOE, based on the analyses observed, was that many candidates started their calculation without first taking time to clearly identify its purpose.

On Day 2, Performance Management role, AO#13 (Loyalty program), the candidates were asked to assess a proposal for a new loyalty program for the corporate stores. Many candidates demonstrated weaknesses in the application of basic management accounting concepts linked with the calculation of the incremental income arising from a new project. Many, for example, failed to incorporate the cost of the incremental sales generated by the program into their calculation, or they failed to incorporate the reduction of sales generated by the loyalty points being issued.

On Day 3, Simulation 2, AO#6 (Financial Reporting – Lawsuit provision and MD&A), candidates were asked to review the draft Management Discussion and Analysis (MD&A) and discuss the accounting treatment for the lawsuit, under IFRS. Many candidates did not see the need to review and critique the MD&A itself and, therefore, failed to identify the misleading statements included in the MD&A as presented. Instead, they focused solely on the discussion of the lawsuit. Knowing that many candidates may be less familiar with MD&As, the BOE was less surprised by the performance on the MD&A part of the required. However, the number of candidates who had difficulty with the lawsuit discussion was surprising to the BOE, as it was the much easier part of the required. The analysis of the criteria for the accounting treatment of the lawsuit was weak, with many candidates misapplying IAS 37, to conclude that the lawsuit was a contingent liability rather than a provision, or simply stating the criteria were “met” without further explanation, failing to demonstrate their understanding of how the *Handbook* criteria applied in this situation.

Some technical weakness was also noted in the various role AOs. On Assurance role, AO#8 (Approach and materiality), some candidates' discussions contained technical errors, such as basing their choice of materiality percentage on the overall financial statement risk instead of on the sensitivity of the users, or not choosing an appropriate percentage range for the basis they selected for materiality. On Assurance role, AO#11 (Reporting options and procedures), candidates were asked to discuss the various reporting options available for an annual statement of gross sales as part of the AO. Some struggled to provide valid reporting options, often only suggesting options that would not apply to the situation, such as a CAS 800 *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* report or a CSRS 4200 *Compilation Engagements* report. Some incorrectly suggested that a CAS 805 report could be performed as a direct or attestation engagement. On the Taxation role AOs, those who displayed technical weakness often did so across multiple AOs, such as using incorrect CCA rates, having incomplete or inaccurate income calculations as a result of omitting or making errors, and then failing to separate business and investment income when calculating income taxes. On the PM role, AO#10 (Departmental analysis), some candidates either incorrectly identified the type of responsibility centres when analyzing the case facts or did not know what the basic responsibility centre types were. On Finance role, AO#10 (Equipment purchase FX hedge), some candidates confused the forward contract with options or did not understand the mechanics of a natural hedge (i.e., not recognizing that U.S. dollar cash inflows are needed in order to create a natural hedge).

The BOE also noted relatively weak technical ability on the Taxation AOs on Day 3, suggesting an overall weakness in this competency area. For example, on Day 3, Simulation 1, AO#4 (Tax – Taxes payable on sale of ABC), some candidates struggled with how to apply the lifetime capital gains exemption (LCGE) and applied the full LCGE against the taxable capital gain, applied 50% of it against the capital gain, applied it directly against taxes payable, or did not use it at all. They also applied a corporate tax rate against the sale, most often using the 22% tax rate that could be calculated from Appendix III. The second taxation AO on this simulation, AO#6 (Tax – Investment options), was also an issue for many candidates, with some confusing the personal taxation of investment income with the corporate taxation of investment income, noting that each option would be taxed at the highest rate. Others struggled with the RRSP calculation and, for example, included dividends in their calculation of the deduction limit or used the 2020 RRSP deduction limit as the 2021 deduction limit without any adjustments. Some weak candidates omitted the RRSP calculation entirely from their response.

Clarity of Communication/Unsupported Discussions/Failure to Integrate the Information Provided

For the September 2021 CFE, the BOE once again noted that most candidates communicated clearly, with fewer very short, point-form, and generic responses that were hard to interpret. Only a few candidates continued to use the “met” or “not met” approach without providing a supported explanation as to why, when analyzing specific criteria. Also less prevalent were quantitative analyses that were unsupported or not explained in the spreadsheet, although the explanations some candidates provided were quite cryptic and brief, sometimes making it difficult to know where the numbers came from or what the calculations were attempting to do.

However, candidates' level of support still needs improvement, as many continue to list case facts without elaborating on why those points are relevant, or do the opposite by failing to integrate the specific case facts into their analysis to support their position and the application of the relevant criteria. Some candidates continue to cut and paste information or list requirements or criteria, typically *Handbook* or Income Tax Act guidance, without applying that information to the case facts, sometimes jumping to a conclusion based on the criteria alone without supporting it.

For example, on Day 2, Assurance role, AO#8 (Approach and materiality), many candidates provided an audit approach that was quite generic (for example, concluding that a fully substantive approach should be used due to the internal control weaknesses that were present, without recognizing that the internal control weaknesses only affected a limited number of stores or that the nature of FFTY's business, a grocery store, would likely prevent a fully substantive approach). On Day 2, Finance role, AO#11 (Investments), some candidates identified the objectives but did not use them throughout their analysis, or did so at a superficial level (e.g., only discussing the annual return for each investment option). On Day 2, Taxation, AO#11 (Interest and penalties – compliance system), some candidates identified some of the potential reasons for interest and penalties being assessed but struggled to clearly link the case facts to the rules in order to explain precisely which deadlines had been missed and by how much. And, on Day 2, Taxation, AO#12 (Shareholder/employee benefits), some candidates discussed only a few of the employee benefits, often simply stating whether something was deductible by FFTY or taxable to the employees, without considering any of the specific case facts provided or explaining why the benefit was, or was not, taxable or deductible. On Day 2, PM role, AO#8 (Mission and vision), some candidates proposed revised mission and vision statements without referring to the case facts, and they generally provided a generic list of core values that had little connection to FFTY's strategic direction. For example, some referenced "satisfied customers," "happy employees," or other objectives that could apply to any business, rather than focusing on elements specific to FFTY's industry and strategy. And, on Day 2, PM role, AO#11 (Managerial performance) candidates who identified the root causes of the poor performance often made little or no use of the case facts presented, such as the management decisions made in the first store and the sewer backup having occurred in the second store. Rather than attempting to link to the case facts describing events that had taken place during the year, weak candidates relied on their theoretical knowledge of the drivers for these ratios and presented hypothetical reasons for the performance changes.

On Day 3, Simulation 3, AO#1 (Financial Reporting – PP&E accounting issues (IFRS)), some candidates concluded on an accounting treatment without using relevant *Handbook* criteria or case facts to support their recommendation (for example, mentioning that the bikes needed to be componentized but not using the case facts provided to explain what the components would be and what period to depreciate them over). These candidates had difficulty integrating the information contained in the different appendices, where they could have found the information needed to better explain how the componentization should be done.

On Day 3, Simulation 2, AO#2 (Finance – Short-term financing options), candidates provided a list of case facts for each option without discussing them or explaining how they would affect HSE. For example, they stated that LMI had an extensive application process without explaining why this could be an issue. On Day 3, Simulation 3, AO#5 (Assurance – Audit risk and first-time audit considerations), some candidates provided generic audit risks that were often not tied to specific case facts (for example, stating that if there were control weaknesses, it would increase the audit risk, without referring to the actual control weaknesses presented in the case, which the candidate had usually discussed earlier in their response). Others simply defined inherent, control, and detection risks from a technical perspective without further discussion of how these applied in this case. When addressing the first-time audit considerations, some candidates copied considerations straight from the *Handbook* without providing any additional analysis.

Notable exceptions, where candidates did a good job of using the case facts to support their discussions or better explained their calculations, include Day 2, Common, AO#2 (Financial Reporting – Revenue recognition), which is the common AO on which candidates performed the strongest. The majority of candidates used ASPE 3400 and focused their discussions on the performance aspect of the various streams, using case facts such as the timing of the services performed for the initial fee to support their discussion. Similarly, on Day 2, Performance Management role, AO#1 (SWOT analysis), candidates generally supported each element in their SWOT analysis with an explanation as to how the element mattered to FFTY. In the Taxation role, there was a noticeable improvement in the taxes payable calculation, AO#10 (Taxes payable, RDTOH, CDA); where in the past a short-cut approach was often applied, candidates in September 2021 took the time to show a supported calculation. Lastly, on Day 3, Simulation 1, AO#7 (Strategy and Governance – U.S. expansion), candidates were able to integrate many of the case facts into their analysis to explain where the expansion met or did not meet the strategic objectives.

Candidates are once again reminded that the role of the CPA is often to advise clients, either on the application of standards and tax rules or on why and how to proceed with certain business decisions. Without a clear explanation, a client would have incomplete information. In the case of responses to CFE simulations, assessing the degree of competence is more challenging without a fully supported explanation. The BOE is interested in understanding the logic used and is looking for evidence of the analysis and professional judgment that was applied in reaching a conclusion. Therefore, it is important for candidates to answer the questions “Why?” or “So what?” when making any point using case facts, and to include the answer in the response. Presenting the rules without applying them to the specific situation, or repeating case facts without further explanation, is insufficient. The BOE is looking for a clearly articulated response.

Higher-Level Integration

There is one additional pattern of performance that the BOE would like to draw particular attention to. Some candidates demonstrated an inability to step back and consider the broader issues presented in some of the simulations. As much as the CFE presents specific requireds and provides information within appendices that is directly related to those requireds, candidates still need to consider the entirety of the situation and integrate the case facts found throughout the simulation to be able to comment appropriately on some of the issues presented or, in some situations, to identify non-directed issues.

On the Day 1 cases in particular, candidates are expected to identify the broader strategic issues, which may be undirected, based on their analysis of the situation and the more specific strategic alternatives they are presented with.

On both Day 1 cases, the BOE noted a tendency to focus too much on the “issue by issue” analysis. Often, candidates recommended proceeding with multiple options, each recommendation being based on an “issue” analysis. Then, in their overall conclusion, they repeated these recommendations rather than stepping back to assess how the individual pieces and recommendations fit together as a whole, while considering the constraints presented in the simulation. As a result, their conclusions were contradictory or of little value, due to their having violated a key constraint or ignored a key objective. This also resulted in a lack of consideration and commentary on the broader overall direction that the company should take. See further explanation on the issues that were specific to the two Day 1 cases below.

Although this pattern was more apparent on the Day 1 cases, it was also noted on the Day 2 and Day 3 cases. On Day 2, candidates were told that the company’s objective was to maximize net income. This overriding objective should have been integrated into the recommendation for each of the financial reporting issues being analyzed (for example, by recommending that the equity option was the most appropriate as it would result in greater investment income in the current year). However, many candidates failed to integrate this objective when making their recommendations.

On Day 3, Simulation 1, AO#2 (Management Accounting – New revenue model – qualitative) and AO#7 (Strategy and Governance – U.S. expansion), both AOs required a connection to FenceCo’s strategic objectives. Many candidates failed to recognize that there was integration between the issues that required some consistency in the recommendations being made. For example, some candidates supported the new revenue model with the fact that it would grow revenue without any capital investment. Day 3, Simulation 3, was a highly integrative simulation, where candidates needed to pull information from different places in the case to be able to properly analyze the issues. In many instances, candidates used the information presented in one appendix only, failing to consider all of the relevant case facts and how they affected their analysis of the issue. For example, AO#1 (Financial Reporting – PP&E accounting issues (IFRS)) required candidates to pull information from three different appendices and from the scenario information. Many had difficulty integrating the information to identify the right issues and then analyze them.

The BOE emphasizes that the ability to analyze and integrate the information presented in order to identify what is, and isn't, relevant to the issues raised in the case is an essential CPA skill. The BOE continues to place case facts in different places and to intentionally include undirected and broader underlying issues in order to increase the required integration. In addition, the BOE reminds candidates that it is looking for them to present recommendations that are useful, which requires that there be internal consistency in their responses and for the decisions to be consistent with the case facts presented. Candidates are encouraged to take time to step back and consider the constraints, objectives, and overall direction that make the most sense for the company based on the case facts presented before formulating their recommendations.

For more detailed commentary, see Appendix F of Part A of the CFE Report.

Additional Comments Specific to Day 1 WDI (Version 2)

Most candidates dedicated the first section of their response to a relevant situational analysis. Most used this information later in their response, making relevant links back to the company's situation when analyzing the specific strategic issues that were presented, and within their conclusions. However, the links that weak candidates made were typically to the more obvious case facts that related to WDI's key success factors, mission, and vision, rather than being tied to the more important factors, which generally varied for each strategic issue.

Beyond the specific objectives that were set, there were two prominent issues relevant to WDI's internal environment that candidates were expected to highlight as part of their situational analysis: the fact that WDI's limited cash availability and limited access to further debt financing was a constraint that affected the choice of investments, and the need to decide which strategic path WDI should follow in light of the differences emerging between the traditional sector and the new niche services being offered. Candidates were expected to integrate the crucial elements of the company's broader situation, including WDI's cash constraint, within their qualitative and quantitative analyses of each strategic alternative. They were also expected to explain how each available alternative aligned with the company's overall choice of strategic direction.

For each of the strategic options available to WDI, candidates were expected to conclude and recommend a course of action that was consistent with their analyses. Within their conclusions, candidates were expected to address how the company's constrained cash position would restrict its ability to make all of the strategic investments available. They were also expected to provide an overall conclusion that incorporated the company's primary objective of securing WDI's long-term success.

There were four strategic options to be analyzed in this case: whether WDI should sell its Nova Scotia landfills or upgrade them in order to recapture biogas, whether WDI should attempt to expand the company's consulting services through a research collaboration with Nova Scotia University, whether WDI should acquire Pendleson Incorporated (PI) by purchasing all of PI's outstanding shares, and whether WDI should proceed with building an electronic-waste recycling facility in the Town of Devyn. In addition, candidates were expected to discuss how WDI should approach the leachate contamination, from both an ethical and governance standpoint.

Within the analysis of the major issues, three main factors differentiated strong responses from weak responses. First, a strong response identified and provided an in-depth discussion on the most important decision factors for each issue. Weak candidates tended to list case facts, often failing to explain why those elements were important and how they affected the decision-making process. Second, strong candidates provided valuable quantitative analyses to help support their recommendations (such as by linking their calculations to the stated objectives of WDI). On the other hand, weak candidates' quantitative analyses were often unstructured and unclear and, therefore, challenging to follow. Many failed to perform the correct calculation to assess the decision. These candidates often struggled to explain how the results of their quantitative analyses affected the decision at hand. Third, strong candidates routinely linked their analysis of each alternative to the two prevalent entity-level issues presented in the case: the overall strategic direction WDI should take and the cash constraint. Strong candidates incorporated these aspects

into their discussion of each strategic alternative, whereas weak candidates either missed making these links altogether or provided a superficial discussion by listing pros or cons, sometimes in contradictory ways from option to option, and failing to adequately highlight the importance of these aspects to the decision. Strong candidates typically incorporated both entity-level issues to some extent and usually prioritized their strategic recommendations, explaining why one alternative should be pursued over another, drawing on the entity-level decision factors.

Weak candidates tended to only perform an issue-by-issue analysis without stepping back to consider the broader perspective and without integrating the key entity-level issues into their conclusions. Their conclusions were often internally inconsistent or would have been impossible for WDI to act on. For example, many weak candidates suggested upgrading the landfills while also acquiring PI. Given WDI's limited access to investment capital, this recommendation was impossible to pursue. Other candidates mentioned the cash constraint in their situational analysis or in their analysis of the strategic alternatives but then lost sight of the constraint and recommended spending more cash than was available.

Most candidates approached their response in a coherent and organized fashion. Only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized approach to their response.

Additional Comments Specific to Day 1 DHC (Version 3)

Similar to WDI Version 2, most candidates dedicated the first section of their response to a relevant situational analysis. Most used this information later in their response, making relevant links back to the company's situation when analyzing the specific strategic issues that were presented, and within their conclusions.

In addition to considering the company's overall occupancy rate and average daily rate (ADR), which are key measures in the industry, candidates should have highlighted two prominent issues relative to DHC's internal environment in their situational analysis: the reputational issues surfacing as a result of Doug Malette's actions, and DHC having limited cash resources (and how to use the cash available most effectively). Strong candidates tended to clearly identify the limitations related to the amount available to invest and identified the importance of the reputational issue that DHC was facing. Strong candidates also highlighted the increased significance of Doug's actions given the importance that social media and viral news stories have on the public's perception of a company. Weak candidates tended to simply list information related to key success factors, mission, and vision, taken from either Capstone 1 or this simulation, without identifying which of those items would have the most influence on their decision-making process.

There were five strategic alternatives that candidates were expected to analyze both qualitatively and quantitatively. They were expected to assess whether DHC should purchase 35% of the outstanding common shares of Peak Revie, evaluate the opportunity to purchase all of the outstanding shares of HHH, assess whether DHC would be better off selling the Cape Breton hotel in order to purchase and renovate the castle in Tofino, and analyze whether the renovation of the Cape Breton hotel was a better investment than the castle in Tofino. In addition, candidates were directed to comment on DHC's overall strategic direction. Relative to that specific request, candidates were expected to discuss whether DHC should divest completely from Eastern Canada in order to escape the negative public perception stemming from Doug's actions. Candidates were also expected to evaluate Derek's proposal for the Western Corridor and how the strategic alternatives in the simulation aligned with the potential for building a linked group of luxury hotels.

One of the main differentiating factors between strong and weak candidates was the ability to identify and discuss in depth the most relevant aspects of each strategic option presented as part of their analysis. Rather than discuss the more pertinent implications associated with the case facts, weak candidates' analyses instead tended to contain superficial links to their situational analysis, such as, for example, repeated statements that a case fact linked back to the mission or vision.

Regarding the reputational issue, most candidates recommended that DHC hire the public relations firm to combat the negative press, but they failed to conclude on whether DHC should leave Eastern Canada in order to focus solely on Western Canada. Regarding the Western Corridor, most candidates did not provide a separate analysis of the proposal and instead only discussed this strategic proposal within their analysis of the other alternatives available to DHC, and many failed to conclude on whether DHC should proceed with the plan to link their Western Canadian hotels together to create vacation packages. Weak candidates seldom provided a separate discussion of the Western Corridor, usually ignoring this proposal altogether. When it was discussed, it was usually only included as a single pro or con in their analysis of the other strategic alternatives.

Only strong candidates tended to incorporate DHC's cash availability throughout each of their issue-by-issue discussions and within their conclusions and overall recommendations. As well, only strong candidates addressed the Western Corridor within a separate analysis and discussed how best to approach the Doug Mallette issue. Strong candidates also typically explained why their recommendations were the most effective use of DHC's limited available investment capital based on the company's objectives. Weak candidates struggled to provide a useful conclusion that DHC's board could act on, usually ignoring the cash constraint. For example, many weak candidates suggested selling the Cape Breton hotel in order to proceed with all three of the available hotels in Western Canada; however, this recommendation lacked value because DHC lacked the cash necessary to do so. Other weak candidates recommended renovating the Cape Breton hotel while also purchasing and renovating the castle in Tofino, an option that the simulation clearly stated was not possible.

As was the case with WDI Version 2, only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized approach to their response.

APPENDIX A

**EXAMINATION DESIGN, MARKING GUIDE DEVELOPMENT, AND MARKING
OF THE COMMON FINAL EXAMINATION**

CFE Design

Day 1 is one four-hour case that is linked to the Capstone 1 case, which is worked on in groups for eight weeks prior to the CFE. When writing the Day 1 case, candidates are allowed access to their Capstone 1 case but not their group's answer or any sample response. The Day 1 case is designed to assess the enabling (professional) skills. Candidates are directed to target a "board room and senior management" level of discussion, with high-level analytics and a strategic focus. There are two versions of the Day 1 case. Candidates pre-select the version they will write.

Day 2 is one four-hour case that candidates are given five hours in which to respond. The extra hour gives candidates time to filter and find the information that they need to answer *their* role requirements from within the common information presented. Day 2 is designed to assess the technical competencies in **depth** (Level 2 and Level 3). Candidates pre-select a role (Assurance, Finance, Taxation, or Performance Management). All candidates work with the same case — it has a common section and four sets of appendices containing additional information applicable to each of the four unique roles. The required tasks, regardless of the role, are clearly directed unless there is an undirected/enabling issue in the case that the board expects candidates to identify on their own. Day 2 evaluates the competencies listed in the *CPA Competency Map* mostly in the elective area and in common Financial Reporting and/or Management Accounting areas in **depth**. The role **depth** test (Level 2) may also include coverage of other competency areas from the common core.

Day 3 is a four-hour examination containing a mix of small cases (60 to 90 minutes each¹) that evaluate the common core competencies only. The Day 3 cases provide additional opportunities for **depth** in Financial Reporting and Management Accounting and all the **breadth** opportunities for all the technical competency areas. Cases are time constrained, and they are designed to cover different competency areas within each case. A higher level of integration and judgment is required on Day 3 of the CFE than in the core modules, although the technical competencies are tested at the common core level of expectation.

The assessment opportunities on the Day 2 case are given mark values such that each of Day 2 and Day 3 are weighted equally.

The Development of Marking Guides and the Provincial Review Centre

Prior to the Common Final Examination booklets being published, provincial reviewers, appointed by each region, meet to examine the simulations and the preliminary marking guides. The provincial reviewers' comments are then considered by the board when it finalizes the examination set and again when the senior markers review the marking guides in the context of actual responses at the Preliminary Evaluation Centre.

¹ The CFE Blueprint allows anywhere between 45 to 90 minutes. The Sept 2021 CFE ranged from 60 to 90 minutes.

The September 2021 CFE Marking Centre

The September 2021 CFE Evaluation Centre was 100% remote due to Covid-19. From the marker applications received, approximately 260 individuals were chosen to participate in the September 2021 CFE marking centre. The criteria for selection included marking experience, motivation, academic achievement, work experience, personal references, and regional representation. The marking was supervised by the CPA Canada CFE full-time board staff.

The Day 1 Version 1 linked case (WDI V2) was marked by a team of 24 people from October 9 to October 22, 2021. The Day 1 Version 2 linked case (DHC V3) was marked by a six-member team from September 24 to October 5, 2021.

The Day 2 Common assessment opportunities were marked by a separate team from the role assessment opportunities by a team of 53 people from October 5 to 19, 2021. Day 2 Assurance was marked by a team of 52 people from October 5 to October 21, 2021. Day 2 Performance Management was marked by a team of 15 people from October 9 to October 19, 2021. Day 2 Finance was marked by a team of seven people from October 2 to October 10, 2021. Day 2 Tax was marked by a team of seven people from September 30 to October 10, 2021. All three Day 3 cases were marked from October 10 to October 27, 2021. The Day 3 simulations were marked by a total of 96 people.

In advance of the marking centre, the members of the CFE subcommittee, staff, leaders, and assistant leaders participated in a five or six-day preliminary evaluation centre (PEC). Participants reviewed the marking guides, applied them to randomly selected candidate responses, and made necessary revisions to the marking guidelines, taking into account the comments on the marking guides received from provincial reviewers.

All teams followed a set marking centre schedule, which included a start-up phase to train the markers. At the beginning of the marking centre, the leaders and assistant leaders presented the marking guides to their teams, while staff, the BOE vice-chair in charge of the examination, and a selected subcommittee member supervised. The teams undertook a two-phase test-marking procedure prior to actual marking. Phase one consisted of marking guide familiarization, during which markers applied the marking guide to copies of candidates' responses and collectively reviewed their results. Phase one thus ensured that all markers understood the issues in the marking guide and the basis on which to apply each expectation level. Phase two consisted of an expanded test marking of several responses to establish marker congruence.

After the training and test-marking phases, and only when marker congruence was achieved, live marking commenced. All teams, for all days, had a leader, and anywhere from one to eight assistant leaders, and had both French-speaking and English-speaking markers. Each team had one or more markers who marked in both languages.

The board strives for the highest possible marking consistency and quality control. Leaders and assistant leaders, therefore, devoted much of their time to cross-marking and other monitoring activities. Control papers were automatically fed into the system daily to check markers' consistency. Markers' statistics were reviewed to ensure that marking remained consistent throughout the centre. Based on analysis of the statistics, leaders reviewed and, if necessary, re-marked papers to ensure that the assessment opportunities were marked fairly for all candidates. Bilingual markers marked papers in both languages, and their results were compared to ensure that the marking was consistent in both languages. Additional audits were performed at the end of marking on any large differences between markers, or language differences.

Borderline Marking (Day 1)

Each candidate's paper was marked once. All candidates' responses that were assessed as clear fail, marginal fail, and marginal pass were marked a second time by the team leader, an assistant team leader or a senior marker. Clear pass results were also audited to ensure accuracy of marking.

Double Marking (Day 2)

Each candidate's Day 2 paper was marked independently by two different markers. If the two initial markings differed on any assessment opportunity, an arbitrator (the leader, the assistant leader, or a senior marker) compared the two initial markings and determined the final assessment.

As an added measure to ensure that markers were consistently applying the marking guide, a two-day rule exists, which results in the second round of marking not beginning until two days have elapsed since the first marking. Adherence to this rule ensures that any movement in the application of the marking guides due to marker interpretations during the first two days of live marking are stabilized before the second marking and arbitration process begin.

Borderline Marking (Day 3)

Day 3 was marked using a borderline model. All Day 3 responses were marked once and then the Day 2 and Day 3 results were combined. All failing candidates who passed the Day 2 role test, had their Day 3 response marked a second time by an independent marker, and any differences between the first and second markings were arbitrated by a leader or senior marker.

Subsequent Request for Remark of Results and Request for Performance Analysis

Failing candidates may request a remark of their examination results and/or a detailed personalized performance analysis for either Day 1, or Day 2 and Day 3, or for all three days.

In an effort to provide failing candidates with more timely feedback, the Board of Examiners is piloting the creation of an automated feedback report for Day 1 of the CFE. The new report is automatically generated using the marking data collected for each response rather than being based on a personalized review of the response. It is therefore being provided at no cost to all failing candidates. This new report is intended to allow for the identification of the key deficiencies in the candidate's Day 1 response, which then allows the candidate to decide whether to request the more detailed, and personalized performance analysis report noted above, for a fee.

Review and Remarking Approach

Great care is exercised in the original marking and tabulating of the papers and results. The following review and marking procedures are applied to all three papers constituting the Common Final Examination.

Under the supervision of the chair of the Board of Examiners, as well as CPA Canada CFE staff, the responses are reviewed by the leaders and assistant leaders who did the original marking. The leaders and assistant leaders read the responses and compare them to the marking guides used at the marking centre. In reviewing candidates' results, two aspects are considered. First, it must be determined that the basis of marking the papers has been consistent with that accorded other candidates who wrote the examination. Second, all responses reviewed are subjected to a careful check to ensure the markers have indicated that consideration has been given to all material submitted by the candidate.

The results are tabulated, and a decision made regarding whether any candidates have been treated unfairly and should be granted a pass on the examination.

The results are then forwarded to the provincial bodies for notification of the candidates.

APPENDIX B

SEPTEMBER 13, 2021 – DAY 1 SIMULATIONS

***See Part B of CFE report for the marking guides for Distinct Hotels Corporation
Version 1, Version 2 and Version 3.***

**COMMON FINAL EXAMINATION
SEPTEMBER 13, 2021 – DAY 1**

Case (WDI-Version 2)

(Suggested time: 240 minutes)

It is March 2023 and Shawn, your boss at Stineman Consulting Group, informs you of a new engagement with Waste Disposal Inc. (WDI) that you have been assigned to.

Shawn met with Laura for an update. She explained that, while under the control of Kingsley Investment Inc. (Kingsley), WDI's strategy was to concentrate on its core business and maximize value while keeping capital investments to a minimum. The only exception was to convert the trucks to natural gas. Kingsley's representatives voted against all other proposals. Profits continued to decline. In November 2021, disappointed with WDI's results and the fact that no dividends had been paid since Kingsley's initial investment, Jack Kingsley decided to sell the WDI common shares that Kingsley held back to WDI, and is no longer involved with WDI.

Based on revised revenue and income projections, Thom's proposal to open a consulting division was accepted in late 2021. The consulting division opened in January 2022.

In February 2022, WDI's Board of Directors updated the company's vision and mission statements to reflect the new consulting business:

Vision: "To be a premier waste disposal and consulting company while meeting the needs of our customers, employees, and local communities, and respecting the environment."

Mission: "We are waste disposal experts providing collection, disposal, recycling, and consulting services to our customers, using environmentally responsible and sustainable methods and leading-edge technologies."

Despite the economy stagnating, with annual growth rates averaging only 1% over the past three years, the waste management industry has been growing at an annual rate of 3%. Interest rates remain low, with a prime rate of 2.5%. Given a sharp increase in packaging generated through online sales, OCC and paper recycling are expected to grow by 5% per year. Hazardous waste disposal is expected to grow by 6% annually.

To gain efficiencies in the traditional services of collection, transfer, landfills, and recycling of OCC and paper, the larger industry competitors continue to expand horizontally. Over the past two years, some large national and international competitors have purchased smaller, locally-owned companies that were unable to compete in these sectors. As well, competitors have continued to invest in technology to reduce recycling costs and to recapture biogas in their landfills. Aside from the natural gas conversion of its collection fleet, WDI has not made any significant technological improvements.

Smaller companies remain competitive in specialty services related to hazardous waste disposal, recycling of plastics and metals, and consulting. Since the institution of additional government regulations intended to reduce GHG emissions and make manufacturers responsible for end-of-life plastic products and packaging, there is increasing demand for consulting services that can assist with regulatory compliance.

In 2021, both the Nova Scotia and New Brunswick provincial governments significantly reduced the allowable capacity of landfills. This forced many local landfills to close an average of seven years earlier than expected. For those landfills with available capacity, such as WDI's, the annual volume received has increased. As a result, tipping fees are expected to increase by 10% annually for the next three years.

With Kingsley no longer a shareholder, the directors are eager to determine a future direction for WDI. Securing the long-term success of WDI is the board's primary objective for 2023. They have turned to Shawn and your team for guidance.

Shawn asks you to draft a report for WDI's board that first evaluates each proposal being considered, and then recommends a strategic direction, based on what you believe will secure WDI's long-term success. For each proposal, you are to advise the board of any significant factors they may not have considered, identify information they should obtain before making a decision, recommend a course of action where possible, and discuss any other significant issues you identify.

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APPENDIX I
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE
March 15, 2023

Laura: Thank you, Shawn, for attending our board meeting. I am now the board chair and CEO, Brian is treasurer, Josefina is secretary, and Peter is vice-chair. There have been no changes in our management positions, but the following significant events have occurred:

2020	April 15	WDI sold its surplus recycled materials, closed its recycling plants for an undefined period, and outsourced its existing recycling contractual commitments. To prevent deterioration of the building and equipment, minimal maintenance is still taking place.
2020	May 12	Kingsley withdrew the proposal to supply vehicles and drivers.
2020	October 2	As recycling services were no longer provided, two major customers terminated their contracts and signed with a large international competitor.
2020	November 21	The system to optimize collection routes was not implemented.
2021	March 14	Three additional customers did not renew their contracts with WDI, given its higher prices relative to competitors.
2021	June 6	Conversion of the remaining fleet to natural gas was completed, reducing GHG emissions by 10%.
2021	September 4	The line of credit was renewed, with the same conditions and terms. The next renewal date is September 2023.
2021	November 19	Kingsley sold its shares back to WDI for \$11 million: \$3 million cash and a loan of \$8 million. The loan matures in February 2027 and can be repaid earlier without penalty. Interest of 12% is payable annually. The principal portion is due at maturity.
2021	November 19	Brian, Josefina, and Peter each purchased 57,000 shares for a total cash investment of \$3,135,000. Laura now owns 70% and the other three shareholders each own 10%.
2022	December 31	At year-end, the total debt-to-equity ratio was 3.4 and EBIT to interest was 2.0. As a result, WDI does not have access to any additional debt financing.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

- Laura: Although WDI's financial results for 2022 show a profit for the first time since 2019, some of our decisions—mainly the closing of our recycling plants—have hurt our good reputation in the industry and our profits. We must find a way to restore both. Brian, please start with the first proposal.
- Brian: USWM Corporation (USWM), an international waste management company that needs more landfill capacity in Nova Scotia, has offered an initial price of \$18 million to purchase both of our Nova Scotia landfill sites. As the municipalities where these landfills are located have recently mandated the recapture of biogas, this is a timely offer. We either sell them or we will be forced to upgrade both landfills. I have gathered relevant information on the landfill sites.
- Laura: I am reluctant to sell these sites. This includes one of the first properties my father purchased, laying a foundation for WDI in Nova Scotia. Selling to an international company may not be well received by the community.
- Josefina: Laura, as you know, the regulatory requirements surrounding landfills are becoming more onerous. If sold, WDI would also not have to worry about maintaining or closing these landfills, which has become a large future obligation that may increase with time.
- Peter: If we sell, we must still fulfill our existing contracts, which could have significant implications. We would need to outsource that function and we may lose more customers. We also need to consider the long-term employees working at these sites.
- Josefina: Owning landfills represents a higher risk than ever before. As our landfills age, I worry that leachate will pollute the ground water and create potential lawsuits. The older our landfills get, the harder they may be to sell.
- Brian: It is time that WDI moved into more specialized areas of the industry, where there are fewer large competitors. We should sell our landfills and invest the proceeds elsewhere. We could even pay down some debt.
- Laura: I am not convinced that selling our landfills is prudent. Our landfill operations are a key element of WDI's traditional business and one of our core competencies. The biogas upgrade would lead to reduced costs and help restore our reputation in the community. The upgrade may also help reduce future carbon taxes that we would have to pay.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

Laura: Moving on, Thom has asked to make a presentation on expanding our consulting services.

Thom joins the meeting.

Thom: Our division currently provides consulting services on site remediation and sustainable power and water usage. Things are going well, and it is time to expand our services. There is a growing niche market where we can help manufacturers improve their product's end-of-life impact on the environment. Since safe disposal at the end of a material's life is highly interrelated with the material itself, this will be an exciting challenge. Because of regulatory changes, this niche service is expected to grow rapidly. If we get in early, we will have a competitive advantage.

Nova Scotia University (NSU) is offering us the opportunity to collaborate on research to create a new type of material that will drastically reduce the toxicity of certain products upon disposal. Once a less toxic material has been developed, WDI will generate revenue by providing manufacturing companies with information on how to use the new material within their existing product line, to replace less environmentally-friendly materials. This collaboration is the quickest way for us to enter this niche and will cost less than creating our own team of researchers, which is what some of the large consulting firms are doing. I see this as a new revenue source that will not require a large upfront investment. Also, the margins for this type of consulting are typically high.

Laura: This seems like a natural progression for the consulting division, and will attract new clients. Collaborating with NSU may help restore our reputation. However, this arrangement is quite different from the consulting services we currently offer. Are WDI's role and responsibilities within the proposed NSU arrangement clear?

Thom: NSU will provide the equipment, resources, and expertise, and WDI will provide a portion of the upfront funding. NSU will also apply for government research grants. We will only get paid if our consulting services produce a viable solution for our clients. However, even if only a portion of these projects prove successful, the overall financial results should be positive.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

Josefina: How much upfront cash must we contribute, and how and when do we get a return on our investment? What kind of success rate does NSU have with its R&D activities? We will need to clarify many issues before we proceed.

Thom: Granted, some details still need to be worked out. As it currently stands, NSU will own the intellectual property created; however, given the collaboration, WDI will be given an exclusive license to use the intellectual property. The university will have the right to use the intellectual property for research and publish the findings.

In addition, once WDI has access to the intellectual property for the new material, we can become experts at recycling it. This could provide another potential source of revenue.

Peter: Research has certain risks, but a potential payoff exists in terms of consulting services and recycling opportunities for WDI. If Thom says we should offer this service, I support the idea.

Laura: Thanks for bringing this to the board, Thom.

Thom leaves the meeting.

Laura: I received another interesting proposal, from Jim Pendleson. Jim is the sole shareholder of Pendleson Incorporated (PI) and he wants WDI to buy all his shares in PI. He believes that we can strengthen both companies if we combine forces. Also, I know that Jim is worried about being able to provide PI's customers with landfill services, given that PI's landfills are quickly nearing capacity. He has offered to sell all his shares of PI to WDI for a total of \$56,310,000. This figure will be broken down into a \$10 million upfront cash payment, a loan of \$40 million, and 350,000 common shares in WDI. Jim also wants to be a director and to have a key management position. He has provided additional information.

Peter: What a great idea! This acquisition will nearly double WDI's size. We would be one of the largest local companies. That said, our cash position is a concern. Can we afford to make this investment? I wonder if Jim would be willing to revise his proposed terms if we suggested changes?

Brian: To me, the terms are irrelevant. I think it would be a much better idea to focus on new emerging areas of the industry.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

Josefina: Let us not forget that PI has also recently lost customers. What if it is already too late for both of our companies to regain customers? Will combining the two companies really make us more competitive?

Laura: If we combine, we can share more expenses and thereby lower costs, and we might also increase revenue by providing PI's current customers with some of our existing services. Also, PI has a good reputation with its customers and within the community, and Jim has been in business a long time. His expertise will undoubtedly help WDI improve operations.

Peter: PI's recycling plants have all been upgraded, so we could provide recycling services again, and maybe reopen our own plants. Along with the administration cost savings, there are undoubtedly other synergies.

Laura: PI does have low debt. Interesting idea.

I received another proposal. The Town of Devyn (The Town) is a progressive municipality. The Town currently incurs high transportation costs to ship its electronic waste, because there are no local recyclers. The Town wants to provide this service locally instead, and has asked whether WDI is interested in building an electronic-waste recycling facility. They have provided some preliminary figures.

Brian: If we build the facility, I doubt we will have any problem reaching capacity within the first few years. A lot of corporations need to dispose of electronic waste, and we should be able to capture their business. It might also be possible to obtain a sizable government grant for this project.

Josefina: There is local demand, but also a huge liability if something goes wrong. In addition to safety concerns, the protection of any recyclable devices holding personal information will certainly be an issue.

Peter: I do not know if we can locally hire the expertise required to manage the facility. Very strict regulations will have to be met before we can open. Given the time required to build and obtain the permits for the facility, we will likely not be able to open until 2024. Also, when they learn that a hazardous-waste disposal facility is in their backyard, the local community might react negatively.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

Brian: There will also be added compliance and certification costs. Hazardous-waste handling requires many special features, such as dust collection systems, uniforms, showers, and extra training. But it looks very profitable, even at low volumes. We will need to be extremely cautious, but we should do it. It is a great opportunity.

Peter: Hmm... I'm not sure everything has been included in the projection provided. The return appears to be higher than what I have seen across the industry, and payback is quicker than normal.

Laura: The Town was one of the first major customers that we lost in 2021. They have committed to using WDI's services again if we build this facility. They will also guarantee us between 25,000 and 30,000 pounds of waste material for the first year and will provide a property tax reduction for up to five years, although they have not said by how much.

Josefina: Why are they offering all these incentives?

Laura: I do not know, but I will take them! I also like that we would already have one large customer. But I am still hesitant because this idea is so different from what WDI usually does. Perhaps we should prepare a list of questions to ask The Town.

I have one more item. Peter, please tell us more about the toxic leachate that was found in one of our landfill sites in Nova Scotia.

Peter: Oh! How did you hear about that? About three weeks ago, one of our technicians found that some leachate had contaminated a small amount of ground water, but we think it is contained. I did not think it was a serious leak and did not want the media to blow things out of proportion and get the public unnecessarily panicked. I intended to tell the board.

Josefina: When? Leachate can contaminate the surrounding area through the ground water or runoff. Did you test for contamination in other places, inside and outside the landfill site? The liability associated with pollution and cleanup costs is one of our greatest risks. You should have done this three weeks ago!

Peter: Well, the issue is resolved, so we can file it away.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH SHAWN BRYSON IN ATTENDANCE

Laura: The issue is not resolved. I do not understand why you did not follow the protocols of informing us, doing the proper tests, and informing the public. We need to figure out how to properly handle the matter. We need Shawn and his team to provide further guidance.

APPENDIX II
EXCERPTS FROM WDI'S INTERNAL REPORTS

Statement of Cash Flows
For the year ended December 31, 2022
(in thousands of Canadian dollars)

Operating activities		
Net income	\$	2,784
Amortization		9,390
Accretion on landfill		390
Change in non-cash working capital balances		(1,916)
Cash flows from operating activities		<u>10,648</u>
Investing activities – investment in PP&E		<u>(5,300)</u>
Financing activities		
Repayment on term loan – GBI		(4,000)
Increase in line of credit		299
Cash flows from financing activities		<u>(3,701)</u>
Change in cash		1,647
Opening cash and cash equivalents		<u>1,473</u>
Closing cash and cash equivalents	\$	<u><u>3,120</u></u>

APPENDIX III SALE OF LANDFILL SITES IN NOVA SCOTIA

Current Details on Nova Scotia Landfill Sites

- The carrying amount of the Nova Scotia landfill sites is \$12.4 million.
- In 2022, these landfill sites generated \$11,880,000 in revenue.

Details on Mandated Biogas Capture Upgrade Project for Nova Scotia Landfill Sites

- If we decide to retain these landfills, the biogas recapture upgrades will cost a total of \$8 million.
- The after-tax annual operating cash flows of these two landfills, which includes the fuel cost savings, will be \$5,819,000 for each of the next eight years.
- Our best estimate for the present value of the closing costs and post-closure maintenance costs, when the landfills are eventually retired, is \$3,723,000.
- The discount rate used is 11%.

**APPENDIX IV
ACQUISITION OF PENDLESON INCORPORATED**

PI has been in business in Nova Scotia and New Brunswick for 20 years. PI operates four collection centres, three transfer stations, four landfill sites (which are close to the capacity limit), and four recycling plants that recycle OCC and mixed residential paper using updated technology.

About 40% of PI's customers are municipalities and 60% are commercial. PI has ten-year contracts with municipalities, which will start to expire in three years. The commercial contracts are for five years or less, many of which will need to be renegotiated next year. PI has lost customers who were attracted to larger competitors, causing its revenues and income to fall steadily over the past three years.

The \$40 million loan will be repaid annually (principal and interest) over 20 years and will carry an interest rate of 5%.

Recent transactions indicate that waste management companies of a similar size sell for 8.5 times after-tax net income.

If combined, WDI believes annual after-tax savings in administration will be \$1 million.

Extracts from PI's 2022 audited financial statements are as follows (*in thousands of Canadian dollars*):

Collection	\$ 33,000
Transfer	7,300
Landfill	21,760
Recycling	13,600
Total revenue	<u>\$ 75,660</u>
<hr/>	
Operating income	\$ 7,860
Income taxes	(1,900)
Net income	<u>\$ 5,960</u>
<hr/>	
Annual cash flow from operations less required capital investments and loan repayments	<u>\$ 4,670</u>
<hr/>	

APPENDIX V
ELECTRONIC WASTE – PRIMARY RECYCLING FACILITY

- A \$12 million initial investment will be needed to build a primary recycling facility that will disassemble incoming electronic waste, such as televisions, computers, and cell phones. The parts will be sorted by robots into circuit boards, steel, plastic, and glass. These parts will then be sent to secondary recyclers for further processing.
- The facility will process up to 40,000 pounds annually. Additional investments can be made to increase the capacity.

Estimates at various volumes are as follows (prepared by the Town of Devyn):

Pounds processed annually	25,000	30,000	40,000
Selling price per pound recycled	\$ 450.00	\$ 450.00	\$ 450.00
Rebate to municipality (5%)	(22.50)	(22.50)	(22.50)
Net revenue per pound	<u>427.50</u>	<u>427.50</u>	<u>427.50</u>
Processing cost per pound (assumed to remain constant)	240.00	240.00	240.00
Net margin per pound	<u>187.50</u>	<u>187.50</u>	<u>187.50</u>
Income before taxes	4,687,500	5,625,000	7,500,000
Less income taxes at 27%	<u>(1,265,625)</u>	<u>(1,518,750)</u>	<u>(2,025,000)</u>
Net income	<u>\$ 3,421,875</u>	<u>\$ 4,106,250</u>	<u>\$ 5,475,000</u>

COMMON FINAL EXAMINATION
SEPTEMBER 13 2021 – DAY 1

Case (DHC-Version 3)

(Suggested time: 240 minutes)

It is March 2023, and your boss, Irene Malik, assigns you to another engagement with Distinct Hotels Corporation (DHC).

Over the past three years, the trend of travellers using websites such as Airbnb and VRBO has increased. Many travellers prefer the convenience, ease of booking and unique accommodations that these websites offer. Whereas chain hotels have suffered significantly from this trend, boutique hotels have not been affected as severely because travellers are still attracted to the unique experiences that many boutique hotels offer. As a result, the occupancy rates of chain hotels have decreased in each of the past three years whereas occupancy rates for boutique hotels have been relatively stable.

In recent years, it has been revealed that websites such as First Canadian Hotel Review are prone to posting fake reviews. This has resulted in travellers losing confidence in online review websites. Therefore, building brand loyalty and retaining customers has become even more vital to the success of companies in the hotel industry. In addition, a hotel's presence and reputation on social media is quickly becoming the main factor behind the public's perception. Viral news stories and negative social media attention have become serious risk factors for the hotel industry.

It has also recently been shown that companies in the hotel industry can increase their customer retention and brand loyalty by providing unique vacation packages. Vacation packages that include a mix of accommodation, activities, and transportation offer a convenient and easy way for leisure travellers to book their entire vacation. Vacation packages appear to be particularly attractive to international travellers.

Business travel has decreased in recent years as companies are relying more heavily on video conferencing as a cost cutting measure. Leisure travel, however, has continually surpassed its growth expectations. In addition, Canada is still a sought-after tourist destination. Growth in the Canadian tourism industry has been driven mainly by travellers who value Canada's natural beauty and the abundance of outdoor activities that the country has to offer.

In March 2020, Doug Mallette was let go due to his unethical behavior. Since his departure, Doug has regularly published negative posts related to DHC on social media and travel blogs for both Ontario and Quebec. He has also been featured in a few newspapers in Ontario and Quebec, claiming he was wrongfully dismissed. As a result, the public's opinion of DHC has been negatively impacted in both of those provinces.

On November 15, 2021, DHC accepted an offer to sell its Northern Ontario hotel along with the rights to the Awani Spa name. Upon sale, the loan related to the Northern Ontario property and the company's line of credit were paid off. DHC now intends to only use its line of credit for operational or emergency reasons, and not for making any major capital investments. DHC currently has \$18 million available in cash resources.

The shareholders decided against taking DHC public. The company's mission, vision, and core values have not changed. Going forward, DHC's Board of Directors (the board) has decided to give preference to investments that will increase the overall occupancy rate and ADR. The shareholders also prefer to make investments that will help DHC increase its brand visibility and brand loyalty.

Irene asks you to review the information that she has provided and to draft a report to the board that analyzes and makes a recommendation for each strategic option that has been presented. She would also like you to comment on DHC's overall strategic direction and how each option may affect that direction, and whether you have noted any other issues that should be discussed with the board.

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**APPENDIX I
TRANSCRIPT OF PREVIOUS BOARD MEETING**

Derek: Thank you for attending today, Irene.

Here is a summary of the major events that have occurred since February 2020:

March 15, 2020	Terminated Doug Mallette for unethical behaviour.
April 1, 2020	Converted the golf course in Kelowna to semi-private, according to the original proposal.
April 1, 2020	Patrick Kuzoff loaned DHC \$20 million in the form of a convertible bond, as originally proposed.
July 1, 2020	Signed management contract with Huron Heights Hotel (HHH) consistent with the original proposal, except that DHC did not allow the use of DHC's name. The hotel is therefore still branded as HHH.
July 1, 2020	Acquired a 20% investment in Topomo Mountain Ski Resort (TMSR), with the same terms as originally proposed.
November 30, 2020	Completed \$8 million of renovations at HHH. The hotel is now rated as a five-star hotel.
November 15, 2021	Sold Northern Ontario hotel for \$46.5 million. At the time of the sale, the outstanding loan was \$40 million.
March 10, 2022	Completed renovations on TMSR on time and only slightly over budget.
July 15, 2022	Renewed line of credit with H&A bank, with the same terms and conditions.

Derek: Doug Mallette's behaviour continues to harm DHC. Given the bad publicity that Doug has brought to DHC, I think we were lucky to get the generous deal we did on the Northern Ontario hotel.

Kelvin: I agree. Doug's negative posts on social media have not stopped and continue to hurt DHC's reputation, especially in Ontario and Quebec. We really need to do something to defend DHC. This has gone on long enough!

Derek: I have a solution—divest completely from Eastern Canada and focus solely on DHC's presence and growth in Western Canada.

Kelvin: That seems drastic, Derek. The eastern provinces represent a significant portion of the overall Canadian market. Why would we divest from them completely?

Derek: I know it sounds extreme, but hear me out. I could not be more excited about this idea.

APPENDIX I (continued)
TRANSCRIPT OF PREVIOUS BOARD MEETING

Jessica: Okay Derek, tell us.

Derek: Gladly! I would like to introduce my proposal for a Western Corridor. With the investment opportunities that DHC currently has, combined with the properties we already own in Western Canada, we have the chance to create a network of luxury hotels. Our guests will be able to travel from one DHC hotel to the next with both convenience and ease.

In addition to enjoying the luxury of DHC's hotels, our guests will be able to participate in unique and sought-after experiences as they move from one to the other!

Alyson: Wow, that is interesting! But how do you intend to accomplish this?

Derek: I came up with the idea while reviewing a potential strategic alliance that Jessica recently discovered. Jessica, please tell us about Peak Revie.

Jessica: Peak Revie is a 150-room, log-cabin-style hotel near a world-class ski hill in Revelstoke, British Columbia. The owner, Miranda Murdoch, recently approached me to express interest in collaborating with DHC.

From what Miranda has told me, her guests are always satisfied, and her customer retention rate proves it. However, she claims that few people are aware of Peak Revie despite all her efforts to promote the hotel, and it continues to underperform. To alleviate this, she wants to collaborate with DHC. Miranda is confident that the hotel's performance would greatly improve if it were rebranded and marketed as a DHC hotel.

Kelvin: Okay, but I fail to see how this opportunity would lead us to leave Eastern Canada.

Derek: Jessica, tell everyone about the vans that Miranda has purchased.

Jessica: Miranda mentioned that the hotel's remote location is the main reason for its underperformance. The nearest major airport is over two hours away in Kelowna, and many guests have complained about how hard it is to access the hotel. As a solution, Miranda purchased a fleet of transportation vans to transport passengers to and from Kelowna, as well as between the hotel and the ski hill. Since purchasing the vans, the hotel's performance has improved. However, Miranda overbought, and a number of these vans are underutilized.

APPENDIX I (continued)
TRANSCRIPT OF PREVIOUS BOARD MEETING

Derek: If we team up with Miranda, we will get both an ownership interest in Peak Revie and the use of these vans! That would allow DHC to transport its guests from various airports to our hotels, and from one DHC hotel to another. Talk about service! On top of that, Peak Revie is located near one of the best ski hills on the continent. It could not be more perfect.

Kelvin: The opportunity does sound interesting, but this hotel lacks any kind of historical appeal.

That said, one thing I like about this proposal is the hotel's proximity to the ski hill. As we have seen, the unique experiences that we offer our guests have quickly become a major competitive advantage for us. After we purchased the stake in TMSR and began to offer skiers a discounted rate at our Canmore hotel, the occupancy rate increased nicely. In fact, an obvious new key success factor is having activities affiliated with our hotels. Our guests love receiving discounts!

However, we need to analyze whether this opportunity makes sense on a stand-alone basis. What is it going to cost? And how much of an upfront cash investment is required?

Jessica: I have compiled the details of the opportunity.

Derek: Next, Alyson, please tell us about the recent development at HHH.

Alyson: HHH is about to go up for sale. Martha is overwhelmed and is ready to move on. She is asking \$25 million for all the outstanding shares of HHH and is giving us the first opportunity to purchase the hotel.

Kelvin: I do not see HHH fitting with our brand as it is clearly not a boutique hotel. The building does not have any historical or artistic appeal. Besides, competition has only become fiercer in that market and occupancy rates are declining.

Alyson: That is true, but HHH is in a popular area of downtown Vancouver, and we do not yet have a presence in an urban core. This is our chance to increase our brand visibility. It would be fantastic for DHC. It is almost impossible to find a historical building for sale in any city's core.

APPENDIX I (continued)
TRANSCRIPT OF PREVIOUS BOARD MEETING

Alyson: Also, Martha has offered us an attractive transition plan where she only requires a 20% cash down payment and will provide financing for the remainder.

Derek: Once rebranded, this hotel would fit perfectly into the Western Corridor. Being directly linked to our other hotels will surely increase the financial performance of HHH. Remember, guests will be transported from one hotel to the next.

Kelvin: DHC cannot accept any strategic proposal simply because it fits into your Western Corridor idea, Derek.

Derek: Kelvin, try to see the big picture. The Western Corridor would boost the occupancy rates at each of our hotels because we will offer vacation packages that include multiple hotels with a variety of experiences. The Western Corridor would be a huge competitive advantage for us.

Let's have Irene's team look at the potential HHH purchase.

Alyson: Moving on, Derek, tell us more about the Tofino castle.

Derek: Thanks, Alyson. We have been given a once-in-a-lifetime opportunity to acquire a historical castle in one of the most beautiful parts of Canada. I have put together some information, as well as an income projection. Not only would this property set us apart from the competition, it would also complete the Western Corridor in spectacular fashion.

Alyson: I understand that the property is oceanfront. There would be an abundance of hotel-affiliated activities that we could offer, such as whale watching and sea kayaking. This does seem like an opportunity to be seriously considered.

Jessica: From your report, Derek, it seems that some Tofino residents are unhappy that the castle has gone up for sale.

Derek: Yes, and there is also a fast-growing petition on social media to have the castle designated as a national historic site. The petitioners claim that converting the castle to a for-profit hotel would be against the public interest and that the castle should belong to the community. They have also threatened further action. We need to move fast on this before the petitioners get their wish.

Kelvin: What is the asking price?

APPENDIX I (continued)
TRANSCRIPT OF PREVIOUS BOARD MEETING

Derek: Unfortunately, the price is high. We could only afford it if we sell another property. Given the bad publicity in Eastern Canada, Cape Breton makes the most sense. The Cape Breton hotel is our only remaining hotel in Eastern Canada, and needs a large renovation. Thankfully, based on a preliminary assessment, the selling price of the Cape Breton hotel would be roughly the same as the purchase price of the Tofino castle.

Kelvin: We need to slow down here. I do not think that selling the Cape Breton hotel makes much sense, especially since the hotel's renovation has already been planned and is set to begin shortly.

Alyson: It is true that this hotel has struggled in the past few years.

Kelvin: Agreed, but with this renovation, which is long overdue, its performance will improve. Once completed, Cape Breton will easily be one of the best hotels in that area.

Speaking of renovations, do we have any idea what it would cost to convert the Tofino castle into a hotel?

Derek: I estimate it will cost \$20 million. Also, H&A bank has agreed to transfer the debt secured by the Cape Breton hotel to the castle.

Kelvin: We know that renovating antique structures is always a major challenge, especially the initial conversion. It will be very difficult for me to create a realistic renovation budget before we complete a full structural assessment. It is impossible to know what kind of potential issues we might find without this kind of analysis.

Derek, I looked at your earnings projection for the Tofino hotel and added some notes. I am not sure about the accuracy of some of your assumptions.

Jessica: Also, before we make any decisions, we need to ensure that each project makes sense for DHC on a stand-alone basis.

APPENDIX I (continued)
TRANSCRIPT OF PREVIOUS BOARD MEETING

Kelvin: I have also compiled more information on the Cape Breton property. For now, we will assume that the proceeds from the potential sale of Cape Breton would be sufficient to purchase the castle in Tofino. Irene, with that assumption in mind, please get your team to provide a complete analysis of both the castle in Tofino and the Cape Breton hotel, and recommend which of the two properties fits best with DHC.

Derek: I still think we should sell Cape Breton and pursue the Western Corridor. We would save money by having all our properties close to each other and would also be able to escape the bad press that we have endured in Ontario and Quebec. Although it has not happened yet, the Cape Breton hotel could easily be hurt by Doug's actions.

Jessica: Your Western Corridor idea is great, Derek, but we cannot abandon Eastern Canada on a whim. Sure, we only have one property there now, but more opportunities are bound to arise in the future.

Kelvin: I spoke with a local public relations firm, Camden and Co., and they have offered to represent DHC to combat the negative perception Doug has generated. They are confident that they can quickly repair the damage done. Camden and Co. have a high success rate and have agreed to charge us \$120,000 for the engagement.

Derek: That seems like a huge waste of money to me, especially given our opportunities out West. Let us not forget our core value of embracing new ideas and change!

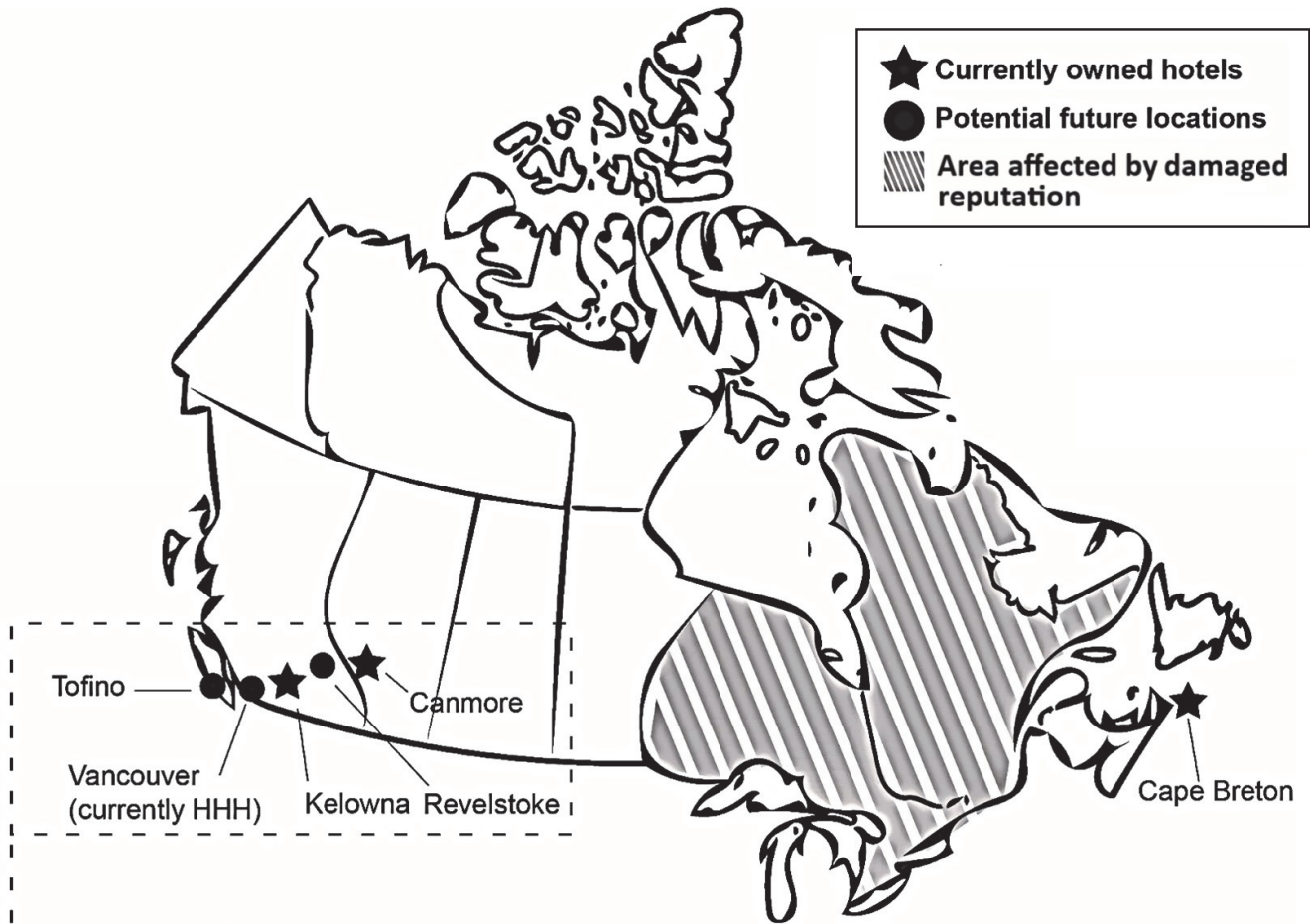
Kelvin: Along with the potential impact on our ADR and occupancy rate, I would also like to know what kind of rate of return DHC could expect on each of these possible investments.

Irene, could your team analyze these proposals for us? We obviously need an impartial assessment.

Irene: Gladly.

Derek: Thank you. Meeting adjourned.

**APPENDIX II
MAP OF CURRENT AND POTENTIAL FUTURE OPERATIONS**



The Western Corridor - from the peak of the Rockies to the shore of the Pacific

Driving distance and time between locations in the proposed Western Corridor are as follows:

Locations	Distance	Travel Time
Canmore to Revelstoke	300 kilometres	3.5 hours
Revelstoke to Kelowna	200 kilometres	2.5 hours
Kelowna to Vancouver	390 kilometres	4.5 hours
Vancouver to Tofino	280 kilometres	5.5 hours (including ferry to Vancouver Island)

**APPENDIX III
PERFORMANCE METRICS**

	DHC (Note 1)		Boutique Hotel Benchmarks	
	2022	2019	2022	2019
Total rooms available	525	760	N/A	N/A
Occupancy rate (Note 2)	75%	70%	77%	78%
Average daily rate (ADR)	\$425	\$400	\$375	\$335
Revenue per available room	\$319	\$280	\$289	\$261

Notes:

1. Excludes the rooms at HHH, which are currently managed by DHC.
2. The occupancy rates at both the Canmore and Kelowna hotels increased when each hotel was formally marketed with its hotel-affiliated activity (TMSR for Canmore, and the semi-private golf course for Kelowna); Canmore hotel's rate rose by 10% whereas Kelowna's rose by 8%.

APPENDIX IV
PEAK REVIE HOTEL PROPOSAL
(Prepared by Jessica Sterne)

Performance Metric Data

	Projected First Year Metrics if Acquired by DHC	2022 (Actual)
Total rooms available	150	150
Occupancy rate (Note 1)	73%	63%
Average daily rate (ADR)	\$395	\$380
Revenue per available room	\$288	\$239

Note 1 – The 10% projected increase is based solely on converting Peak Revie to a DHC hotel.

Proposal Details

Peak Revie has 150 guest rooms and is rated as a five-star hotel. Amenities include a full-service restaurant, fitness facility, pool, etc. The hotel was built in 1992 and was last renovated in 2016. It is located only five kilometres from the ski hill, which is not directly affiliated with the hotel.

Reviews for Peak Revie have been very positive, both online and in the community. As many guests return year after year to see friends and ski the nearby mountain, customer retention is high. In 2022, the hotel's profit margin was equal to 8% of room revenue.

Important aspects of the proposal are as follows:

- For a \$3.5 million upfront cash investment, DHC will receive 35% of the outstanding common shares of the business. Currently, Miranda is the sole owner, with 100% of the common shares.
- All future renovation and improvement costs will be divided according to ownership percentages.
- DHC can use Peak Revie's fleet of transportation vans for other operations and hotels.
- The hotel will be rebranded as a DHC hotel; however, no licensing fees will be paid.
- DHC will be responsible for managing the hotel. A management fee equal to 10% of the gross profit generated by the hotel operations will be paid quarterly to DHC.
- DHC will be responsible for marketing the hotel.
- Miranda will retain the right to sell her shares to other parties; however, no new shares will be issued.
- All major decisions will require the unanimous support of the shareholders. Any disputes between shareholders will be resolved through an independent arbitration process.

APPENDIX V
PROPOSAL TO PURCHASE HURON HEIGHTS HOTEL
(Prepared by Jessica Sterne)

Performance Metric Data

	<u>2022 (Actual)</u>
Total rooms available	170
Occupancy rate	68%
Average daily rate (ADR)	\$325
Revenue per available room	\$221

Additional Information

- In 2022, HHH had net earnings of \$2.1 million, cash flow from operations of \$2.4 million, and a profit margin of 7%.
- The debt component of the proposal would have an interest rate of 5% and a term of 12 years.
- 17 years remain on DHC's existing management agreement with HHH.
- The management contract with HHH has been successful; however, without 100% control over HHH, to date, the management of it has been challenging. Working with Martha has hindered the decision-making process.
- The hotel currently does not have any affiliated activities. However, given HHH's location, there are an abundance of activities near the hotel. Moreover, there are several golf courses within an hour's drive, and a famous ski hill is within a two-hour drive.
- Competition in major metropolitan areas has increased in recent years as new hospitality companies have entered the market. This trend is expected to continue.
- Given that DHC manages the hotel, the quality of service meets the company's high standards.
- Currently, 70% of HHH guests are business travellers.

APPENDIX VI
PROPOSAL TO PURCHASE TOFINO HISTORICAL CASTLE
(Prepared by Derek Sterne)

Projected Performance Metric Data

	Year 1 of Operations (Projected)
Total rooms available	105
Occupancy rate	85%
Average daily rate (ADR)	\$600
Revenue per available room	\$510

	Annual Earnings (Projected)	Notes
Revenue		
Room revenue	\$19,545,750	Hotel to be open 365 days per year 60% of room revenue
Food and beverage	11,727,450	
Total revenue	31,273,200	
Expenses		
Room operating costs	10,750,163	55% of room revenue
Food and beverage costs	8,795,588	75% of food and beverage revenue
Other variable costs	5,316,444	17% of total revenue
Fixed costs	2,500,000	
Total operating costs	27,362,195	
Operating income	3,911,005	
Tax (27%)	1,055,971	
Net earnings	<u>\$2,855,034</u>	
Profit margin	9%	

Additional Information

- The castle was featured in *Classic Canada* magazine. According to the magazine, the building and surrounding area meet the requirements to be designated as a national historic site.
- Celebrities and British royals have stayed at the castle in the past.
- If acquired by DHC, the property will be closed to the general public as too many visitors will disrupt guests. Only DHC's guests will be allowed on the property.

APPENDIX VII
NOTES ON PROPOSAL TO PURCHASE THE TOFINO CASTLE
(Prepared by Kelvin Chung)

- The structure was never meant to be divided into individual rooms, so 105 rooms may be overly optimistic. As it will be a challenge to effectively divide the space, 95 rooms is likely more realistic, but there is a chance it could be even fewer.
- An 85% occupancy rate seems high—why would this hotel’s occupancy rate exceed DHC’s average occupancy?
- At an ADR of \$600, we would be charging our customers a large premium relative to the industry.

APPENDIX VIII
INFORMATION ON CAPE BRETON HOTEL AND UPCOMING RENOVATION
(Prepared by Kelvin Chung)

Performance Metric Data

	<u>2022 (Actual)</u>
Total rooms available	165
Occupancy rate	66%
Average daily rate (ADR)	\$390
Revenue per available room	\$257

2022 Annual Earnings

	<u>Pre-renovation Actuals</u>	<u>Notes</u>
Revenue		
Room revenue	\$15,501,915	Hotel is open 365 days per year
Food and beverage	8,526,053	55% of room revenue
Total revenue	<u>24,027,968</u>	
Expenses		
Room operating costs	7,905,977	51% of room revenue
Food and beverage costs	5,882,977	69% of food and beverage revenue
Other variable costs	4,565,314	19% of total revenue
Fixed costs	2,500,000	
Total operating costs	<u>20,854,268</u>	
Operating income	3,173,700	
Tax (27%)	<u>856,899</u>	
Net earnings	<u><u>\$2,316,801</u></u>	
Profit margin	10%	

Additional Information

- This hotel was last renovated in 2014. Therefore, the rooms and decor are outdated, causing the hotel to underperform.
- The renovation will cost \$12 million, based on a negotiated, fixed-price contract.
- After renovation, the occupancy rate of the hotel is expected to be in line with DHC's 2022 averages, but it may take a few years before the ADR reaches DHC's average.
- Although DHC and Patrick have discussed a formal agreement that would provide DHC's hotel guests with preferred rates at Patrick's Nova Scotia golf courses, an agreement has yet to be reached.

APPENDIX C

**SEPTEMBER 14, 2021 – DAY 2
SIMULATION AND MARKING GUIDES**

**COMMON FINAL EXAMINATION
SEPTEMBER 14, 2021 – DAY 2**

Case

Assume the pre-selected role in which you will be formulating your response. Answer all requireds as specifically directed in your role. Within the requireds for each role, candidates are directed to look at specific additional appendices, which are unique to each role. Use only the information you have been directed to refer to.

Information that is shared by all roles is presented in the “Common Information” section. Additional information, customized to each role, is presented in the “Specific Information” section.

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**BACKGROUND
COMMON INFORMATION FOR ALL ROLES**

Farm Fresh to You Inc. (FFTY), a Canadian-controlled private corporation founded in 2010 by Scott McMaster and Antonia Lee, is a grocery store chain specializing in locally-produced, farm fresh foods. Having both previously worked for a nationwide grocery chain, Scott and Antonia saw an unmet demand and opened their first FFTY location in Toronto in 2010. Currently, FFTY has nine corporate-owned stores in Ontario. It also has two franchised stores in Ontario, both opened in 2020. Both franchisees are former managers of FFTY stores.

Scott and Antonia each own 50,000 of FFTY's 100,000 outstanding common shares. Scott is the chief executive officer and Antonia is the vice-president, finance and real estate.

FFTY's Board of Directors (board), which met once last year to approve the audited financial statements, is comprised of three directors: Scott, Antonia, and Michelle Walker, FFTY's vice-president, franchising operations. The management committee, made up of the three directors plus Dennis Mitchell (vice-president, corporate-owned stores) and Laura Zhang (controller), meets regularly to review the actual and budgeted statements and make operational decisions.

FFTY plans to grow significantly through franchising. Michelle was hired in September 2020 to manage and expand the franchising operations. Michelle has extensive experience with grocery store franchises and has suggested several changes and hired additional accounting staff.

Today is February 19, 2021. FFTY reports under ASPE, and its December 31, 2020 financial statements have not yet been finalized.

Additional information, customized to your role, is presented in your role package.

REQUIREMENTS FOR YOUR ROLE
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)

ASSURANCE REQUIREMENTS

You, CPA, work as an audit manager at Crawford & Powell LLP (Crawford), FFTY's external auditor, and report directly to Shelley Winters, the audit partner. Shelley recently met with Scott and Antonia to discuss several issues.

Shelley asks you to address the FFTY management committee's requests from their most recent meeting. Shelley has already dealt with any independence and conflict-of-interest considerations.

Also, Shelley asks you to prepare the audit plan for the 2020 year-end audit, and the audit procedures for any accounting issues you identify.

Antonia informed Shelley of payroll problems at one of the stores. Shelley asks you to review the store's summary wage report, and recommend audit procedures that should be performed on any significant changes during the year and any anomalies you identify.

In early 2020, FFTY signed a new lease agreement with SMT Enterprises Inc. (SMT), for three stores. The agreement requires independent verification of the annual statement of gross sales, which Antonia has asked Crawford to provide. Shelley asks you to discuss the various reporting options available for this engagement, and the procedures that would need to be performed for the recommended report.

In 2020, FFTY installed self-checkouts in three stores. As the systems are new, Shelley wants you to assess the related internal controls for weaknesses and recommend improvements.

FFTY has prepared a disclosure document for potential franchisees, which will include the audited financial statements. FFTY has asked for consent to include Crawford's audit report in the disclosure document. Given that Crawford will be associated with the disclosure document, Shelley asks you to perform the appropriate audit procedures on the document, and discuss what additional information may be needed to perform the procedures.

In addition to the common appendices (I to VI), information provided in Appendix VII (Assurance) is relevant for your analysis.

REQUIREMENTS FOR YOUR ROLE
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)

FINANCE REQUIREMENTS

You, CPA, work as a financial analyst at Crawford & Powell LLP (Crawford) in the finance consulting division, and report directly to Hans Meindl, a partner. Hans recently met with Scott and Antonia to discuss several issues.

Hans asks you to address the FFTY management committee's requests from their most recent meeting.

Also, the MG Bank long-term debt comes due in June 2022. To eliminate their personal guarantees, Scott and Antonia plan for FFTY to repay the loan early and replace it with alternative financing. FFTY is therefore seeking \$50 million in financing. There have been discussions with Kings Bank and a private investor. FFTY would like a comparison of the two financing alternatives, including the impact on annual cash flows, and a recommendation.

FFTY wants to pilot a project that will offer home delivery of freshly prepared meals, using its own vehicles and staff. Laura and Antonia have estimated the delivery service's costs and revenue. Hans asks you to prepare a quantitative analysis, and to recommend whether FFTY should proceed.

Antonia would like an estimate of FFTY's weighted average cost of capital. You are told to assume that FFTY's equity has a fair value of \$30 million.

FFTY plans to purchase equipment from a U.S. supplier, for delivery in October 2021. Hans asks you to discuss the three proposed alternatives for hedging the equipment purchase, determine the final cost of the equipment under each alternative, and recommend the best option.

FFTY has excess funds available from a 2020 property sale, which will only be used in 12 to 15 months from now to fund the anticipated expansion costs. Scott and Antonia have different views on how to invest these funds in the interim. Hans asks you to discuss the company's investment objectives, review the current investment, and to recommend changes, if any, to the investment mix.

Antonia is concerned about the financial viability of Franchisee #1 because it is behind in its payments to FFTY. Antonia asks you to review their financial statements, assuming that there are no accounting issues, evaluate their financial health, and recommend ways that FFTY could avoid similar situations with future franchisees.

REQUIREMENTS FOR YOUR ROLE
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)

FINANCE REQUIREMENTS (continued)

A warehouse manager received a proposal from Logistics Inc. (Logistics), a warehousing and distribution service provider. Hans wants to understand the impact of accepting the proposal on working capital and net warehouse costs, and asks you to recommend whether FFTY should accept the proposal.

In addition to the common appendices (I to VI), information provided in Appendix VII (Finance) is relevant for your analysis.

REQUIREMENTS FOR YOUR ROLE
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)

PERFORMANCE MANAGEMENT REQUIREMENTS

You, CPA, work at Crawford & Powell LLP (Crawford) in the management consulting division, and report to Larry Osbourne, a partner. Larry recently met with Antonia and Scott to discuss several issues.

Larry asks you to address the FFTY management committee's requests from their most recent meeting.

Also, both Scott and Antonia want to better understand FFTY's position in the industry. They would like you to perform a SWOT analysis, clearly explaining a few of the most relevant considerations for each element of the SWOT.

Antonia thinks FFTY's current vision and mission statements are outdated. With franchising in mind, Larry asks you to review them and suggest changes. He also asks you to prepare a list of core values, which FFTY has never had before.

FFTY is considering offering home delivery of freshly prepared meals to either seniors or millennials. Larry asks you to calculate the cash flows, perform a qualitative analysis of the proposal for each market segment, and provide a recommendation.

Antonia would like you to identify which type of responsibility centre each of the four specific departments is, and discuss how each department's performance should be evaluated. She would also like your opinion on how the performance bonuses are currently determined for Dennis and Michelle.

Scott needs assistance evaluating the performance of two of the corporate-owned stores that are underperforming. Larry asks you to identify the causes of each store's low operating income, and recommend ways to improve their performance.

Antonia has been working with Riverside Dairy Company (Riverside) to secure a long-term supply contract. Larry would like a quantitative and qualitative analysis of the proposed contract.

In her previous job, Michelle successfully implemented a customer loyalty program and has suggested that FFTY do the same. Larry would like a quantitative and qualitative analysis of the proposed program for the corporate-owned stores.

In addition to the common appendices (I to VI), information provided in Appendix VII (Performance Management) is relevant for your analysis.

REQUIREMENTS FOR YOUR ROLE
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)

TAXATION REQUIREMENTS

You, CPA, work at Crawford & Powell LLP (Crawford) in the tax group, and report to Thomas, a partner. Thomas recently met with Antonia and Scott to discuss several issues.

Thomas asks you to address the FFTY management committee's requests from their most recent meeting.

In addition to those requests, Antonia and Scott would like to better understand FFTY's taxes and have asked for a supported calculation of taxable income and taxes payable for 2020, based on the revised net earnings. Thomas asks you to prepare these calculations.

You do not need to prepare the financial reporting entries for current and future taxes payable, but Thomas wants to know the ending undepreciated capital cost balances so he can prepare the entries later.

Since FFTY may pay dividends in future, Thomas asks you to explain what the RDTOH and capital dividend accounts are, and calculate FFTY's balances at January 1, 2021.

In 2020, FFTY was assessed interest and penalties on income taxes for 2019. Antonia wants to know why. Recently, Laura informed Antonia that the company only made two instalments in 2020. Thomas asks you to calculate the corporation income tax instalments that should be paid for 2021. Antonia would also like guidance on how to ensure that tax payments are made on time from now on.

Antonia's husband Ross, as well as Scott, each want to borrow funds from FFTY, and some terms have been drafted. Thomas asks you to comment on the tax implications of these loans.

Some employees are suggesting that FFTY provide them with certain benefits. Thomas asks you to comment on the tax implications of these benefits, from both the employees' and FFTY's perspective.

Antonia just learned the GST/HST return for January 2021 has not yet been completed. Thomas asks you to estimate the GST/HST balance payable for January and explain how it was calculated. Thomas would also like an explanation of any GST/HST implications for FFTY for each of the suggested employee benefits.

In addition to the common appendices (I to VI), information provided in Appendix VII (Taxation) is relevant for your analysis.

APPENDIX I – COMMON BACKGROUND INFORMATION

FFTY currently owns two warehouses and the buildings for two of its stores. It leases its other seven store locations. FFTY's stores are about 28,000 square feet each, which is smaller than many competitors' stores.

FFTY's success is attributed to having recognized early and capitalized on the emerging trend of healthy eating. FFTY also offers customers a unique experience by having friendly, knowledgeable staff and a variety of food-tasting stations. Because its stores have a reputation for superior freshness and cleanliness, FFTY's brand is well recognized in southern Ontario. Unlike some of its competitors, FFTY does not have a seating area for customers to consume food purchased in the store.

FFTY's focus is on whole (unprocessed or minimally refined) foods. The product mix in each store, on average, consists of: 75% perishable products, such as fruit and vegetables, dairy and meat; 15% non-perishable products, such as canned and dry goods; and 10% freshly prepared, hot and cold food.

FFTY differentiates itself by ensuring that at least 60% of all products are locally sourced. About 10% of all products are purchased from the U.S. The value of the Canadian dollar has been deteriorating relative to the U.S. dollar for the past six months, and this is expected to continue.

About 30% of FFTY's perishable products are organic. FFTY recently signed contracts with some of its key suppliers for one or more years, ensuring a reliable supply of whole and organic foods. Some of the contracts require minimum purchase volumes.

FFTY's prices are 5% higher than national chain prices; its customers are willing to pay a premium for locally produced, whole foods. Unless offering temporary discounts, which are usually on non-perishable products, FFTY tries to keep prices for most items stable throughout the year. To date, the company has no customer loyalty program and does not sell any items under an FFTY label.

**APPENDIX II – COMMON
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Farm Fresh to You Inc.
Statement of Earnings
For the years ending December 31
(in thousands of Canadian dollars)*

	2020	2019
	Draft	Audited
Sales (net of returns and discounts)	\$ 152,916	\$ 142,148
Franchise fee revenue	598	0
Total revenue	<u>153,514</u>	<u>142,148</u>
Cost of goods sold	86,860	78,078
Direct store costs (Note 1)	7,284	6,907
Sales and marketing	3,240	3,145
Amortization	6,302	6,890
Employee wages and benefits	21,853	20,789
Occupancy costs, including rent	14,170	13,234
General and administration	4,678	4,547
Total operating expenses	<u>144,387</u>	<u>133,590</u>
Operating income	9,127	8,558
Dividend income	85	0
Interest income	10	0
Gain on sale of land and building	4,000	0
Loss on sale of delivery vehicles	(150)	0
Interest expense – long-term debt	(3,520)	(3,940)
Interest expense – line of credit	(42)	(50)
Income before taxes	<u>9,510</u>	<u>4,568</u>
Income taxes	<u>(2,265)</u>	<u>(1,142)</u>
Net earnings	<u>\$ 7,245</u>	<u>\$ 3,426</u>

APPENDIX II – COMMON (continued)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS

Farm Fresh to You Inc.
Balance Sheet
As at December 31
(in thousands of Canadian dollars)

	2020	2019
	Draft	Audited
<u>Assets</u>		
Current assets		
Cash and cash equivalents	\$ 3,899	\$ 678
Accounts receivable (Note 2)	1,147	215
Inventories	6,178	5,735
Prepaid expenses	125	110
Total current assets	11,349	6,738
Property, plant and equipment (Note 3)	83,323	91,512
Investment in Leila's Organic Bakery	1,907	0
Total assets	\$ 96,579	\$ 98,250
<u>Liabilities</u>		
Current liabilities		
Line of credit (Note 4)	\$ 1,480	\$ 642
Trade payables and accrued liabilities	10,586	10,330
Income taxes payable	1,365	375
Current portion of long-term debt (Note 5)	3,000	3,000
Total current liabilities	16,431	14,347
Long-term debt (Note 5)	50,170	61,170
Total liabilities	66,601	75,517
<u>Shareholders' equity</u>		
Share capital	2,500	2,500
Retained earnings	27,478	20,233
Total shareholders' equity	29,978	22,733
Total liabilities and shareholders' equity	\$ 96,579	\$ 98,250

APPENDIX II – COMMON (continued)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS

Notes (in thousands of Canadian dollars):

1. Direct store costs include distribution, shipping, shelving and display, training and promotions. Promotions include weekly flyers, emails to customers, and weekly, in-store promotions.

2. Accounts receivable:

	2020	2019
Franchisees – monthly royalty fees	\$ 150	\$ 0
Franchisees – inventory sales	656	0
Vendor rebates	341	215
	\$ 1,147	\$ 215

3. Property, plant and equipment:

	Land	Buildings	Furniture and Fixtures	Delivery Vehicles	Leasehold Improvements	Total
Carrying amount Jan 1, 2020	\$5,170	\$39,390	\$26,012	\$250	\$20,690	\$91,512
Additions			4,063		5,300	9,363
Amortization		(2,980)	(1,542)		(1,780)	(6,302)
Disposals (Note a)	(1,400)	(9,600)		(250)		(11,250)
Carrying amount Dec 31, 2020	\$3,770	\$26,810	\$28,533	\$ 0	\$24,210	\$83,323

Note a – FFTY sold land and a building to Retail Properties REIT (REIT) for total proceeds of \$15,000. The original cost of the land and building was \$1,400 and \$12,560, respectively. The gain on the sale was \$4,000.

FFTY also sold all its delivery vehicles for \$100. The net loss on the sale was \$150.

FFTY amortizes assets on a straight-line basis over their useful lives, with monthly amortization beginning in the month of purchase.

APPENDIX II – COMMON (continued)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS

Notes (*in thousands of Canadian dollars*) (continued):

4. The line of credit with MG Bank is secured by inventory. Interest is at prime (currently 3%) plus 1%. Effective January 1, 2021, the bank increased the limit from \$1,500 to \$3,000.
5. The long-term debt with MG Bank is secured by land, buildings and equipment, and personal guarantees from the shareholders. The loan is repayable in annual principal payments of \$3,000 and bears interest at 6%. Additional principal can be repaid without penalty. Using proceeds from the sale to REIT, FFTY paid off an additional \$8,000 during the year.

**APPENDIX III – COMMON
EXCERPTS FROM MANAGEMENT COMMITTEE MEETING
FEBRUARY 17, 2021**

Attendees: Scott McMaster, Antonia Lee, Michelle Walker, Laura Zhang, Dennis Mitchell

Scott: Before finalizing the draft 2020 financial statements, we need Crawford to review the accounting treatment for some transactions. Where possible, we want to maximize our net income. Let's start with the investment in Leila's Organic Bakery (LOB).

Antonia: Leila Qureshi, the sole shareholder, asked us to invest in LOB, one of our organic, fresh, and frozen bread suppliers. On September 1, 2020, FFTY invested \$1,907,000 for 18% of the outstanding common shares. The agreement states that LOB will pay FFTY at least 5% in dividends annually, and grants me a seat on its board.

Scott: If I remember correctly, only Leila, one other person, and you sit on the board. How have we accounted for our ownership in LOB and how is its performance?

Laura: The \$1,907,000 has been recorded on the balance sheet as an investment. The \$85,000 in dividends that we received in 2020 has been recognized as income.

LOB's net income from September 1 to December 31, 2020, was \$1.25 million. FFTY represents about 30% of LOB's annual revenues. At the end of December, there was no inventory from LOB on hand.

Michelle: We signed two franchise agreements in 2020 (Appendix IV). Laura, how have the revenues from these franchisees been recognized?

Laura: The initial fees, optional services fees, and monthly royalty fees are included in franchise fee revenues as they are received.

Scott: On September 1, 2020, FFTY sold the land and building from its head office to REIT for their fair market values of \$1.5 million and \$13.5 million, respectively. The building had an estimated remaining economic life of 25 years. On that same date, FFTY entered a 20-year lease arrangement with REIT. We got a great deal—the present value of the minimum lease payments is \$13,958,077 using our incremental borrowing rate. Laura, how have you reported this sale and the total lease payments of \$400,000 that we have paid up to year-end?

APPENDIX III – COMMON (continued)
EXCERPTS FROM MANAGEMENT COMMITTEE MEETING
FEBRUARY 17, 2021

- Laura: The lease payments made to REIT have been included in rent expense. The gain has been recognized as income.
- Scott: How did you account for our exchange with Design Webmasters Corp. (DWC)?
- Laura: We provided DWC with freshly prepared foods that we could normally sell to customers for \$290,000. This was a great deal because DWC provided us with an estimated \$310,000 in web design services. I therefore made an adjustment to increase sales, and sales and marketing expenses, by \$310,000.
- Scott: Let's discuss our proposal for selling organic wines.
- Laura: I gathered information on selling prices and costs (Appendix V). Crawford will help us determine the breakeven number of bottles to be sold.
- Michelle: How is the 2021 operational plan coming along?
- Antonia: We had an employee, Jim, prepare some charts and graphs to help us identify relevant considerations for this year's plan (Appendix VI).
- Michelle: Sounds like a good start. Let's ask Crawford to look at Jim's summary, analyze the data, and provide us with any recommendations they have for improving our operating profits.

APPENDIX IV – COMMON FRANCHISE INFORMATION

The standard franchise agreement, which is not expected to change in the next few years, is for 10 years, with a renewal option for an additional 10 years. The franchisee is a distinct corporation, in which FFTY has no ownership, and that operates independently of FFTY.

Fees

Each franchisee pays a non-refundable, initial fee of \$140,000, due on signing the agreement. This fee covers assistance with initial setup of the store, upfront training, and an operations' manual, all provided in the two-week period prior to the store opening date.

Optional services, including record keeping, administration, and IT support, commencing when the store opens, can also be obtained by the franchisee for the first six months, for a payment of \$60,000.

The franchisee also pays monthly royalty fees of 5% of the franchise's gross sales to FFTY for the right to use the FFTY brand name. These royalties accrue when sales are recognized by the franchisee and are payable to FFTY within seven days following the month to which they relate.

Franchises Opened to Date

	Franchisee #1	Franchisee #2	Total
Date contract signed	July 1, 2020	August 1, 2020	
Date store opened	November 1, 2020	December 1, 2020	
Initial franchise fee collected	\$140,000	\$140,000	\$280,000
Optional services fee collected	\$60,000	\$60,000	\$120,000
Sales from store opening to December 31, 2020	\$2,256,000	\$1,700,000	\$3,956,000
Monthly royalty fees (5%)	\$112,800	\$85,000	\$197,800
Monthly royalty fees receivable as at December 31, 2020	\$65,300	\$85,000	\$150,300

APPENDIX V – COMMON ORGANIC WINE PROPOSAL

FFTY conducted a survey, costing \$23,000, to determine whether to sell organic wines in its stores. The survey results indicated that for every bottle of organic wine purchased, people will also purchase organic cheese, for an additional average contribution margin of \$0.75.

FFTY would operate an organic wine boutique within each of its stores, and sell the producers' organic wines at two price points.

The expected sales mix is as follows:

Bottle Price	Percentage of Sales	Direct Cost of Wine
\$15.00	40%	65%
\$25.00	60%	60%

Shipping and distribution costs are \$19.80 for a 12-bottle case. FFTY will purchase, for \$3 million, shelving that is expected to last for 10 years.

The other annual costs are as follows:

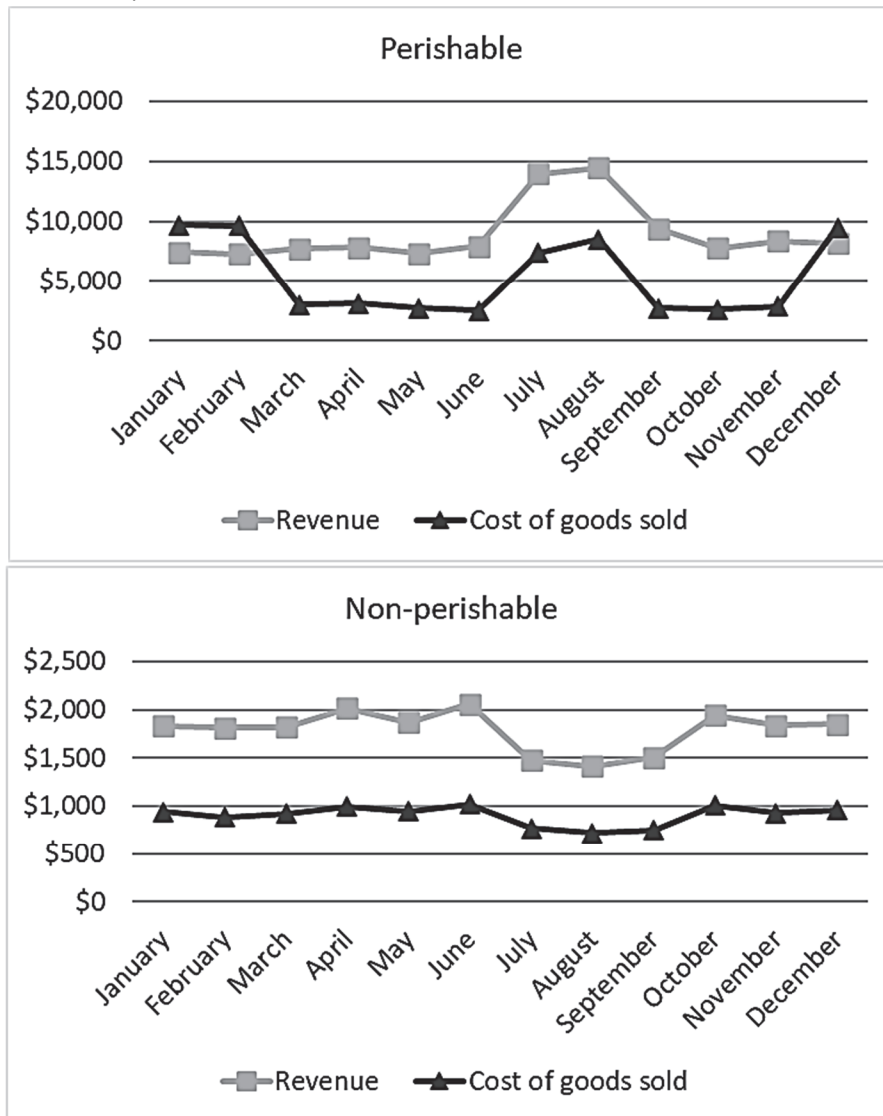
Labour to operate and manage the boutique, including \$40,000 for the current administrative staff's wages	\$450,000
Marketing costs for print and electronic media	\$280,000
Supplies	\$180,000
Warehousing costs for volumes less than 200,000 bottles (Note 1)	\$300,000
Occupancy costs (portion related to space occupied by the boutique)	\$25,000

Note 1 – If volumes are greater than 200,000 bottles, the cost is \$400,000.

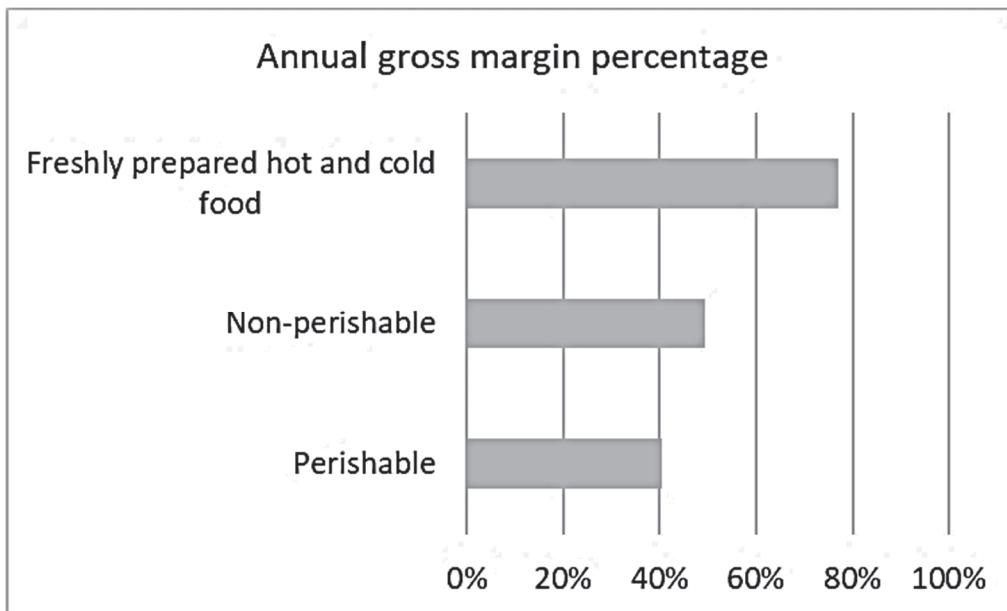
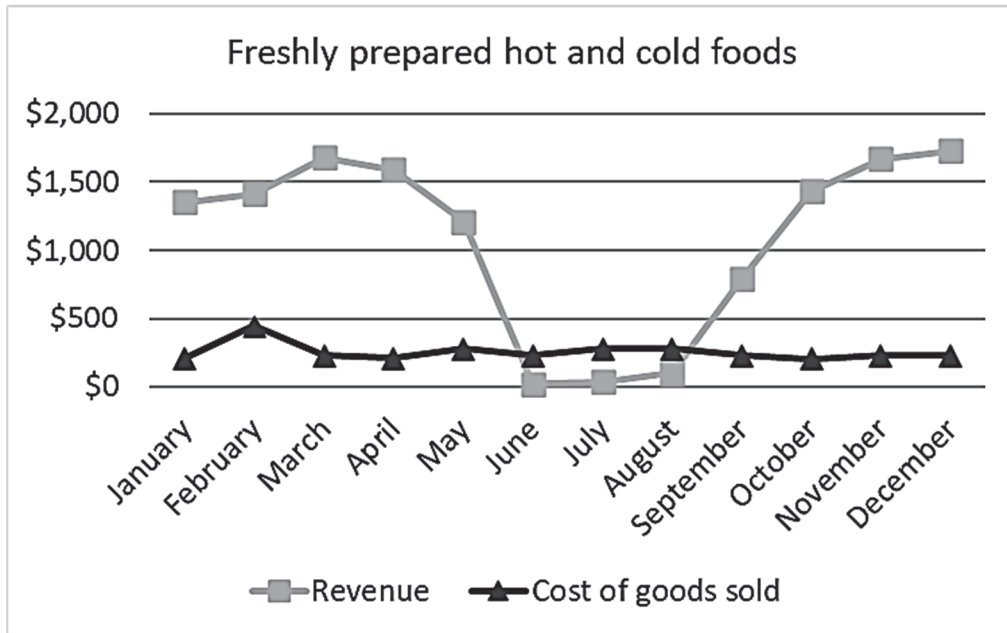
**APPENDIX VI – COMMON
2021 OPERATIONAL PLAN – RELEVANT INFORMATION**

Being quite unique, FFTY cannot be compared to its competitors. Therefore, Jim only used internal data. Since the 2020 audit has yet to be completed, his main source of data was the 2019 accounting system records. To minimize the sources of data, the only other information Jim gathered was from a spreadsheet that tracks spoilage. Whenever employees throw out spoiled or expired items, they document on the spreadsheet, which is accessible by all stores, the date, item, product number and amount thrown away. Jim was surprised that this information was available; when he toured one store last month, he saw several employees throw items away and continue their work. He did not see them write anything down and there was no computer available for employees to record this information.

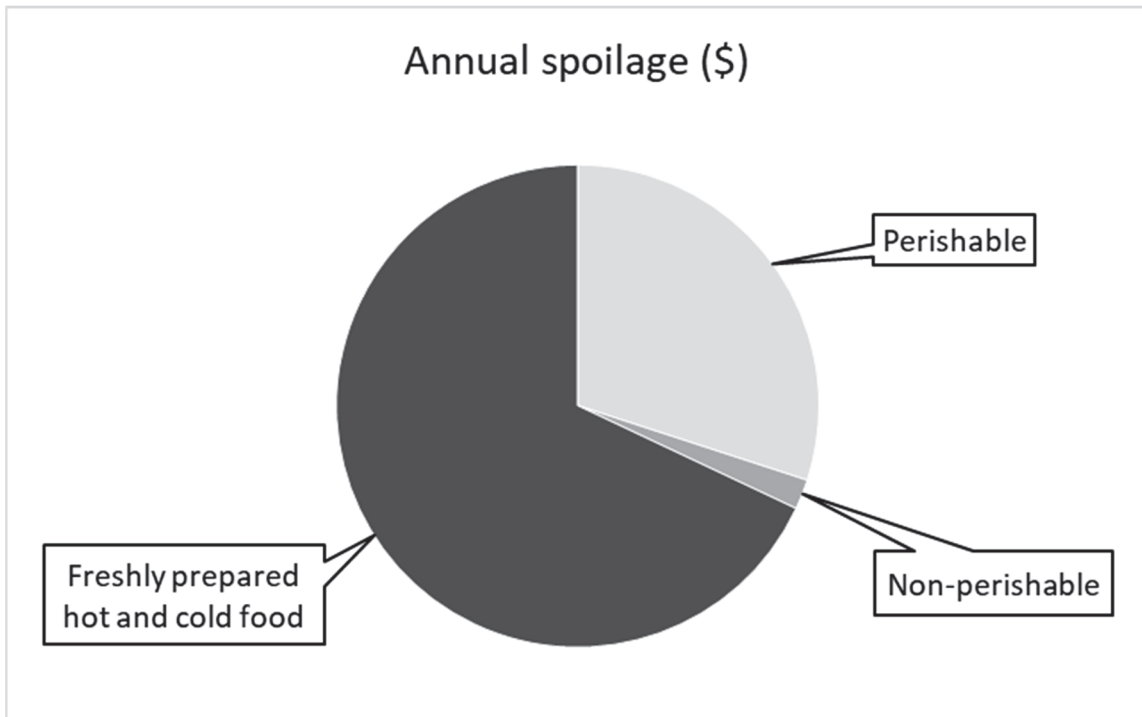
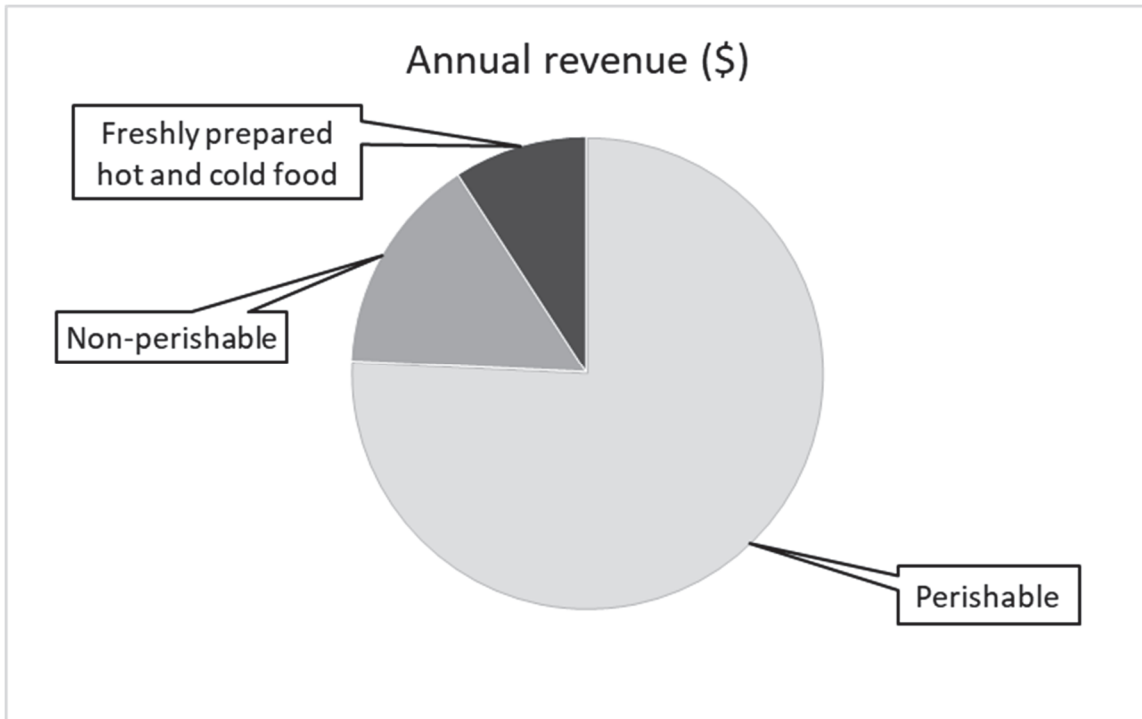
Jim prepared the following summary related to revenues, gross margins, and spoilage (*in thousands of dollars*):



APPENDIX VI – COMMON (continued)
2021 OPERATIONAL PLAN – RELEVANT INFORMATION



APPENDIX VI – COMMON (continued)
2021 OPERATIONAL PLAN – RELEVANT INFORMATION



***ASSURANCE ROLE
ADDITIONAL INFORMATION***

**APPENDIX VII – ASSURANCE
ADDITIONAL INFORMATION**

Wage Report for Store #3004

Employees fill out daily timesheets, which are approved by the store manager. The information is entered at the store and then electronically transferred to head office where the weekly payroll report for hourly employees is prepared. This report is also approved by the store manager.

The hourly pay for employees ranges from \$15 to \$20 and employees' weekly hours range from 20 to 25, with a maximum, as per FFTY policy, of 40 hours.

The summary wage report for Store #3004, which excludes management salaries, is as follows:

2020	Number of Hourly Employees Paid per Month	Average Number of Hours per Employee per Week	Average Hourly Pay per Employee	Total Gross Pay	Total Net Pay	% of Net to Gross Pay
Jan.	60	20	\$17.00	\$20,400	\$17,340	85%
Feb.	60	22	\$17.10	\$22,572	\$19,186	85%
Mar.	60	25	\$17.30	\$25,950	\$22,058	85%
Apr.	60	45	\$16.90	\$45,630	\$36,504	80%
May	63	20	\$16.40	\$20,664	\$16,738	81%
June	63	22	\$16.50	\$22,869	\$13,950	61%
July	63	11	\$16.70	\$11,573	\$10,416	90%
Aug.	65	20	\$14.65	\$19,045	\$15,998	84%
Sept.	65	22	\$16.80	\$24,024	\$19,940	83%
Oct.	65	20	\$16.90	\$21,970	\$18,675	85%
Nov.	63	21	\$17.10	\$22,623	\$19,004	84%
Dec.	63	46	\$17.00	\$49,266	\$40,891	83%

Lease Agreement

On March 1, 2020, FFTY signed a new lease agreement with SMT. In addition to a fixed payment, FFTY must pay a variable rent of 10% of gross monthly sales that are over a minimum amount. FFTY must provide SMT with a monthly unaudited statement of gross monthly sales, which will specify revenue for each of the three store locations being leased. FFTY will also provide annual statements showing gross sales by month, by store, prepared in accordance with ASPE and verified by an independent CPA. Returns and discounts (defined in the agreement) are to be shown separately.

APPENDIX VII – ASSURANCE (continued)
ADDITIONAL INFORMATION

Self-checkout Process

In September 2020, FTTY started using four self-checkout systems in three of its corporate-owned stores. One attendant is assigned to all four checkouts, to assist with problems and ensure that customers are following the prompts correctly. The attendant has a personalized card that allows access to the system.

At the checkout:

- The customer scans an item, then puts it into a bag that sits on a weigh scale. The system reads the universal product code (UPC) and accesses the price and weight per unit from the database. If there is no UPC, a sticker on the item has the code to be entered by the customer. For items with a sticker (usually items charged by weight), the customer puts them on the scanner, which has a weigh scale, and the system calculates the price to be charged based on the weight and the price from the database. If there is no UPC or code sticker, the customer asks for assistance and the attendant inputs the product code.
- For items with UPC codes, the weight of the bag on the scale is compared to the weight as per the database, and the item description and the price are itemized on the screen. An alert sounds if the weight does not match, and the attendant checks the item and weight to ensure it is accurate. Often, the attendant is too busy and overrides the error without checking.
- If an item is scanned and not put in the bag, the machine prompts the customer to do so.
- The system then asks if the customer wants to scan another item or pay. If paying, the system asks for any coupons, which the customer inserts into the machine. The coupon has a barcode that indicates the item, coupon value and expiry date. If the coupon is valid and is for an item purchased, the coupon value is deducted from the amount owing.
- The customer is then prompted to choose the form of payment (cash, debit or credit card). If the customer removes the bags before paying, an alert sounds to notify the attendant, ensuring that the customer pays.
- Once payment is complete, a numbered sales receipt is printed that details the quantity and price of each item purchased, any coupons used and the total payment amount. The system automatically updates the perpetual inventory system. On exit, the attendant quickly reviews the sales receipt to ensure that the list of purchases is reasonable in comparison to the volume of items in the cart. However, given management has told attendants not to make people wait for this review, it only occurs when the attendant is immediately available.

APPENDIX VII – ASSURANCE (continued)
ADDITIONAL INFORMATION

Self-checkout Process (continued)

At the end of each shift:

- The attendant takes the cash and coupons from the four self-checkouts to the back office.
- In the back office, the attendant counts the cash and prints off the sales report by checkout, which details each individual sale, payment amount and type, value of coupons and the total sales per shift. The total cash received is reconciled to the report. No other verification is performed.
- There is also an exception report produced by the system, which details attendant interventions and the nature of the intervention, such as whether it was a correction or an override; however, it is not reviewed.

Reports:

- A weekly spot check compares the perpetual inventory system report to the actual inventory in the stores, and any discrepancies are investigated. One store manager commented that some items seem to have more discrepancies than others, but could not remember which ones because there is no tracking.
- Pricing changes are made as required and input into the system by the pricing clerk. A price change report is printed weekly, and is reviewed and initialled by the pricing clerk as evidence that the change was made.

APPENDIX VII – ASSURANCE (continued)
ADDITIONAL INFORMATION

Excerpts from Disclosure Document for Potential Franchisees

Disclaimer

The information provided in this report is for potential franchisees only. Crawford & Powell LLP has audited the information included in this report.

Company information

Farm Fresh to You Inc. (FFTY) is a grocery store chain specializing in locally supplied, farm fresh foods and freshly prepared, hot and cold foods. Currently, FFTY has two franchised stores in southern Ontario that began operations in January 2020. The company plans to grow significantly through franchising in the next several years.

FFTY's focus is on fresh, whole foods. The company differentiates itself from other competitors by ensuring that at least 60% of all products are locally sourced and that about 50% of the perishable products are organic.

FFTY's audited 2020 results, which are attached, indicate that total revenues were \$153 million, representing a 10% increase from 2019 and a 15% increase from 2018. Net earnings also jumped up by 111% for 2020, mainly driven by an improvement in gross margins. FFTY has a long-term debt-to-asset ratio of 52%, which is in line with its competitors.

Franchise details

The franchise agreement is initially for 20 years. The franchisee will pay a non-refundable, initial fee of \$140,000, due on signing the agreement. Ongoing, the franchisee will pay FFTY a monthly royalty fee of 3% of gross sales for the right to use the FFTY brand name.

In the first 12 months of operations, each franchisee averaged net earnings of \$40,000, after deducting the owner's salary.

***FINANCE ROLE
ADDITIONAL INFORMATION***

**APPENDIX VII – FINANCE
ADDITIONAL INFORMATION**

Alternative Sources of Financing

1. Kings Bank will lend \$50 million, with blended interest and principal repayments of \$330,000 per month for 20 years. The annual interest rate is 5%. The loan is secured by the land, buildings and equipment. It cannot be repaid early without incurring significant penalties. FFTY must maintain a long-term debt-to-asset ratio of 0.60 or less. Any dividend payments, sale of assets or new loans must be approved by Kings Bank. If any covenant is breached, the outstanding balance becomes immediately repayable.

2. Jason Puneet is a private investor who recently sold his chain of Canadian franchised coffee shops to a large, public company. He recently met Scott through a mutual friend and became quite interested in FFTY. Jason believes that FFTY has the potential to become very successful and would like to be part of that success. He is willing to lend \$50 million to FFTY under the following terms:
 - The interest rate is 3%, payable annually on the anniversary date of the loan.
 - The principal is due when the loan matures in 10 years.
 - The loan has 40,000 detachable warrants. Each warrant gives the holder the right to purchase a share in FFTY at a strike price to be negotiated. The warrants can be exercised at any time after two years, at the holder's option, and expire when the loan matures.
 - While the loan is outstanding, Jason Puneet will have a seat on FFTY's board. If Jason exercises the warrants and becomes a shareholder, only he can decide to end his term as a director.

The yield on similar-risk unsecured loans, without warrants, is 6%.

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

New Delivery Service

On January 1, 2022, a delivery service will be piloted at some of FFTY's corporate-owned stores. The project has a five-year life and needs to generate an 8% rate of return. FFTY's applicable tax rate is 26.5%.

Upfront costs:

- Delivery vehicles equipped with heated storage: \$800,000
- Additional upfront costs: \$400,000
- Working capital investment (additional food): \$100,000

At the end of the project, the vehicles can be sold for \$50,000.

Additional information:

- Average food selling price per delivery: \$35
- Additional delivery fee charged to customer: 20% of the food selling price
- Average deliveries per week: 1,000 for the first year, increasing by 100 in each subsequent year
- Cost of food: 50% of the food selling price
- Annual labour costs: \$450,000
- Annual website maintenance costs: \$80,000
- Annual vehicle operating and maintenance costs: \$100,000
- Marketing costs: \$150,000 in the first year and \$70,000 in each subsequent year

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Information on Public Companies

Company	Description	Number of Stores	Average Store Size (sq. ft.)	Beta
Brone's Inc.	Grocery retailer and gas stations	1,500	45,000	0.5
Best Foods Emporium	Organic and whole foods retailer	150	25,000	1.6
Himyl's Fresh Foods Inc.	Fresh foods and freshly prepared foods retailer	195	28,000	1.3
My Favorite Food Corp.	Grocery retailer and restaurants	450	35,000	0.9
Rosey's Sisters Food Corp.	Grocery retailer and freshly prepared foods	395	30,000	1.4
Worthy's Grocery Inc.	Grocery retailer and coffee shops	1,020	50,000	0.6

Additional information:

- Risk-free rate: 2.5%
- Market risk premium: 6%

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

U.S. Equipment Purchase

FFTY plans to purchase equipment for U.S. \$5 million that will be delivered on October 1, 2021, at which time the full amount is payable. FFTY currently purchases 10% of its products in U.S. dollars, but has no U.S. dollar cash inflows.

FFTY has the following options with respect to the equipment purchase:

1. The supplier offers a 2% discount if the full amount is paid when the order is placed on April 1, 2021. The exchange rate on April 1, 2021, is expected to be USD \$1 = CAD \$1.22. FFTY plans to borrow the full purchase price in Canadian dollars.
2. The bank has offered to sell a forward contract for U.S. \$5 million, due on October 1, 2021, at a forward rate of USD \$1 = CAD \$1.28. FFTY would enter the contract on April 1, 2021.
3. On October 1, 2021, FFTY can borrow U.S. \$5 million from a U.S. bank through a five-year term loan to pay for the equipment. The bank suggested the loan could be repaid through ongoing U.S. dollar transactions, which would reduce FFTY's exposure to exchange rate fluctuations during the term of the loan. Antonia isn't sure how this would work.

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Investment Options

As a result of its 2020 property sale, FFTY has funds available to invest for the next 12 to 15 months.

Scott's preference is to have all the funds remain in the savings account so they are easily available for the expansion whereas Antonia wants investments that will generate high returns.

Currently, the \$3 million is invested in a savings account. The following investments are available to FFTY.

Investment	Annual Return
Savings account	0.5% (minimum balance of \$100,000)
Three-year, non-redeemable Guaranteed Investment Certificate (GIC)	2.0%
S&P 500 Index Exchange Traded Fund (ETF)	2020: 29%
Five-year private loan (Note 1)	10%
Money market funds	2020 return: 1.4% The annual return has only fallen below 0.75% once in the past ten years
Publicly traded preferred shares	5.5%

Note 1 – A loan would be made to an established local business with 20 years of operating history; their financial forecasts indicate good debt coverage.

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Financial Statements of Franchisee #1
Income Statement – Internally Prepared
For the period from November 1, 2020, to January 31, 2021

	<u>3 Months</u>
Sales	<u>\$ 3,384,000</u>
Cost of goods sold	2,064,200
Monthly royalty fee	169,200
Amortization of furniture and fixtures	84,000
Amortization of intangible assets	10,000
Startup costs	140,000
Store operating costs	605,800
General and administration	285,300
	<u>3,358,500</u>
Operating income	25,500
Interest expense	(32,600)
Earnings (loss) before income taxes	<u>(7,100)</u>
Income taxes	<u>0</u>
Net earnings (loss) for the period	<u><u>\$ (7,100)</u></u>

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Financial Statements of Franchisee #1 (continued)
Balance Sheet – Internally Prepared
As at January 31, 2021

<u>Assets</u>	
Cash	\$ 500
Inventory	376,800
Prepaid expenses	600
Furniture and fixtures	2,281,000
Intangible assets	295,000
	<hr/>
Total assets	\$ 2,953,900
	<hr/>
<u>Liabilities</u>	
Bank indebtedness	\$ 99,600
Accounts payable and accrued liabilities	611,400
Current portion of long-term debt	150,000
Long-term debt	1,700,000
	<hr/>
Total liabilities	2,561,000
	<hr/>
<u>Shareholder's equity</u>	
Common shares	400,000
Retained earnings (deficit)	(7,100)
	<hr/>
Total shareholder's equity	392,900
	<hr/>
Total liabilities and shareholder's equity	\$ 2,953,900
	<hr/> <hr/>

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Benchmarks for Franchisees

Ratios	Benchmark
Cost of goods sold as a percentage of sales	60%
Operating margin	5%
Times interest earned (EBIT/interest)	4.0
Days in inventory	22
Current ratio	0.70
Debt ratio (total liabilities / total assets)	0.60
Minimum average sales per month in first year of operations for the franchise to be viable	\$1,500,000

APPENDIX VII – FINANCE (continued)
ADDITIONAL INFORMATION

Logistics Proposal

Currently, FFTY owns two warehouses. Total monthly costs for both warehouses are as follows:

Wages and benefits – paid on 30 th day of the month	\$84,350
Delivery vehicle leases – paid on 30 th day of the month	\$16,700
Operating costs – paid on 30 th day of the month	\$38,000

The proposed contract with Logistics requires a monthly payment of \$135,000, payable on the first day of the month.

Logistics has promised faster delivery times, reduced spoilage and better inventory management, which will reduce stock-outs. Logistics estimates that FFTY can reduce its inventory by 25%.

***PERFORMANCE MANAGEMENT ROLE
ADDITIONAL INFORMATION***

APPENDIX VII – PERFORMANCE MANAGEMENT ADDITIONAL INFORMATION

Vision and Mission

Vision: To be the largest Canadian-owned retailer of fresh, whole foods.

Mission: To support our local producer partners, and be the fastest growing retailer of whole foods by ensuring that customers are offered a unique experience.

Industry Information

The Canadian food retail industry has three segments: grocery stores, specialty food stores and warehouses. Specialty stores sell whole and organic foods. FFTY is in the specialty food segment.

The entire industry grew less than 1% in 2020 and is expected to continue to grow at this rate; however, the specialty food segment grew by 5% in 2020 and is expected to grow by 7% in 2021 and 2022.

The four largest players in the grocery store segment have 70% of the total industry market, although the warehouse segment has been steadily increasing its share. Many large grocery store chains have also entered the warehouse segment and increased their market share. Because margins are small, consolidation has been occurring in the industry as a way of achieving economies of scale.

Although some customers are willing to pay a premium for specialty foods, the industry still competes on price. Most customers tend to visit multiple stores looking for the best prices. Large grocery store chains can negotiate lower costs due to their high volumes, and pass these savings on to consumers. Many retailers have customer loyalty programs which they use to gather customer data, perform target marketing on specific products and increase traffic.

Since margins are low, product and labour costs must be constantly monitored. This is a labour-intensive industry, using low-skilled labour. However, wages that are too low can hinder service and increase employee turnover.

Inventory management is critical to controlling costs, and any disruption in distribution impacts profits. Data captured by the point-of-sale system helps determine which products are selling well and when inventory needs to be replenished in order to ensure availability.

Specialty food stores appeal to consumers who are particular about their food choices. Customers tend to shop at these types of stores less often. To stabilize costs and ensure that high-quality products are consistently available, retailers enter long-term supplier contracts.

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

A successful franchisor needs to attract franchisees who share goals, beliefs, and values, while still allowing their entrepreneurial spirit to flourish. Franchisees look for companies that demonstrate leadership, integrity and have a well-defined vision, mission, and a strong support system. The brand must be well recognized and respected, and the business model must be easily replicated so that every store is similar. Franchisees like being consulted on important business decisions.

Trends in the industry include:

- implementing loyalty programs that result in increased sales and customer loyalty.
- performing analytics on the data collected by the point-of-sale system. The data can also be used to personalize the customer's shopping experience and provide discounts on their favourite items. Some customers are concerned with their privacy and object to the tracking of their purchases and receiving targeted marketing.
- introduction of new products, including wine, beer and liquor, freshly prepared foods and health and wellness products.
- delivery of groceries to homes or to other convenient locations.
- increasing the percentage of private-label products offered, to reduce costs and increase margins.

In Ontario, disposable income per capita is forecast to increase over the next five years. In the past, as disposable income has increased, consumers spent more on specialty foods. Customers in their forties are now tending toward healthier living, consuming fresh, whole products. Higher income retired seniors are less interested in cooking and are looking for delivery of healthy, freshly prepared foods. Millennials who are busy building their careers are also interested in delivery of freshly prepared foods.

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

Food Delivery Service Proposal

Starting on January 1, 2022, a few of the corporate-owned stores plan to pilot a delivery service.

	Seniors Market	Millennials Market
Average sale per delivery	\$35	\$75
Number of deliveries per year	60,000 to 68,000	28,000 to 45,000
Fee charged by FFTY per delivery	\$8	\$8
Cost of food as a percentage of selling price	50%	50%
Labour costs – for cooks and drivers	\$740,000	\$560,000
Labour costs – for telephone support	\$40,000	0
Costs for app development	\$350,000	\$520,000
Amortization	\$270,000	\$270,000
Brand loyalty	High, but values price over quality; less spending power	Lower, but values quality over price; more spending power

Additional information:

- Only one competitor currently delivers prepared foods made with whole and organic ingredients specifically targeted to seniors.
- Millennials spend up to 8% of their food budget on prepared foods whereas seniors spend only 2%.
- Millennials tend to live in the downtown core while seniors tend to live in the suburbs. Due to downtown traffic congestion, delivery to millennials takes longer.
- Grocery stores and restaurants are also competing for the millennials' prepared-food delivery market.
- Expectations are that, by 2030, 60% of meals will be delivered rather than cooked at home.

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

FFTY's Departments

Four of FFTY's departments are managed as follows:

Manager, Marketing	<ul style="list-style-type: none"> Responsible for all marketing activities, including brand marketing and local marketing for individual stores
Manager, Product Purchasing	<ul style="list-style-type: none"> Responsible for product purchasing and negotiation of supplier contracts and shipping requirements Manages store inventory levels
VP, Franchising Operations (Michelle)	<ul style="list-style-type: none"> Responsible for selecting franchisees, training and onsite support, and monitoring franchisee sales and purchases Receives a performance bonus based on a percentage of franchise fees
VP, Corporate-owned Stores (Dennis)	<ul style="list-style-type: none"> Involved in investment decisions for the equipment and leasehold improvements for each corporate-owned store Oversees the corporate-owned store managers' work Sets selling prices and employee wages and oversees all store operating costs Receives a performance bonus based on a percentage of total net profit of all corporate-owned stores (see calculation below)

Net profit is calculated as follows:

Total revenue of all corporate-owned stores
Less costs:
Cost of goods sold
Distribution and shipping
Marketing and advertising
Wages
Electricity
Property taxes
Allocated costs of overhead for finance, human resources, and information technology
Interest cost on capital invested in property, plant and equipment

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

Information on Two Corporate-owned Stores (CO)

2020	CO #1002	CO #1009
Sales	\$ 16,350,000	\$ 14,780,000
Cost of goods sold	(11,718,000)	(9,459,000)
Direct store costs	(664,000)	(680,000)
Wages	(1,435,000)	(2,032,000)
Amortization	(302,000)	(314,000)
Occupancy costs	(1,487,000)	(1,595,000)
Allocated head office costs based on sales	(255,000)	(230,000)
Operating income	\$ 489,000	\$ 470,000

Key performance measures:

		Target	CO #1002	CO #1009
Financials	Annual increase in sales	3%	5%	-10%
	Gross margin percentage	35%	28%	36%
	Inventory turnover	20 times	21 times	19 times
	Percentage of sales of high-margin items	15%	4%	18%
	Wages as a percentage of sales	10%	9%	14%
	Operating margin	5%	3%	3%
Customers	Product returns as a percentage of sales	2%	2%	1%
	Number of customer complaints per week	10	8	4
Internal Business Processes	Percentage of sales of new products	10%	6%	12%
	Employee turnover	5%	25%	1%
	Average weekly hours for each employee	30	19	31
	Average hourly rate for employees (minimum for new employees is \$15; maximum for full-time, experienced employees is \$20)	\$16.50	\$15.20	\$17.00
	Food and safety inspection failures	0	2	0

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

Information on Two Corporate-owned Stores (CO) (continued)

Additional information:

- CO #1002 – During the year, the store manager lowered the prices of commonly sold items to less than a local competitor's prices. He also reduced the average weekly hours worked for each employee to less than 20 hours, to save on benefits.
- CO #1009 – During the year, the store was closed for six weeks due to a sewer backup caused by the municipality; lost sales totalled \$2,235,000. However, the employees helped with the cleanup and, in addition to working the regular number of hours during this period, were paid overtime totalling \$340,000.

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

Riverside Contract Proposal

Dairy sales for 2021 are forecast to be \$16 million. Selling prices and unit costs are expected to increase by 2% annually, due to inflation. Dairy prices are kept low to attract customers. FFTY currently uses four local suppliers as each one has a variety of products, giving customers more choice. All suppliers are paid within 30 days.

Under existing contracts, the 2020 purchases for the four suppliers are as follows:

Supplier	Products	Purchases	Minimum Order Period Prior to Delivery	Point of Delivery
Riverside	Milk, butter, cheese, and yogurt	\$ 5,000,000	15 days	To the stores
Supplier #2	Cheese	1,700,000	7 days	FFTY does pickup and distribution
Supplier #3	Milk and yogurt	2,400,000	8 days	To the warehouse
Supplier #4	Butter and cheese	2,900,000	12 days	FFTY does pickup and distribution
		\$12,000,000		

If FFTY does not sign the proposed contract with Riverside, the cost of goods sold for the dairy products is expected to be \$12 million in 2021, and the quantities purchased are expected to remain stable.

APPENDIX VII – PERFORMANCE MANAGEMENT (continued)
ADDITIONAL INFORMATION

Riverside Contract Proposal (continued)

The proposed contract has the following terms:

- The contract is for six years, starting on January 1, 2022.
- The minimum annual purchases are \$10 million. If the minimum is not reached in any year, FFTY will either purchase enough product to reach the minimum or pay a penalty equal to 50% of the shortfall.
- Prices will be fixed for the first three years, and will increase by 2% a year thereafter.
- At the beginning of each year, FFTY is to provide a forecast of annual purchases, by quarter.
- Orders must be placed by FFTY no less than 15 days before delivery.
- Payment terms are 25 days.
- Deliveries will be made directly to the stores at no cost to FFTY.
- Riverside will be responsible for any products returned by customers.
- FFTY's stores will receive one type of each product rather than three to four types.

Note: FFTY would continue to purchase the remainder of its required dairy products from the three existing suppliers; due to reduced volumes, their prices will increase by 8%.

Customer Loyalty Program

Customers in the corporate-owned stores will be awarded one point for each dollar spent; each point will be worth \$0.02 and will expire at the end of the following calendar year. The points can be redeemed for any products sold in the store.

Sales in 2021 are forecast at \$158 million for the corporate-owned stores. The program should increase sales by at least 5% in all corporate-owned stores. Head office will incur annual costs of \$250,000 to manage the program. Michelle estimates that customers will eventually redeem 55% of the points awarded.

On average, the corporate-owned stores currently have gross margins of 43%.

***TAXATION ROLE
ADDITIONAL INFORMATION***

**APPENDIX VII – TAXATION
ADDITIONAL INFORMATION**

Capital Cost Allowance

Undepreciated capital cost (UCC) balances at January 1, 2020, are as follows:

Class	Description	UCC Balance
1	Buildings (all at 4%)	\$45,790,200
8	Furniture and equipment	\$16,754,300
10	Delivery vehicles	\$180,000
12	Computer software	\$56,890
13	Leasehold improvements	\$17,360,000
50	Computer hardware	\$75,300

The original capital cost of the leasehold improvements included in Class 13 totalled \$22,679,000. The length of all store leases is 10 years, and the leasehold improvements in 2020 were made at the commencement of new leases.

After the sale of delivery vehicles during 2020, there are no remaining items in Class 10.

Information for the Calculation of Net Income for Tax Purposes and Taxable Income

General and administrative expenses are comprised of the following:

Wages and benefits	\$ 2,780,000
Travel	570,000
Computer application software purchases	120,000
Mileage (at the per-kilometre rates allowed by the CRA)	230,000
Meals	130,000
Donations to registered charities	112,000
Membership dues for social club	20,000
Automobile leasing costs for Dennis (Note 1)	16,800
Life insurance on shareholders	40,000
Interest and penalties on late payments of income taxes	35,000
Other operating expenses	624,200
	<u>\$ 4,678,000</u>

Note 1 – The automobile lease is for 24 months and began on October 1, 2019. The retail price of the automobile on that date was \$65,000. Monthly lease payments are \$1,700 plus 13% HST. Dennis reimburses the company \$300 per month for personal use of the vehicle, and the \$16,800 expense is net of this reimbursement. A refundable deposit of \$15,000 was made at the start of the lease. The amount deducted for tax purposes in 2019 was \$1,483.

APPENDIX VII – TAXATION (continued)
ADDITIONAL INFORMATION

Information for the Calculation of Taxes Payable

During 2020, LOB paid \$472,220 in dividends and received a dividend refund of \$118,055 from its eligible RDTOH balance. FFTY received \$85,000 of those dividends.

FFTY's provincial tax rate on income eligible for the small business deduction is 3%, and on all other income is 11.5%.

FFTY's Non-Eligible RDTOH balance at December 31, 2019, was \$0. Its Eligible RDTOH balance at December 31, 2019, was \$60,000, and FFTY did not receive any dividend refund for 2019. The balance in the general rate income pool (GRIP) at January 1, 2020, was \$10 million.

FFTY's taxes payable for the 2019 taxation year was \$1,142,000, and FFTY paid \$1 million of this in May of 2020. The income tax return for 2019 was filed on August 17, 2020, and the remaining amount was paid on that date.

Capital Dividend Account

Prior to 2019, capital transactions were as follows:

Year	Asset Sold	Proceeds	Adjusted Cost Base
2013	Land and building	\$8,630,000	\$7,850,000
2016	Investment securities	\$730,000	\$960,000
2018	Investment securities	\$567,000	\$432,000

There have been no capital dividends paid in prior years.

Eligible dividends, received on short-term investments in public companies, were:

Year	Amount
2016	\$150,000
2017	\$225,000
2018	\$215,000

APPENDIX VII – TAXATION (continued)
ADDITIONAL INFORMATION

Proposed Loans

Ross Lee, Antonia's husband, has no ownership in FFTY. FFTY will lend Ross \$300,000 to invest in his own business, Next Opportunity Inc. The loan will be for five years and will bear interest at 0.5% annually. Interest is payable annually and the principal is due only on the maturity date of the loan. The loan will be advanced on April 1, 2021.

FFTY will lend Scott \$500,000 to help him purchase a new home. The loan will be advanced on May 1, 2021. Principal in the amount of \$50,000 is repayable annually on May 1 until the loan matures in 2031. The loan bears interest at an annual rate of 0.5%, which is payable monthly.

Proposed Employee Benefits

- All employees would receive a 10% discount on all products sold in FFTY stores.
- FFTY would issue non-cash awards for every fifth anniversary at FFTY, starting at a value of \$500 and increasing by \$500 on each subsequent fifth anniversary date. For example, a non-cash award of \$1,000 and \$1,500 would be paid to employees achieving their tenth and fifteenth anniversaries, respectively. Employees would select their non-cash award from a list of ten items, such as a watch, tablet, or barbecue.
- All employees would be eligible to have FFTY annually contribute an amount equal to 5% of their wages to their tax-free savings account.
- FFTY would create a group disability insurance plan that could be funded in one of three ways: FFTY would pay all the premiums; the employee would pay all the premiums; or FFTY and the employee would share the premium payments.

APPENDIX VII – TAXATION (continued)
ADDITIONAL INFORMATION

GST/HST

FFTY is required to file monthly GST/HST returns. All transactions take place in Ontario, where the HST rate is 13%.

In January 2021, FFTY had the following transactions (all figures are net of GST/HST):

Sales	\$14,700,000
Franchise fees received	\$180,000
Cost of goods sold	\$8,400,000
Rent	\$1,568,000
Salaries and wages	\$2,670,000
Financing costs (interest)	\$300,000
Other operating costs	\$1,753,000
New furniture and fixtures	\$10,400,000

Notes:

- Of the total sales, \$7.2 million was for zero-rated items and the remaining amount was for taxable supplies.
- Purchases were \$10.7 million, of which \$4.2 million was for zero-rated items and the remaining amount was for taxable supplies.
- In other operating costs, 100% were for taxable supplies and include the following items:
 - Lease costs for Dennis’s vehicle
 - Social club membership of \$1,800
 - Meals of \$25,000
- The furniture and fixtures have a useful life of eight years. At the end of the month, there was \$3.2 million in accounts payable related to this purchase.

**DAY 2 – MARKING GUIDE – COMMON
FARM FRESH TO YOU INC. (FFTY)**

All candidates are expected to discuss the accounting issues identified by Antonia and Scott, prepare a breakeven analysis for the organic wine proposal, and provide recommendations for improving operating profits based on the summary information provided by Jim.

Assessment Opportunity #1 (Common)

The candidate discusses the accounting treatment for the investment in LOB.

The candidate demonstrates BREADTH or DEPTH in Core Financial Reporting.

CPA Map Technical Competencies (based on the 2020 CPA Competency Map):		Core
1.2.1	Develops or evaluates appropriate accounting policies and procedures	A
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

On September 1, 2020, FFTY purchased an 18% investment in LOB. First, we must determine if FFTY has significant influence.

Under ASPE 3051 – *Investments*:

.05 *Significant influence differs from control and joint control (see SUBSIDIARIES, Section 1591, and INTERESTS IN JOINT ARRANGEMENTS, Section 3056). An investor may be able to exercise significant influence over the strategic operating, investing and financing policies of an investee even when the investor does not control or jointly control the investee. For example, the ability to exercise significant influence may be indicated by representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel or provision of technical information. If the investor holds less than 20 percent of the voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence, unless such influence is clearly demonstrated. On the other hand, the holding of 20 percent or more of the voting interest in the investee does not in itself confirm the ability to exercise significant influence. A substantial or majority ownership by another investor would not necessarily preclude an investor from exercising significant influence.*

In this case, FFTY owns only 18% of the outstanding shares of LOB. However, FFTY has one of the three directors on the board and, therefore, has an ability to influence policies (i.e., 33% representation). In addition, FFTY represents 30% of all of LOB's sales, which constitutes material intercompany transactions. FFTY was also able to negotiate annual dividend payments of at least 5%, which implies some impact on decision making.

Based on these facts, the conclusion is that FFTY has significant influence over LOB.

Next, we need to determine what method should be used to account for the investment. Under ASPE 3051:

.06 *An investor that is able to exercise significant influence over an investee shall make an accounting policy choice to account for the investment using either:*

- (a) the equity method; or*
- (b) the cost method.*

An investor shall account for all investments subject to significant influence using the same method. In making this accounting policy choice, an investor need not meet the criterion in ACCOUNTING CHANGES, paragraph 1506.06(b).

Therefore, we can choose between the cost and equity methods. LOB's shares are not quoted in an active market, so paragraph 7 does not apply.

Cost Method

If the cost method is chosen, the investment will be recognized at cost on the balance sheet.

The cost of the investment is \$1,907,000.

With respect to dividends, ASPE 3400 states:

.12 Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends shall be recognized when reasonable assurance exists regarding measurement and collectability. These revenues shall be recognized on the following bases:

- (a) interest: on a time proportion basis;*
- (b) royalties: as they accrue, in accordance with the terms of the relevant agreement;*
and
- (c) dividends: when the shareholder's right to receive payment is established.*

Therefore, dividends are recognized as income when the shareholder's right to receive the amounts is established. As LOB declared and paid dividends to FFTY of \$85,000 in 2020, these are recognized as income in 2020.

Therefore, under the cost method, FFTY would report the following:

Investment in LOB	\$1,907,000
Investment income	\$85,000

Accordingly, no adjustments would be needed to the draft financial statements.

Equity Method

Per ASPE 3051:

.08 Investment income, as calculated by the equity method, shall be the investor's share of the income or losses of the investee.

.09 In accounting for an investment by the equity method, the investor's share of the investee's discontinued operations, changes in accounting policy, corrections of errors relating to prior period financial statements and capital transactions shall be presented in the investor's financial statements according to their nature.

.12 The investment account of the investor reflects:

- (a) the cost of the investment in the investee;*
- (b) the investment income or loss (including the investor's share of discontinued operations) relating to the investee subsequent to the date when the use of the equity method first became appropriate;*
- (c) the investor's share of a change in an accounting policy, a correction of an error relating to prior period financial statements and capital transactions of the investee subsequent to the date when the use of the equity method first became appropriate; and*
- (d) the investor's proportion of dividends paid by the investee subsequent to the date when the use of the equity method first became appropriate.*

If the equity method is chosen, the investment will initially be recognized at the cost of \$1,907,000. Each year, FFTY will recognize investment income equal to 18% of LOB's income, and it will also increase the investment account. In addition, dividends received from LOB will be deducted from the investment account.

In addition, ASPE 3051 states:

.17 When an investor purchases assets in the normal course of operations from an equity-accounted investee, the investor shall not recognize its share of the profit or loss of the investee on the transaction until the assets are sold to a third party. However, when the transaction provides evidence of a reduction in the net realizable value, or a decline in the value of the relevant assets, the investor shall recognize its share of the loss in income immediately.

While there are intercompany transactions (because FFTY purchases bread products from LOB), there is no unrealized profit from the transactions since FFTY has no inventory on hand from LOB at year end.

Using the equity method, FFTY will report the following as the investment account:

Initial cost	\$ 1,907,000
LOB's net income from Sep 1 to Dec 31 (18% × \$1,250,000)	225,000
Dividends declared	<u>(85,000)</u>
Investment balance – December 31, 2020	<u>\$ 2,047,000</u>

Therefore, under the equity method, FFTY will report the following:

Investment in LOB	\$2,047,000
Investment income	\$225,000

Recommendation

Scott has stated that the company wants to maximize net income. Under the equity method, FFTY will recognize a greater amount of investment income, resulting in a higher net income. Therefore, we recommend that FFTY use the equity method to account for this investment.

DR Investment in LOB	\$225,000	
CR Investment income		\$225,000

To recognize investment income under the equity method for the year.

DR Dividend income	\$85,000	
CR Investment in LOB		\$85,000

To reverse the dividend income that was recognized.

For Assessment Opportunity #1, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of the accounting treatment for the investment in LOB.

Competent – The candidate provides a discussion of the accounting treatment for the investment in LOB.

Competent with distinction – The candidate provides an in-depth discussion of the accounting treatment for the investment in LOB.

Assessment Opportunity #2 (Common)

The candidate discusses the accounting treatment for the franchise revenue.

The candidate demonstrates BREADTH or DEPTH in Core Financial Reporting.

CPA Map Technical Competencies:		Core
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

During 2020, two franchises were set up: one on July 1 and one on August 1. The company received \$140,000 as an upfront initial fee, and an optional fee of \$60,000 from each franchisee, and receives ongoing royalty fees.

In the draft financial statements, the franchise revenue includes the initial fees, optional services fees, and ongoing royalties received from franchisees.

Each of these sources of revenue and its related accounting treatment is discussed below.

Initial Fee of \$140,000

Under AcG-2 – *Franchise fee revenue*:

Revenue from initial franchise fees relating to the sale of an individual franchise or an area franchise shall be recognized, with an appropriate provision for estimated uncollectable amounts, when all material conditions relating to the sale have been substantially performed by the franchisor. Substantial performance is considered to have occurred when:

- (a) the franchisor has performed substantially all of the initial services required by the franchise agreement or volunteered by the franchisor as a result of normal business practice;*
- (b) the franchisor has no remaining obligation or intent (by agreement, industry practice or legislation) to refund amounts received or forgive unpaid amounts owing; and*
- (c) there are no other material unfulfilled conditions affecting completion of the sale.*

In practice, these conditions will not normally be met before the franchisee commences operations. Paragraphs 8–11 provide exceptions to the requirements in this paragraph in specific circumstances.

For the initial fee, the revenue can be recognized upon the store opening date, given that the fee represents a contract for several deliverables and all these deliverables would have been provided by that time. In addition, there is no remaining obligation to refund amounts received at that time (as the amount is non-refundable) and there are no other material unfulfilled obligations after the store opening date. Since both stores had opening dates before December 31, 2020, FTTY can recognize the full amount of the initial fees prior to year end.

[Marking note: Under ASPE 3400 – Revenue:

.04 Revenue from sales and service transactions shall be recognized when the requirements as to performance set out in paragraphs 3400.05-.06 are satisfied, provided that at the time of performance ultimate collection is reasonably assured.

.05 In a transaction involving the sale of goods, performance shall be regarded as having been achieved when the following conditions have been fulfilled:

- (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; and*
- (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.*

Consistent with AcG-2, candidates should conclude that the full initial fee can be recognized by December 31, 2020, using ASPE 3400, as all performance has been provided and collection is reasonably assured.]

Optional Services Fee of \$60,000

AcG-2 does not explicitly address optional services to be provided to the franchisee by the franchisor. Therefore, we use ASPE 3400 – *Revenue* to analyze these fees.

.04 Revenue from sales and service transactions shall be recognized when the requirements as to performance set out in paragraphs 3400.05-.06 are satisfied, provided that at the time of performance ultimate collection is reasonably assured.

.06 In the case of rendering of services and long-term contracts, performance shall be determined using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance shall be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.

As the optional services are provided over six months, starting when the store opens, they must be allocated over that period. There is no reason to believe that the franchisee would not pay the fees at the time of performance, so collection is reasonably assured.

Therefore, the revenue to be recognized during the period ended December 31, 2020, is as follows:

- Franchisee #1 — store opened November 1, 2020: $\$60,000 \times 2/6 = \$20,000$
- Franchisee #2 — store opened December 1, 2020: $\$60,000 \times 1/6 = \$10,000$

The total amount recognized as revenue is \$30,000. The total amount recognized as deferred revenue is \$90,000 [$(\$60,000 - \$20,000) + (\$60,000 - \$10,000) = \$40,000 + \$50,000$].

The correcting journal entries for the initial fee are, therefore:

DR Franchise revenue	\$90,000	
CR Deferred revenue		\$90,000

Ongoing Royalty Fees

Per AcG-2, paragraph 12: “*Continuing franchise fees shall be recognized as revenue in the period in which the services are rendered.*” These fees are paid based on 5% of the gross sales and are currently recorded when the sales are recognized by the franchisee. The fees are for the use of the FFTY brand name. Therefore, the service has been rendered over time, and royalty income earned to December 31, 2020, is appropriately recognized as revenue.

[Marking note: Per ASPE 3400.12: “Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends shall be recognized when reasonable assurance exists regarding measurement and collectability. These revenues shall be recognized on the following bases: (a) interest: on a time proportion basis; (b) royalties: as they accrue, in accordance with the terms of the relevant agreement; and (c) dividends: when the shareholder’s right to receive payment is established.”

Consistent with AcG-2, candidates should conclude that the royalty income earned to December 31, 2020, is appropriately recognized as revenue under ASPE 3400.]

Overall, as a result of the above entries, there will be a negative impact on FFTY’s net income for the year ending December 31, 2020. However, as this revenue was deferred, this adjustment will result in an increase to net income for the following fiscal year.

For Assessment Opportunity #2, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not attain the standard of reaching competence.

Reaching competence – The candidate attempts a discussion of the accounting treatment for the franchise revenue.

Competent – The candidate provides a discussion of the accounting treatment for the franchise revenue.

Competent with distinction – The candidate provides an in-depth discussion of the accounting treatment for the franchise revenue.

Assessment Opportunity #3 (Common)

The candidate discusses the accounting treatment for the sale and leaseback transaction.

The candidate demonstrates BREADTH or DEPTH in Core Financial Reporting.

CPA Map Technical Competencies:		Core
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:

- 6.2.1 *Maintains an objective and questioning mindset to avoid biased analyses*
- 6.2.4 *Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives*
- 6.3.1 *Uses evidence and judgment to recommend and justify solutions or conclusions*
- 6.3.3 *Applies decision criteria to choose among viable alternatives*
- 7.1.1 *Targets message content and tone to meet audience needs within areas of work responsibility*
- 7.1.2 *Communicates non-complex financial information logically, clearly, concisely*

On September 1, 2020, FFTY sold land and a building to Retail Property REIT for \$15 million. The fair market value of the land and building was \$1.5 million and \$13.5 million, respectively.

There are two issues with respect to this transaction:

1. What type of lease arrangement is this and how should it be recognized?
2. Based on the lease type, how should the gain on sale be recognized?

In the draft financial statements, the lease payments have been expensed and included in rent expense and the total amount of the gain on disposal has been included in income.

Type of Lease Arrangement

Under ASPE, the lease is classified as either a capital or operating lease. To qualify as a capital lease, one or more of the following criteria must be met, per ASPE 3065 – Leases:

.06 From the point of view of a lessee, a lease normally transfers substantially all of the benefits and risks of ownership to the lessee when, at the inception of the lease, one or more of the following conditions are present:

(a) There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. Reasonable assurance that the lessee will obtain ownership of the leased property is present when the terms of the lease result in ownership being transferred to the lessee by the end of the lease term or when the lease provides for a bargain purchase option.

There is no indication of transfer of ownership at the end of the lease or a bargain purchase option; therefore, this criterion is not met.

(b) The lease term is of such a duration that the lessee will receive substantially all of the economic benefits expected to be derived from the use of the leased property over its life span. Although the lease term may not be equal to the economic life of the leased property in terms of years, the lessee is normally expected to receive substantially all of the economic benefits to be derived from the leased property when the lease term is equal to a major portion (usually 75 percent or more) of the economic life of the leased property. This is due to the fact that new equipment, reflecting later technology and in prime condition, may be assumed to be more efficient than old equipment that has been subject to obsolescence and wear.

The lease term is 20 years, and the remaining economic life of the building is 25 years. The lease term represents 80% (20/25), which is greater than 75%. Therefore, this criterion is met.

(c) The lessor is assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement. This condition exists if the present value, at the beginning of the lease term, of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (usually 90 percent or more) of the fair value of the leased property, at the inception of the lease. In determining the present value, the discount rate used by the lessee is the lower of the lessee's rate for incremental borrowing and the interest rate implicit in the lease, if known.

Using FFTY's incremental borrowing rate, the present value of the minimum lease payments is \$13,958,077. This amount represents 93% of the fair value (\$13,958,077/\$15,000,000). This criterion is met.

For the lease to be considered capital, only one of the above criteria has to be met. Given that two of the three criteria are met, this is a capital lease.

Accounting for the Capital Lease

Because this is a capital lease for land and building, paragraphs ASPE 3065.71 and .72 provide guidance on whether the asset needs to be divided into land and building:

.71 When a lease involving land and building(s) does not contain terms that allow ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is minor in relation to the total fair value of the leased property, the land and the building(s) are considered a single unit for the purposes of classification of the lease. The economic life of the building(s) is considered the economic life of the unit.

.72 When a lease involving land and building(s) does not contain terms that allow the ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is significant in relation to the total fair value of the leased property, the land and building(s) are considered separately for purposes of classification. The lessee and lessor allocate the minimum lease payments between the land and building(s) in proportion to their fair values. Both parties classify the portion of the lease applicable to land as an operating lease.

The land represents 10% (\$1.5 million/\$15 million) of the total fair market value. We conclude that this is not significant and, therefore, do not require that the land and building be separated.

As required by ASPE 3065.17: “*The capitalized value of a depreciable asset under a capital lease shall be amortized over the period of expected use, on a basis that is consistent with the lessee’s depreciation policy for other similar fixed assets (see PROPERTY, PLANT AND EQUIPMENT, Section 3061). If the lease contains terms that allow ownership to pass to the lessee or a bargain purchase option, the period of amortization shall be the economic life of the asset. Otherwise, the property shall be amortized over the lease term.*” As there is no transfer of title at the end of the lease or a bargain purchase option, the lease term is used in this case. The asset must be amortized over the term of the lease (240 months).

Therefore, a leased asset should be recognized at December 31, 2020, as follows:

Leased asset on September 1, 2020	\$ 13,958,077
Less amortization from September 1 to December 31 (\$13,958,077 × 4/240 months)	<u>(232,635)</u>
Net book value at December 31, 2020	<u>\$ 13,725,442</u>

Per ASPE 3065.18: “*An obligation under a capital lease is similar to a loan. Lease payments shall be allocated to a reduction of the obligation, interest expense and any related executory costs. The interest expense is calculated using the discount rate used in computing the present value of the minimum lease payments applied to the remaining balance of the obligation.*” Therefore, the lease obligation is amortized over the lease term using a monthly interest rate of 0.5% (6% annually).

The lease obligation will be reported as follows:

	Lease Payment	Interest at 0.5%	Balance Outstanding
Sept 1			\$13,958,077
Sept 30	\$100,000	\$ 69,790	\$13,927,867
Oct 31	100,000	69,639	\$13,897,506
Nov 30	100,000	69,488	\$13,866,994
Dec 31	100,000	69,335	\$13,836,329
Total	\$400,000	\$278,252	

The correcting journal entries are as follows:

DR Leased asset	\$13,958,077	
DR Amortization expense	\$232,635	
DR Interest expense	\$278,252	
CR Rent expense		\$400,000
CR Lease obligation		\$13,836,329
CR Accumulated depreciation – leased asset		\$232,635

To reverse the lease payments and correctly set up the leased asset, lease obligation, and related amortization and interest expense for 2020.

Treatment of the Gain on Sale

As required under ASPE 3065.65: *“When the leaseback is classified as a capital lease, any profit or loss arising on the sale shall be deferred and amortized in proportion to the amortization of the leased asset except for leases involving land only, in which case it shall be amortized over the lease term on a straight-line basis.”* In this case, the \$4 million gain must be deferred and amortized in proportion to the amortization of the leased asset.

Since the leased asset is amortized on a straight-line basis over the lease term of 240 months, the related gain on sale will be as well.

The gain on sale of the property is calculated as follows:

Proceeds on sale	\$ 15,000,000
Less net book value of land	(1,400,000)
Less net book value of building	<u>(9,600,000)</u>
Gain on sale	<u>\$ 4,000,000</u>

The balance of the deferred gain will be:

Initial deferred gain	\$ 4,000,000
Amortization (4,000,000 × 4/240)	<u>(66,667)</u>
Balance outstanding at December 31, 2020	<u><u>\$ 3,933,333</u></u>

The following correcting journal entry is required:

DR Gain on sale	\$3,933,333	
CR Deferred gain on sale		\$3,933,333

The reversal of the gain will lower net income substantially for the current year, but will increase net income by \$66,667 over the following years as the deferred gain is recognized into income.

The reversal of the rent expense of \$400,000 will increase net income. However, this will be offset by the entries to interest expense and amortization. In the current year, the combined entries of the interest and amortization will be greater than the lease payments, but these will eventually be lower as the interest amounts decrease over time.

For Assessment Opportunity #3, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of the accounting treatment for the sale and leaseback transaction.

Competent – The candidate provides a discussion of the accounting treatment for the sale and leaseback transaction.

Competent with distinction – The candidate provides an in-depth discussion of the accounting treatment for the sale and leaseback transaction.

Assessment Opportunity #4 (Common)

The candidate discusses the accounting treatment for the non-monetary transaction.

The candidate demonstrates BREADTH or DEPTH in Core Financial Reporting.

CPA Map Technical Competencies:		Core
1.2.3	Evaluates treatment for non-routine transactions	B

CPA Map Enabling Competencies:

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

FFTY exchanged freshly prepared food for web design services. As this is a non-monetary transaction, ASPE 3831 – *Non-monetary transactions* applies:

.06 An entity shall measure an asset exchanged or transferred in a non-monetary transaction at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received, unless:

(a) the transaction lacks commercial substance;

- (b) the transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange;*
- (c) neither the fair value of the asset received nor the fair value of the asset given up is reliably measurable; or*
- (d) the transaction is a non-monetary non-reciprocal transfer to owners to which paragraph 3831.14 applies.*

.11 A non-monetary transaction has commercial substance when the entity's future cash flows are expected to change significantly as a result of the transaction. The entity's future cash flows are expected to change significantly when:

- (a) the configuration of the future cash flows of the asset received differs significantly from the configuration of the cash flows of the asset given up (see paragraph 3831.12); or*
- (b) the entity-specific value of the asset received differs from the entity-specific value of the asset given up, and the difference is significant relative to the fair value of the assets exchanged.*

First, we need to consider whether the transaction lacks commercial substance (criterion (a)). The configuration of the cash flow of FFTY's website (e.g., the future required outflow of expenditures to host and maintain the website; the additional customers attracted as a result, resulting in future cash inflows; etc.) is different from the cash flow of the freshly prepared foods (i.e., the revenue and expense that would have been associated with the sale of that food). The timing of the cash flows also differs in that the freshly prepared foods create short-term cash flows while the website provides longer-term, future cash flows. The entity-specific value of the two items (how FFTY expects to use the items) is not significantly different, given that it is only about 7% [$(\$310,000 - \$290,000) \div \$290,000$]. However, as only one of the criteria above needs to be met for the cash flows to be expected to change significantly, the exchange has commercial substance.

In addition, FFTY did not exchange a product with another product that is sold in the same line of business, since FFTY does not sell web design services; therefore, criterion (b) is not met. Both the fair value of the web design services and the freshly prepared foods can be determined, so criterion (c) is not met, and the transaction is not a transfer to owners, so criterion (d) is not met. As none of the exceptions in paragraph 6 apply, the asset should be recorded at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received. Given that FFTY knows the exact value of what it would have charged for the freshly prepared foods, and the amount of services provided by DWC is only an estimate, the transaction should be recorded at \$290,000, not at the currently recorded amount of \$310,000.

The entry to correct this transaction is as follows:

DR Sales revenue	\$20,000	
CR Sales and Marketing expense		\$20,000

The above entry will have no impact on net income as the entries to revenue and expenses will offset each other.

For Assessment Opportunity #4, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of the accounting treatment for the non-monetary transaction.

Competent – The candidate provides a discussion of the accounting treatment for the non-monetary transaction.

Competent with distinction – The candidate provides an in-depth discussion of the accounting treatment for the non-monetary transaction.

Assessment Opportunity #5 (Common)

The candidate calculates the break-even number of bottles to be sold for the organic wine proposal.

The candidate demonstrates BREADTH or DEPTH in Core Management Accounting.

CPA Map Technical Competencies:		Core
3.5.1	Performs sensitivity analysis	A
3.5.2	Evaluates sustainable profit maximization and capacity management performance	A

CPA Map Enabling Competencies:

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

The company is considering operating a wine boutique and offering organic wines. Management wants to know the number of bottles per week that FFTY needs to sell in order to break even.

Irrelevant Costs

The break-even analysis should only include the directly attributable costs for the organic wine boutique and should not include costs that would be incurred even if the organic wine was not introduced.

The following irrelevant costs have been excluded from the break-even calculation:

1. The survey cost is a sunk cost since it has already been incurred.
2. Wages for current administration staff are not an additional cost and would be incurred regardless of the sale of organic wine.
3. The occupancy costs for the FFTY store space are also not relevant as they are incurred regardless of whether the boutique goes ahead.

Step-Fixed Costs

The warehousing costs are step-fixed costs; that is, if the volume is under 200,000 bottles, the cost is \$300,000, and if the volume is over 200,000, the cost is \$400,000. Because the break-even volume is greater than 200,000 bottles, we have used the higher warehousing cost as a fixed cost.

Because the volume to be sold and the direct costs at each price point are different, we have calculated a weighted average selling price.

Break-even analysis for the organic wine proposal			
Selling price per bottle		\$15.00	\$25.00
Direct cost percentage to wine producers		65%	60%
Direct cost to wine producers		\$9.75	\$15.00
Net profit per bottle before common variable costs		\$5.25	\$10.00
Expected sales mix		40%	60%
Weighted net price per bottle		\$2.10	\$6.00
Weighted average net price per bottle			\$8.10
Other variable costs per bottle			
Shipping and distribution	\$19.80/12 = \$1.65 per bottle		(1.65)
Contribution margin on organic cheese sales			0.75
Contribution margin per bottle			<u>\$7.20</u>
Fixed costs			
o Labour to staff and manage the wine department (\$450,000 - \$40,000)		\$	410,000
o Annual amortization of new shelving required			300,000
o Marketing for print and electronic media			280,000
o Supplies and other costs			180,000
o Warehousing costs			400,000
	Total fixed costs		<u>\$ 1,570,000</u>
	Number of bottles to breakeven		218,056
	Number of bottles per week to sell		4,193

Assuming the sales mix is correct, 4,193 bottles per week will, therefore, need to be sold in order for the wine boutique to break even.

However, the break-even volume will change if any of the following are true:

- The percentage of sales at each of the two bottle prices changes. If there are more sales at the \$15 price, more bottles will need to be sold. If more bottles are sold at the \$25 price, fewer bottles will need to be sold due to the higher net profit per bottle before common variable costs.
- The cheese sales are not as expected.
- The warehouse cost, as a step-fixed cost, is only \$300,000, if volumes of fewer than 200,000 bottles are required. Although unlikely, this would occur if 100% of the sales were at the \$25 price, for example.
- The opportunity cost of giving up space to install the wine boutique is more than the \$25,000 provided. For example, if this space was being used by another department or for sale of other items, FFTY may be giving up revenue from the sales of those additional products. We would require more information to determine this amount.

For Assessment Opportunity #5, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate the break-even number of bottles for the organic wine proposal.

Competent – The candidate provides a reasonable calculation of the break-even number of bottles for the organic wine proposal.

Competent with distinction – The candidate provides a thorough calculation of the break-even number of bottles for the organic wine proposal and considers factors that may affect the calculation.

Assessment Opportunity #6 (Common)

The candidate analyzes the summary of data presented and provides recommendations to improve FFTY's operating profits. The candidate also questions the reliability and/or gaps in the information presented.

The candidate demonstrates BREADTH or DEPTH in Core Management Accounting.

CPA Map Technical Competencies:		Core
3.2.1	Develops or evaluates data and information inputs for operational plans, budgets, and forecasts	A
3.3.4	Recommends cost management improvements across the entity	B
3.5.2	Evaluates sustainable profit maximization and capacity management performance	A

CPA Map Enabling Competencies:

1.3.2 Recognizes bias, uncertainty and ambiguity in the information and assumptions that underlie assigned work

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

Recommendations to Improve Profitability

Jim has gathered data and summarized some key financial information. Based on the information presented, we can provide some insights and recommendations.

Profitability of perishable items

Throughout the majority of the year, perishable items are providing a reasonable gross margin (approximately 40%, based on the annual gross margin percentage shown). However, during the winter months (December to February), it appears that perishable items are being sold at a loss, since the cost of goods sold during those months is higher than the revenue generated. FFTY aims to keep prices consistent throughout the year, but it appears that the cost of perishable items increases during those months, perhaps due to lack of access to organic perishable items driving up the cost, and selling prices are not being adjusted to cover the increase. Given that FFTY's customers are willing to pay a premium for locally sourced foods and, therefore, appear to be less price sensitive than others, FFTY should increase the pricing of perishable items during the winter months to maintain the same margin as throughout the rest of the year.

Customers moving from non-perishable to perishable items

There appears to be an increase in perishable revenue during the summer months (July to September) and a decrease in non-perishable revenue during the same time period. Because FFTY tries to keep prices stable, this increase in perishable revenue is likely due to an increased volume of sales. Given that customers are likely substituting non-perishable items with perishable ones during the summer (e.g., fresh peaches instead of canned peaches), this is reasonable. FFTY could attempt to keep non-perishable revenue high during the summer months by offering a small discount on non-perishable items that pair well with perishable items. For example, salad dressing could be discounted with the purchase of lettuce or spinach, which would encourage customers to buy more non-perishables from FFTY during that time. FFTY could also offer discounts on non-perishable items in general.

Freshly prepared hot and cold foods — revenue

The freshly prepared foods revenue is lower in the summer months. This could be due to customers being away or perhaps having more time or motivation to cook their own food rather than purchase prepared food during those months. FFTY does not currently have seating areas for people to eat prepared foods, unlike some of its competitors. Management should consider adding seating areas, which may help increase revenue during the summer months since there may be a group of customers, such as a regular lunch or dinner crowd, who will purchase freshly prepared food to eat at FFTY.

Freshly prepared hot and cold foods — expenses

Freshly prepared food expenses are quite stable throughout the year. In several months, however, the revenue earned from freshly prepared foods does not cover the costs. These foods also contribute the most to spoilage. It appears that too much food is being prepared. Adding a seating area in each store may help reduce spoilage, in which case current levels may end up being fine. If seating areas are not added, FFTY should consider tracking which types of prepared foods are being thrown out on a regular basis and reduce the amount made of those items. In addition, more sophisticated data analysis could be used to determine which items will be popular on which days, which would allow FFTY to better plan and to prepare the right amounts and types of foods on the right days. FFTY could also consider implementing discounts on prepared foods that have not yet sold several hours before store closing to encourage customers to buy these items so they do not need to be thrown out.

Product mix

The largest portion of revenue currently comes from perishable items; however, this category currently has the lowest gross margin percentage of the three types of items. Similarly, freshly prepared foods make up the smallest portion of revenue but have the highest gross margin percentage. FFTY would benefit from either a) shifting customer spending from perishable items to freshly prepared foods, perhaps by offering coupons that would provide a discount on perishable items if customers also purchase a prepared food item; or b) improving the gross margin of perishable goods, perhaps by increasing the pricing of produce, especially during the summer months (as discussed above) or by negotiating volume discounts during the summer months.

Reliability and/or Gaps in the Information Provided

The above recommendations are based solely on the information provided. However, it appears that the data used to prepare the summary information may not be entirely reliable. Additional data that would help in interpreting the information provided is as follows:

- Jim has only used financial data from 2019, not 2020. There are some changes in 2020, such as company growth and new franchisees, that could cause 2019 not to be representative of 2020 or of future years. Using the most recent data available will likely yield a better analysis. The fact that 2020 financial information has not been audited is of less concern, since the data that is used should be just day-to-day transactions, and not accounting adjustments. Ideally, both 2019 and 2020 data would be used and compared, which would allow for identifying trends, isolating items that have changed in 2020, etc.
- Jim has provided summary information on spoilage, but it appears that the information may not be reliable. Jim noted that, on his tour of one of the store locations, employees did not appear to be tracking the information. The fact that the spreadsheet exists must mean that at least some employees are tracking this information, but it does not appear that the information on the spreadsheet is complete. The reliability of the data is also questionable, since it is possible that not all employees are following the policy, and perhaps the data is skewed towards those departments that are consistently using the spreadsheet. If this data is to be relied upon, Jim should at least talk with employees and identify which employees and/or locations are using the spreadsheet so that the information can be better understood. Additionally, if this information is to be used in the future, FFTY should be stricter on adhering to the policy of tracking spoilage. For example, store managers can review the spreadsheet daily and ensure entries have been made. More technological solutions, such as handheld scanners or tablets that employees can update instantly, may be a valuable investment as well, to ensure that this tracking is performed.
- Jim used only two sources of data: the accounting system and the spoilage spreadsheet. He should seek additional sources of information. For example, information in the point-of-sales system should have useful data, such as which products and brands are more popular and when products are being purchased (e.g., whether they align with product promotions/discounts, etc.). This would provide useful information for FFTY's operational plans.
- Jim has used internal sources of information only. Although internal information is important, external sources, such as industry statistics, are also valuable in helping to interpret results. While FFTY is unique, it also has similar competitors. Even if the industry statistics are not directly comparable to FFTY, they can be used to understand whether FFTY is making good decisions. For example, is FFTY's strategy of keeping prices consistent throughout the year different, or the same, as its competitors? The answer will help guide any future operational decisions.

Overall, improvements could be made to the data used, which will improve the analysis and insights FFTY is able to obtain.

For Assessment Opportunity #6, the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate provides some recommendations consistent with the information presented or discusses some of the reliability issues/gaps in the information provided.

Competent – The candidate provides several recommendations consistent with the information presented or discusses several of the reliability issues/gaps in the information provided.

Competent with distinction – The candidate provides many recommendations consistent with the information presented and discusses many of the reliability issues/gaps in the information provided.

**DAY 2 – MARKING GUIDE – ASSURANCE ROLE
FRESH FOOD TO YOU INC. (FFTY)**

To: Shelley Winters
From: CPA
Subject: Requests with respect to Audit and Assurance work

See Common Marking Guide for the Common Assessment Opportunities #1 to #6.

Assessment Opportunity #7

The candidate discusses the risk assessment for the 2020 audit.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies (based on the 2020 CPA Competency Map):		Core	E3 AS
4.3.5	Assesses the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures	B	A

CPA Map Enabling Competencies:

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

You have asked that an audit plan be prepared. This includes an assessment of the risks of material misstatement in the financial statements.

Risks of material misstatement at the financial statement level include the following:

- Scott has indicated that FFTY wants to maximize profits when possible. As the owners seem highly motivated to present good financial performance and may manipulate the financial statements in order to do so, this increases risk.
- Michelle has hired additional accounting staff. As new staff may not be familiar with FFTY's processes and may, therefore, be more prone than current staff to making errors, this increases risk.
- The Board of Directors met only once last year, to approve the audited financial statements. As this amount of oversight may be insufficient to detect errors in the financial statements, this increases risk.

- There have been several new transactions during the year (investment in LOB, franchise revenue, sale-leaseback transaction, and non-monetary transaction), and several errors were found in the draft financial statements. This increases the risk that there are complex transactions that staff do not know how to account for, as well as other errors that we are unaware of.
- FFTY has recently changed its revenue model to include franchising and is planning to expand this model in the coming years. As it is likely that the company has implemented new processes for which its controls are inadequate, resulting in increased errors, this increases risk.
- FFTY wants to expand through franchising. To attract franchisees, the company must show strong profits. As management may be biased to manipulate the financial results, this increases risk.
- FFTY has a significant amount of debt relative to its balance sheet position and is highly leveraged. As management may be biased to choose accounting policies and treatments that improve financial performance, in case the company requires additional financing or needs to replace existing financing, this increases risk.
- Some control weaknesses were noted in the areas of payroll (errors in payroll report) and revenue (self-checkouts). This increases risk since there may be other control weaknesses that are pervasive to the overall financial statements and there may not be sufficient controls in place to detect errors made in payroll and revenues.
- FFTY operates in an environment where theft can easily occur, increasing fraud risk. It has been noted that some items seem to have more discrepancies in terms of inventory, which may be indicative of theft. This increases the risk of error since current controls (e.g., spoilage tracking, as noted elsewhere in this report) may not detect the theft, resulting in errors in the financial statements.
- Scott and Antonia have been the sole shareholders of FFTY for a long time. They are very involved in the company and meet regularly as part of the management committee to review the actual and budgeted statements. As any errors in the financial statements would likely be caught by them, this decreases risk.
- FFTY's operations are relatively simple and the day-to-day transactions are routine. As staff are likely able to account for regular transactions accurately, reducing the risk of error, this decreases risk.

Based on the above factors, the overall financial statement risk is assessed as high. We will be required to respond to the above risks throughout our audit.

For Assessment Opportunity #7 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to perform a risk assessment.

Competent – The candidate performs a risk assessment and concludes on the overall risk of material misstatement or recognizes the auditor needs to respond to the risks identified.

Competent with distinction – The candidate performs an in-depth risk assessment and concludes on the overall risk of material misstatement or recognizes the auditor needs to respond to the risks identified.

Assessment Opportunity #8

The candidate discusses the audit approach and materiality for the 2020 audit.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.3.4	Assesses materiality for the assurance engagement or project	B	A
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

2.2.2 Recognizes the importance of internal controls within areas of work responsibility

5.1.1 Applies general business knowledge to enhance work performed

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.1 Identifies and articulates issues within areas of work responsibility

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

Preparation of an audit plan includes consideration of what audit approach to take and of materiality.

Audit Approach

There are several factors to consider related to the audit approach. FFTY, as a grocery store, would have routine, high-volume, low-dollar-value transactions throughout the year. Overall, this indicates that a combined approach should be used, if possible, to reduce the amount of substantive testing required. We should identify controls over the major business cycles, such as sales and purchases, and assess the design and implementation of those controls. If those controls are appropriately designed and implemented, we should consider performing control tests. If the controls are operating effectively, we can reduce our substantive testing in those areas.

The checkout systems are highly dependent on IT controls, so if we plan to rely on controls over revenue, cost of sales, and inventory, we will also need to test the operating effectiveness of IT general controls and IT application controls in those systems. For example, we will need to consider controls over databases (of product prices and quantities) and programs (to ensure that no one changes the program code).

There are some specific areas where controls may not be operating effectively. Given the errors noted in the summary wage report in one of the stores, we should discuss the errors with management and consider whether the control weaknesses in payroll may be confined to one store. Our assessment of the design and implementation of payroll controls at the other stores will provide some insight into whether we may be able to test the operating effectiveness of payroll controls at those stores. It is possible that the control failures are isolated, in which case payroll controls may still be relied upon at the other stores. However, more substantive work would have to be performed over the store with the payroll issues.

Also, given the addition of franchises during the year, control risk is increased since there are likely new processes in place related to the franchising model. We should identify and assess the design and implementation of these controls to determine whether it makes sense to test their operating effectiveness, in the hope of reducing our substantive testing related to franchise operations.

The self-checkouts implementation is another area where we need to assess the design and implementation of controls, including IT controls, before deciding whether it makes sense to test them for operating effectiveness. Given the control weaknesses identified (see further on in this report), however, we likely cannot rely on controls for the revenues recorded by the self-checkouts. Therefore, we will not be able to reduce our substantive testing in this area.

Overall, although we will likely take a combined approach, we may need to adopt more of a substantive audit approach for those areas in which controls are not operating effectively.

Materiality

The following are users of the financial statements:

- FFTY has commenced selling franchises and sold two in 2020. In addition, potential franchisees receive a disclosure document that includes FFTY's audited financial statements. Therefore, potential franchisees will rely on the financial statements and will be interested in FFTY's profitability.
- The audited financial statements will be used by MG Bank, FFTY's current bank. The bank will be interested in FFTY's ability to repay its debt (i.e., cash flow) and in the value of any potential collateral.
- Scott and Antonia, the owners of the company, are interested in FFTY's profitability.
- The board and management will use the financial statements to assess company performance and profitability.

Based on the above analysis, all users are interested in the profitability of FFTY; therefore, income before tax is the most appropriate basis to use for materiality. This is also consistent with CAS 320 – *Materiality*, paragraph A5, which suggests that “*profit before tax from continuing operations is often used for profit-oriented entities.*” CAS 320.A8 also states that:

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment... 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.

Given that 5% is recommended for profit-oriented entities, and because there are no other factors to suggest another percentage would be more appropriate, 5% should be applied to the income before taxes.

The gain on sale of the land and building should be an adjustment to normalize income.

Using the draft financial statements, the calculations are as follows:

$$\begin{aligned} & 5\% \text{ of earnings before taxes} \\ & = (\$9,510,000 - \$4,000,000) \times 5\% \\ & = \$275,500, \text{ or } \$276,000 \text{ rounded} \end{aligned}$$

Performance Materiality

We must also calculate the performance materiality for the audit. Per CAS 320.A13, performance materiality is “set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole.” Performance materiality is usually in the range of 50% to 90% of materiality. Given that the risk of material misstatement at the financial statement level has been assessed as high and there are known accounting errors to be corrected, a performance materiality factor of 60% has been applied. Therefore, performance materiality is $\$276,000 \times 60\% = \$165,600$, or $\$166,000$ rounded.

Revision as the Audit Progresses

Materiality needs to be revised as the auditor becomes aware of issues affecting the calculation. Given the adjustments made to the financial statements, the new materiality based on the revised financial statements is as follows:

$$\begin{aligned} &= [\$5,510,000 \text{ (draft income before taxes and gain)} + \$140,000 \text{ (LOB adjustment)} - \$90,000 \\ &\text{(franchise revenue adjustment)} - \$110,887 \text{ (sale-leaseback, excluding gain, which has already} \\ &\text{been excluded)}] \times 5\% \\ &= \$5,449,113 \times 5\% \\ &= \$272,456, \text{ or } \$272,000 \text{ rounded} \end{aligned}$$

Performance materiality will also need to be adjusted and will be $\$163,200$ ($\$272,000 \times 60\%$), or $\$163,000$ rounded.

For Assessment Opportunity #8 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate provides a discussion of audit approach or materiality.

Competent – The candidate provides a discussion of audit approach and materiality.

Competent with distinction – The candidate provides an in-depth discussion of audit approach and materiality.

Assessment Opportunity #9

The candidate discusses audit procedures for the specific accounting issues identified.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.2.1 Uses existing knowledge in new or different ways

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

The following audit procedures are related to specific accounting issues that arose in 2020.

Investment in LOB

- To ensure existence, rights and obligation, and accuracy, we should examine the purchase agreement for the purchase amount and the fact that ownership of shares has transferred. The amount paid should also be vouched to the bank statement.
- To ensure appropriate classification, we should verify that management has the ability to exercise significant influence. We should confirm that FFTY owns 18% of the outstanding common shares by vouching to the shareholder agreement. In addition, we should confirm that FFTY has a seat on the board by reviewing board minutes and shareholder minutes where the board appointments are approved.
- To ensure accuracy of the investment amount recorded at year end, we should obtain the financial statements of LOB for the current period and verify the income that has been used to calculate equity income for the period:
 - Consider whether there are any differences in accounting policies or reporting practices between the investor and the investee by reviewing the disclosure of accounting policies in the financial statements and discuss this with management. If there are differences that are material, ensure that appropriate adjustments have been made.
 - Verify the dividends declared and ensure that the amounts have been deposited in the bank account (e.g., by reviewing a deposit slip).
 - Obtain a listing of FFTY’s inventory at year end and ensure that there is no LOB inventory on the listing.

Franchisee fees

- To ensure accuracy, we should verify that the amount allocated to each of the initial, royalty, and optional fees is accurate by examining each franchise agreement and vouching the amounts of the initial and optional fees and the percentage of sales that would be used to calculate the royalty fee.
- To ensure occurrence and accuracy, we should verify that the initial fees have been earned and recorded at the correct amount by vouching amounts recorded to the deposit slip or bank statement.
- To ensure accuracy and cut-off of the royalty fees, we should verify the monthly sales from each franchise from the monthly sales reports. We should also check the calculation of the monthly royalty fees to ensure that the percentages agree to the franchise agreement.
- To ensure revenue related to the optional fees has occurred and is accurate, we should confirm with franchisees that the operations manual has been provided and that there has been upfront training and ongoing support since the store opening.

Sale of the land and building

- To ensure occurrence and accuracy of gain on the sale of the land and building, we should do the following:
 - Vouch the sale proceeds to bank deposit slips and disposal costs to invoices.
 - Compare the net book value at date of disposal to the amount used to calculate the gain, and ensure the net book value is accurate by vouching the original cost to supporting documentation, such as an invoice, and recalculating the depreciation to the date of disposal.
 - Examine the calculations to allocate the proceeds between land and building and vouch to supporting documentation (e.g., recent appraisals) for this allocation.

Lease

- To ensure existence, rights and obligations, and accuracy, examine the lease agreement for relevant terms to verify that it has been properly classified as capital. For example:
 - To determine whether the lease term is more than 75% of the useful life of the asset, agree the lease duration used for the calculation to the lease agreement, and consult with the appraiser to determine whether management's estimate of the building's useful life is appropriate.
 - To determine whether the present value of the minimum lease payments is greater than 90% of the fair value of the asset, verify the present value of the minimum lease payments by vouching the incremental borrowing rate used to FFTY's recent borrowing agreements and the lease payments to the lease agreement. Verify the fair value of the land and building by vouching it to supporting documentation, such as an appraiser's report or recent sales prices for similar properties in the area, if they exist.
- To ensure accuracy, recalculate the amount to be capitalized, the lease obligation, and the amortization/interest expense based on lease payments and other terms in the agreement.

Non-monetary transaction

- To ensure occurrence, accuracy, and appropriate classification, examine the agreement related to the exchange of web design services for freshly prepared foods, and confirm the terms and amounts, as well as the fact that it is a non-monetary transaction.
- In addition, to ensure appropriate classification:
 - Obtain any estimates of future cash flows of the web design services and freshly prepared foods to support that there is commercial substance.
 - Examine the documentation (e.g., FFTY price list) supporting that the values of the freshly prepared food total \$290,000.
 - Examine documentation (e.g., research online; invoice for other purchases made by FFTY) supporting that the value of similar web design services is \$310,000.

For Assessment Opportunity #9 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some audit procedures for the specific issues identified.

Competent – The candidate discusses several audit procedures for the specific issues identified.

Competent with distinction – The candidate discusses many audit procedures for the specific issues identified.

Assessment Opportunity #10

The candidate reviews the summary wage report for store #3004 and recommends the audit procedures that should be performed for any significant changes during the year and any anomalies identified.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A
4.3.7	Performs the work plan	B	A
4.3.8	Evaluates the evidence and results of analysis	B	A

CPA Map Enabling Competencies:

- 1.3.1 Maintains a skeptical mindset when performing assigned work*
- 2.2.1 Assists in identifying and monitoring risks within areas of work responsibility*
- 5.1.1 Applies general business knowledge to enhance work performed*
- 5.1.3 Develops and uses knowledge of the organization, industry and stakeholders*
- 5.2.1 Uses existing knowledge in new or different ways*
- 6.1.1 Identifies and articulates issues within areas of work responsibility*
- 6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems*
- 6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues*
- 6.2.1 Maintains an objective and questioning mindset to avoid biased analyses*
- 6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions*
- 7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility*
- 7.1.2 Communicates non-complex financial information logically, clearly, concisely*

The following audit procedures are required for any significant changes noted during the year, as well as for any anomalies identified.

Number of Hourly Employees per MonthItem noted

The number of employees increased in May from 60 to 63. In August, there was again an increase, from 63 to 65 employees. Although the change in number of employees is not significant, any time employees are added, there is an increased risk of error or fraud. To ensure occurrence, we must verify that these are legitimate, and not fictitious, employees:

- With store management, discuss the personnel changes, particularly in May and August, to verify that three new employees started in May and two more started in August.
- If more employees started than these numbers indicate, verify that some of the employees were terminated or did not work during the month.
- Identify who these new employees are and examine their contracts to ensure they are real, and not fictitious, employees.
- Examine the approval to add these employees to the store payroll and ensure it was properly approved by FFTY management.
- Agree the hours worked for each new employee to the report of hours worked for the month in which they started. Ensure the rate of pay agrees to the employee record.

Item noted

The number of employees decreased in November, from 65 to 63. Again, although the decrease in numbers is not significant on its own, there is increased risk because of the change. To ensure completeness, we must verify that these employees either were terminated or did not work during the months of November and December:

- Discuss changes in personnel during these periods with store management.
- Assuming termination, vouch to the paperwork to approve the termination.
- Check that the last payroll paid to the terminated employees ended on their termination date.
- Check that the last pay was calculated correctly, including any vacation pay or other pay that might be owing.

Average Hours per Week per EmployeeItem noted

The average hours per week, per employee, generally ranged from 20 to 25. Two months are outside of this range. In April and December, the average number of hours per week per employee increased significantly and was also over the 40 allowable hours. To ensure accuracy and occurrence, this needs to be investigated to confirm that payments were made only for work performed:

- Discuss with store management why the hours were higher than normal in April and December. In order for the average hours to double, a significant event may have occurred, such as an inventory count in December. If there were no significant events, or the events do not seem to account for the doubling of hours, consider the possibility that timesheets were modified by someone (i.e., potential fraud).
- For each week of April and December, examine the payroll to determine the weeks in which the average hours exceeded 40 hours. Trace back to timesheets to identify why more than the maximum hours were worked and by whom. Ensure there is approval for these hours. Ensure the timesheets have been properly approved.
- If the increased average is due to overtime pay or bonuses, ensure the excess hours or pay have been approved by management and that a reason was provided for the excess hours.

Item noted

The average number of hours decreased significantly in July to 11, from 22 average hours per week in June. To ensure accuracy and completeness, the following needs to be done:

- Discuss with store management why the hours per week might be low in July (e.g., store closure for some event). Determine whether this variance was already investigated by management and, if so, what was found and what action was taken.
- For each week of July, examine the weekly payroll report from head office to determine the weeks in which the average hours were low. Obtain the information transferred from the store for those weeks and ensure that all hours were transferred and recorded by head office.

Average Hourly Pay per Employee

Item noted

The average hourly rate for this store has been between \$16.40 and \$17.30. In August, the average hourly pay was \$14.65, which is below FFTY's minimum hourly wage of \$15. To ensure accuracy, the following audit procedures need to be performed:

- Examine other stores to determine whether their range of average hourly rates is consistent with this store. The range represents a 5% differential ($\$17.30 - \$16.40 \div \$16.40$). Determine whether this is consistent with other stores and whether other stores' rates also declined during the same months.
- As the hourly rate should not be below \$15, an error has likely occurred for August. Discuss with management how the average pay rate is calculated and why it was so low in August. Determine whether an error was noticed as part of the review by the store manager and, if it was noticed, whether it was corrected.
- Examine the payroll reports for each week of August. Check the calculation of the average pay rate for August. Look for employees with a low rate of pay. Trace back to their pay rate in previous periods and to their payroll records.
- Examine adjustments to the pay rate and ensure that these adjustments were approved by FFTY management.
- Recalculate the pay to assess for any miscalculations.
- If a correction was made, trace back to the correction to determine who made the adjustment, who approved it, when the correction was made, and whether it was adjusted correctly.

Net Pay as a Percentage of Gross Pay

Item noted

In June, the net pay was only 61% of the gross pay, whereas in July, it was 90% of the gross pay. In other comparable periods, the net pay has ranged from 80% to 85%. To ensure accuracy, the following audit procedures are required:

- Discuss with FFTY management why the net pay as a percentage of gross in June and July was significantly different than in the other months of the year.
- Not only was the net pay possibly incorrect, but also the average hours per employee per week were too low for July. Perhaps these variances are connected. As we perform the additional audit procedures, we should be mindful that something could cause variances in both these items.
- Examine the payroll reports for June and July to find where the net pay appears to be incorrect. For the week(s) in which this is the issue, determine whether the net pay is incorrect for all employees or just for some. For those whose net pay appears incorrect, recalculate the gross and net pay. Also, check against previous periods and review for any unusual adjustments. If any are found, investigate the reason and authorization for these adjustments.
- For the relevant employees, trace the net pay to the deposit.
- If this was subsequently corrected (which might be the case since July has the higher net pay), recalculate the net pay for the relevant employees for that subsequent period also.

For Assessment Opportunity #10 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses audit procedures for some of the significant changes during the year and the anomalies identified.

Competent – The candidate discusses audit procedures for several of the significant changes during the year and the anomalies identified.

Competent with distinction – The candidate discusses audit procedures for many of the significant changes during the year and the anomalies identified.

Assessment Opportunity #11

The candidate discusses the various reporting options available and the procedures that would have to be performed on the annual statement of gross sales.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.2.1	Advises on an entity's assurance needs	B	A
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.2.1 Uses existing knowledge in new or different ways

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

SMT Enterprises Inc. (SMT), the landlord, requires an independent verification of the annual statement of gross sales for the three store locations. This schedule is used to calculate the variable rent. FFTY has asked us to provide the report required by SMT.

Reporting Options

SMT is looking for verification on revenues from three stores. As revenue is a type of historical financial information, one report that can be issued is under CAS 805, *Special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement*. This report would be addressed to SMT and would contain a reference to the annual statement of gross sales, the financial reporting framework under which the statement is prepared (i.e., ASPE), and any specific definitions used (e.g., discounts; returns). It would also contain a description of the responsibilities of management and the firm and a statement as to whether, in the firm's opinion, the statement is prepared, in all material respects, in accordance with the financial reporting framework chosen. The report provides reasonable assurance, and the nature of audit procedures performed would be those of inspection, observation, confirmation, recalculation, re-performance, and analytics. A specific materiality would be used in performing procedures over store-level gross revenues (likely lower than materiality used for audit engagement). Because of the extent of assurance offered and the level of procedures required, this is often the costliest of the options available, although the cost is significantly reduced when the auditor preparing the CAS 805 report is also the auditor of the annual financial statements.

Another report we could consider is one that can be issued under CSRE 2400, *Engagements to review historical financial statements*. The scope of this standard covers other historical financial information, so this standard applies to the annual statement of gross sales. While it is similar to the CAS 805 report, this report provides a lower level of assurance. We would provide limited assurance that nothing has come to the firm's attention to indicate that the statement is not prepared, in all material respects, in accordance with the financial reporting framework chosen. The nature of procedures would typically be limited to analytical procedures and inquiry, and the procedures performed would be less rigorous than a CAS 805 report and, therefore, less costly.

Finally, we could potentially issue a report under Section 9100, *Reports on the results of applying specified auditing procedures to financial information other than financial statements*. Under this report, the firm would perform specific procedures as requested and report on the results of those procedures, but would not provide any assurance in the report. The lease agreement states that the annual statement of gross sales by month and by store needs to be "verified" by an independent CPA, but it does not seem to explicitly ask for assurance from the CPA; therefore, a Section 9100 report could be an option. The advantage of this is that SMT could have input on the procedures to be performed, and only the exact amount of work required to give SMT the information it needs would be performed. We would also report factual results from those procedures, and SMT could interpret those results as it chooses. The cost of the engagement would depend on the number and type of procedures that are agreed to. Because we are not providing assurance, the firm takes on less risk. However, no opinion or conclusion is provided on this report, so SMT would have to interpret the results of the procedures.

It is unclear what SMT means by verification and whether assurance is required. SMT is receiving rental revenue based on the statement, so the landlord is unlikely to be satisfied with no opinion or with limited assurance. Therefore, they will likely insist on a CAS 805 report. However, I recommend that FFTY confirm with SMT whether a CSRE 2400 or Section 9100 report might be sufficient for its needs, which will likely reduce the cost to FFTY, or that FFTY request that SMT pay a portion of the cost of the CAS 805 report.

Audit Procedures

SMT will be most concerned if sales are understated, since that would reduce the variable rent payment, so our procedures should test sales for completeness. Procedures covering occurrence and accuracy would also be required. Assuming that a CAS 805 report is required, the following procedures will likely be performed:

- To ensure completeness:
 - We should first obtain the detailed general ledger account on sales for the three stores and agree the amounts to the annual statement. Then, we would select a sample of daily sales reports to ensure that each report agrees to an entry in the general ledger.
 - In addition, we should consider performing analytical procedures, for example, by comparing the sales of each of the three stores to other stores in a similar geographical area to determine whether the sales amounts are reasonable.
- To ensure occurrence and accuracy:
 - We should select a sample of sales transactions from the checkout tills and trace them through the daily sales reports to the sales accounts in the general ledger.
 - As the volume of sales would be high, and sampling individual sales alone would not be sufficient to reduce risk to an acceptable level, we will likely need to take a combined approach. We will have to visit all three locations to audit the systems and controls used at each store, as well as the sales reports prepared by each store, since they may not have been specifically tested at the year-end audit. We should also test any controls to verify that the daily sales reported by the three stores were all recorded in the general ledger.
 - We may need to test the IT systems in the three stores (i.e., the checkout tills) to ensure they are processing sales and inventory transactions correctly. We would not need to test the controls over the general ledger system at head office because we would have done that in our year-end audit.
 - Given the specific requirements of the lease, we will need to specifically design audit procedures to identify returns and discounts that would have been deducted in determining sales for financial statement purposes. This may involve the following:
 - Reviewing a sample of returns during the year to ensure they are valid. For every return sampled, we should ensure that inventory has been increased. As the risk is that the number of returns is overstated, a sample of the returns should also be vouched to supporting documentation (for example, approval and sign-off by a store manager).
 - Reviewing a sample of discounts provided throughout the year and vouching the amounts to supporting documentation (e.g., flyer advertising, coupons, etc.).
 - We may perform some analytical procedures to compare sales and gross margins to other similar stores in the company, to gain additional assurance that sales are reasonable.

For Assessment Opportunity #11 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some of the reporting options available or some of the procedures that would be performed.

Competent – The candidate discusses some of the reporting options available and some of the procedures that would be performed.

Competent with distinction – The candidate discusses most of the reporting options available and most of the procedures that would be performed.

Assessment Opportunity #12

The candidate discusses the weaknesses in the internal controls for the new self-checkouts and makes recommendations for improvement.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.1.1	Assesses the entity's risk assessment processes	A	A
4.1.2	Evaluates the information system, including the related processes, using knowledge of data requirements and risk exposures	B	A

CPA Map Enabling Competencies:

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

2.2.2 Recognizes the importance of internal controls within areas of work responsibility

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.1.1 Identifies and articulates issues within areas of work responsibility

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

You asked me to assess any weaknesses in the internal controls for the self-checkouts and to recommend improvements.

Overriding Weight CheckWeakness

If an item's weight does not match the product code, an alert sounds. The attendant is supposed to check the item and the weight to ensure their accuracy. The attendant is often too busy and overrides the error without checking.

Implication

The weight is a check that the customer has scanned the correct item. The alarm indicates a mismatch between the weight and the item code. If the attendant does not check the error, the wrong item code may have been entered, either by accident or on purpose (i.e., the code is for a cheaper item); therefore, the item will not be charged at the proper price. Alternatively, customers may be putting items in the bag without scanning them, which would also result in a weight mismatch. Failure to investigate these weight discrepancies will lead to misstatements in sales and inventory adjustments.

Recommendation

The system relies on the attendant to ensure that input errors are corrected. The attendant must ensure that each error is investigated and corrected. They should be watching for customers scanning items incorrectly. For this manual control to be performed properly, FFTY may need to reallocate more staff to the self-checkout lines during busy times.

Review of Exception Report

Weakness

An exception report of overrides and corrections is available but is not reviewed.

Implication

When attendants are busy, they perform overrides without understanding the nature of the errors. Errors could be in type of item, price, or quantity and lead to misstatements of revenue and inventory. The exception report allows FFTY to determine the nature of common errors and implement controls to reduce the number of overrides and error corrections.

Recommendation

The report on overrides should be reviewed daily so that store management understand the nature of the adjustments, the machines on which they are occurring, and the attendants who are making them. With this review, management can see if the errors

- are constantly occurring on the same inventory item, which could result from an input error in the database for the weight of the item;
- are with the same attendant, indicating that the attendant is not doing their work properly to ensure the control is effective; or
- are on the same machine, which could mean that it is faulty.

FFTY can then use this information to improve the current processes.

Receipt Check

Weakness

When a customer has checked out and is leaving the store, the attendant is supposed to quickly review their sales receipt to ensure the list of purchases is reasonable in comparison to the volume of items in the cart. However, management has told attendants not to make people wait for this review, so it is only done when the attendant is immediately available. If the attendant is occupied with another customer or distracted, this review does not get completed.

Implication

If the attendant is not available to make this review, there is nothing preventing the customer from leaving items in their cart, avoiding the scanner, and walking out. This results in customers not paying for items (either accidentally or on purpose), sales being understated, and inventory not being adjusted correctly. Ideally, the attendant should be watching for such actions, but if they are distracted or busy with another customer, this review is not being done.

Recommendation

Management should not ask attendants to skip the review when customers are waiting. Again, FFTY may need to hire additional attendants to ensure this check is performed if management does not want customers to wait. When doing the check, attendants should look for certain items, such as large items that cannot fit into a bag or on the scale or expensive items that customers may not put through the scanner on purpose.

Pricing Changes

Weakness

It appears that the pricing changes made by the pricing clerk are not approved or double-checked by anyone other than the pricing clerk.

Implication

The company relies on the system to price items correctly. If the pricing clerk is putting price changes into the system without anyone double-checking them, there is a risk they will be entered incorrectly. This could lead to misstatements in the revenue amounts and, if customers are over-charged, to customer dissatisfaction and complaints.

Recommendation

The store manager should review the printed weekly report that details all price changes that have been entered, look for any errors or anomalies, and initial the report to indicate their approval.

Inventory Count Discrepancies

Weakness

Discrepancies between the perpetual inventory system report and inventory counts are investigated but not formally tracked.

Implication

The lack of formal tracking could lead to errors or theft not being detected. For example, a customer could scan a cheaper item for a more expensive item. If the unit weights are different, this should be immediately caught with the alert, as described earlier. However, if the unit weights are the same, this may go undetected. There is also no way to detect this after the event by the sales reports. This error will likely only be discovered when inventory is counted and some items are found to have more or fewer units on hand than there should be, which would lead to the sales and inventory being misstated.

Recommendation

Although a store manager investigates the discrepancies between the perpetual inventory and what is on hand, there should also be formal records kept that they can review to determine if these same discrepancies are happening every week. This would highlight incidents where incorrect codes for the same products are consistently being entered or where customers are stealing items by not scanning them. If the company determines that the loss is significant for these items, additional controls could be implemented to detect this fraudulent behaviour by customers.

Lack of Segregation of Duties over Cash Reconciliation

Weakness

The attendant from the four self-checkouts counts the cash and coupons, prints the sales report for the self-checkouts, and reconciles the cash to the sales report. No one else verifies the reconciliation.

Implication

While the attendant probably cannot change the sales report, they do have access to the cash. The attendant could take some cash, and since no one else checks that the cash actually reconciles to the sales report, the theft may be undetected. They could also destroy one of the sales reports and take that cash.

Recommendation

Another person, preferably in management, should be checking that the daily cash from each checkout reconciles to the report for that checkout.

Incomplete Reconciliation of Sales

Weakness

Only the total cash received is reconciled to the sales report.

Implication

There may be discrepancies in total sales related to debit/credit card receipts or coupons. These will go undetected, which can lead to a misstatement of revenue.

Recommendation

The attendant should reconcile total sales to not only cash, but also debit/credit card receipts and coupons, to ensure the total sales amount is accounted for.

For Assessment Opportunity #12 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some internal control weaknesses for the new self-checkouts.

Competent – The candidate discusses several internal control weaknesses for the new self-checkouts and makes recommendations.

Competent with distinction – The candidate discusses many internal control weaknesses for the new self-checkouts and makes recommendations.

Assessment Opportunity #13

The candidate documents and performs the audit work required with respect to the information presented in the disclosure document.

The candidate demonstrates DEPTH in the Assurance role.

CPA Map Technical Competencies:		Core	E3 AS
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A
4.3.7	Performs the work plan	B	A
4.3.9	Documents the work performed and its results	B	A

CPA Map Enabling Competencies:

1.3.1 Maintains a skeptical mindset when performing assigned work

1.3.2 Recognizes bias, uncertainty and ambiguity in the information and assumptions that underlie assigned work

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

FFTY has prepared a disclosure document for potential franchisees that includes the audited financial statements. FFTY has asked for consent to include Crawford's audit report in the disclosure document. This means that Crawford is associated with the document. CAS 720, *The auditor's responsibility relating to other information* does not explicitly include disclosure documents in its scope, as it deals with other information included in an entity's annual report. However, the concepts in CAS 720 could be applied in this case, as an auditor's responsibilities would be similar for disclosure documents.

Specifically, CAS 720 outlines the following that the auditor of the financial statements would be required to do:

14. *The auditor shall read the other information and, in doing so shall: (Ref: Para. A23-A24)*
 - (a) *Consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration, the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements) with such amounts or other items in the financial statements; and (Ref: Para. A25-A29)*
 - (b) *Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. (Ref: Para. A30-A36)*
15. *While reading the other information in accordance with paragraph 14, the auditor shall remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated. (Ref: Para. A24, A37-CA38)*

Therefore, we need to read the disclosure document and ensure that the other information is not materially inconsistent with the audited financial statements. The following inconsistencies were found in the document:

- The document indicates that revenues were \$153 million for 2020, representing a 10% increase from 2019 and a 15% increase from 2018. The increase for 2020 compared to 2019 was only 7.6% $[(\$152,916,000 - \$142,148,000) \div \$142,148,000]$. We need to verify the 15% growth rate from 2018 by reviewing the 2018 financial statements.
- The document also indicates that 2020 net earnings improved by 111% over 2019, mainly driven by an improvement in gross margins. Although the draft statements show an increase of 111% for net earnings, this was not driven by gross margin improvements, as the cost of goods sold as a percentage of revenue actually increased from 54.9% in 2019 $(\$78,078,000/\$142,148,000)$ to 56.8% in 2020 $(\$86,860,000/\$152,916,000)$. The main reason for the increase in net earnings was an unusual gain of \$4 million included in 2020 profits; therefore, this statement is misleading and needs to be corrected.
- The document states that FFTY has a long-term debt-to-asset ratio of 52%, which is in line with competitors. although the 52% is correct $(\$50,170,000/\$96,579,000)$, this will have to be compared with any audit work we performed in the debt section, if we have documented any information on competitors, to determine if it is actually in line with competitors.

- Also, several accounting errors have been found in the financial statements, and the revised figures will need to be included in this document.

We also need to ensure that there is no material inconsistency between the information and what the auditor's knowledge is of FFTY, as gained from doing the audit. The following inconsistencies were found in the report:

- The report indicates that the franchisees have been with the company since January 2020; however, the new franchisees did not sign the franchise agreements until July 1, 2020, and August 1, 2020.
- The report states that the company differentiates itself from other competitors by ensuring that at least 60% of all products are locally sourced and about 50% of the perishable products are organic; only 30% of FFTY's products are organic, not 50%.
- The report states that the franchise agreement is initially for 20 years, but the agreement is actually for 10 years, with a 10-year renewal.
- The report states that, ongoing, the franchisee will pay 3% of its gross sales to FFTY for royalties. However, the franchise agreement indicates that this amount is 5%, not 3%.
- The report indicates that the franchisees have earned net profits of \$40,000 after owner's salary in the first 12 months of operations. However, the franchisees have operated for less than 12 months, so there is no evidence of what the first year's net income will be.
- The report indicates that FFTY is planning to grow significantly through franchising in the next several years. As we likely have reviewed management and board minutes during our audit, we should ensure our understanding is consistent with this statement.

Since inconsistencies have been identified, the auditor needs to take the appropriate action.

CAS 720 states:

16. If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:
(Ref: Para. A39-A43)

- (a) *A material misstatement of the other information exists;*
- (b) *A material misstatement of the financial statements exists; or*
- (c) *The auditor's understanding of the entity and its environment needs to be updated.*

Based on our audit work, we believe that these represent material misstatements of the other information. For the misinformation identified above, we will need to ensure that the inconsistencies are discussed with Scott and Antonia and that FFTY corrects the document. We will also have to examine the additional evidence noted above (such as, for example, the 2018 financial statements) to further verify information.

Based on the auditor's knowledge obtained during the audit, there are signs that the other information not related to the financial statements may be materially misstated. In addition to the inconsistencies listed above, the disclaimer section notes that Crawford & Powell LLP has audited the information in the disclosure document. This is incorrect; management is responsible for the information provided, and we did not audit the information. The reference will need to be changed. In addition, CAS 720 requires the following:

21. *The auditor's report shall include a separate section with a heading "Other Information," or other appropriate heading, when, at the date of the auditor's report:*
 - (a) *For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or*
 - (b) *For an audit of financial statements of an entity other than a listed entity, the auditor has obtained some or all of the other information. (Ref: Para. A52)*
22. *When the auditor's report is required to include an Other Information section in accordance with paragraph 21, this section shall include: (Ref: Para. A53)*
 - (a) *A statement that management is responsible for the other information;*
 - (b) *An identification of:*
 - (i) *Other information, if any, obtained by the auditor prior to the date of the auditor's report; and*
 - (ii) *For an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report;*
 - (c) *A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;*
 - (d) *A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this CAS; and*
 - (e) *When other information has been obtained prior to the date of the auditor's report, either:*
 - (i) *A statement that the auditor has nothing to report; or*
 - (ii) *If the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.*

For Assessment Opportunity #13 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to document and perform the work required with respect to the information presented in the disclosure document.

Competent – The candidate documents and performs the work required with respect to the information presented in the disclosure document.

Competent with distinction – The candidate documents and performs in-depth the work required with respect to the information presented in the disclosure document.

**DAY 2 – MARKING GUIDE – FINANCE ROLE
FRESH FOOD TO YOU INC. (FFTY)**

To: Hans Meindl
From: CPA
Subject: Various issues

See Common Marking Guide for the Common Assessment Opportunities #1 to #6.

Assessment Opportunity #7

The candidate calculates the impact on cash flows, discusses the advantages and disadvantages of each alternative, and makes a recommendation.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies (based on the 2020 CPA Competency Map):		Core	E2 FIN
5.1.2	Develops or evaluates financial proposals and financing plans	B	A
5.2.3	Evaluates sources of financing	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.2 Communicates non-complex financial information logically, clearly, concisely

To repay its current long-term debt, which has a high interest rate and requires personal guarantees, FFTY is looking for alternative sources of financing. The company currently has two proposals to consider. The impact on annual cash flows and advantages and disadvantages of each are discussed below.

Kings Bank Loan

Cash flow implications

- This loan requires monthly blended payments of \$330,000, which totals \$3.96 million per year in cash flows.
- As the monthly payment consists of both interest and principal, the loan balance will decline each year until it is fully repaid in 20 years. No large principal payment will be required at the time of maturity.

Advantages

- The annual interest rate of 5% is lower than the current long-term debt rate of 6% but is higher than the rate on the loan with warrants.

Disadvantages

- The following covenants must be met:
 - The long-term debt-to-asset ratio cannot exceed 0.60. At the end of 2020, FFTY's long-term debt-to-asset ratio is 0.55 ($\$53,170,000 \div \$96,579,000$). Therefore, although FFTY can currently meet this covenant, there is a risk the covenant will not be met in the future because it is close to being breached.
 - The company is not allowed to pay dividends, sell assets, or acquire new loans without Kings Bank's approval. This could hinder management in making future decisions with respect to these items, since Kings Bank could not give its approval.
- There are significant penalties for early repayment of the principal. If FFTY breaches a covenant, immediate repayment could be demanded, which could be difficult for FFTY to come up with.
- The loan is secured by the land, buildings, and equipment that the company owns. If FFTY is unable to make its payments, it risks losing this property.

Jason Puneet Loan

Cash flow implications

- The annual cash flows will be only the interest on the loan, which is \$1.5 million ($\$50 \text{ million} \times 3\%$). Therefore, in comparison with the Kings Bank loan, this loan will result in \$2.46 million more available cash flow ($\$3.96 \text{ million} - \1.50 million).
- Whereas the Kings Bank loan requires ongoing principal payments, the principal on this loan is not due until the end of 10 years.

Advantages

- The loan has no security on the assets, which is beneficial for FFTY if management wants to obtain more debt (could be secured against these assets).
- Due to the presence of the detachable warrants, which provide the holder with upside, the 3% interest rate is lower than the current rate of 6%.
- There is no requirement for prior approval for dividends, asset sales, or new issues of debt.
- If and when the warrants are exercised, they may provide additional funds for expansion.
- Jason will become a member of the Board of Directors and, therefore, involved in setting strategic, operating, and financial policies and direction for the company. Jason has significant experience in franchising and, as a board member, may provide valuable advice on being a franchisor.

Disadvantages

- If Jason opposes the future direction that Scott and Antonia want to take with the company, it could be difficult to get decisions made at the board level.
- If the warrants are exercised, Jason will own 28.6% (40,000/140,000) of the outstanding shares of FFTY, which results in Scott and Antonia losing some control of FFTY.
- Through the reduced ownership interest, Scott and Antonia will lose some upside on the associated shares.

Recommendation

We recommend that the company accept the Kings Bank loan. Although Jason's loan saves significant cash flow each year, the cost of giving up 28.6% ownership of the company if the warrants are exercised is prohibitive and could be detrimental in the long term if Jason disagrees with Scott's and Antonia's outlook for the company.

[Marking note: A recommendation to accept Jason's loan is also acceptable due to the cash flow savings and management expertise.]

For Assessment Opportunity #7 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to evaluate the two sources of financing.

Competent – The candidate evaluates the two sources of financing and provides a recommendation.

Competent with distinction – The candidate evaluates the two sources of financing, provides a recommendation, and considers the impact of the warrants.

Assessment Opportunity #8

The candidate prepares a capital budgeting (NPV) analysis of a new product line (delivery of freshly prepared meals) and provides a recommendation.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.3.1	Develops or evaluates capital budgeting processes and decisions	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.2 Communicates non-complex financial information logically, clearly, concisely

	Note		2022	2023	2024	2025	2026
Initial costs							
Purchase of delivery vehicles		\$ (800,000)					
Tax shield on delivery vehicles	1	173,567					
Additional upfront costs		(400,000)					
Increase in inventory		(100,000)					
Revenues							
Number of weekly deliveries			1,000	1,100	1,200	1,300	1,400
Weeks in a year			52	52	52	52	52
Total annual deliveries			52,000	57,200	62,400	67,600	72,800
Average price of food per delivery			\$35.00	\$35.00	\$35.00	\$35.00	\$35.00
Sale of food			\$1,820,000	\$2,002,000	\$2,184,000	\$2,366,000	\$2,548,000
Delivery charge	20%		364,000	400,400	436,800	473,200	509,600
Total revenues			\$2,184,000	\$2,402,400	\$2,620,800	\$2,839,200	\$3,057,600
Expenses							
Cost of food	50%		\$ 910,000	\$1,001,000	\$1,092,000	\$1,183,000	\$1,274,000
Labour costs			450,000	450,000	450,000	450,000	450,000
Website maintenance			80,000	80,000	80,000	80,000	80,000
Vehicle maintenance			100,000	100,000	100,000	100,000	100,000
Marketing costs			150,000	70,000	70,000	70,000	70,000
Total expenses			1,690,000	1,701,000	1,792,000	1,883,000	1,974,000

Net operating cash flows			494,000	701,400	828,800	956,200	1,083,600
Taxes	26.5%		(130,910)	(185,871)	(219,632)	(253,393)	(287,154)
Net after-tax operating cash flows			363,090	515,529	609,168	702,807	796,446
Salvage of vehicles							50,000
Lost tax shield on vehicles	2						(10,461)
Recovery of inventory							100,000
Total cash flows		(1,126,433)	363,090	515,529	609,168	702,807	935,985
Discount factor	8%	1.0000	0.9259	0.8573	0.7938	0.7350	0.6806
Present value		(1,126,433)	336,194	441,983	483,577	516,584	637,016
Total net present value		\$1,288,921					

Notes:

1. Tax shield on delivery vehicles, using the present value of CCA tax shield formula:

Initial cost	\$800,000
CCA	30%
Tax rate	26.5%
Discount rate	8%
	<hr/>
PV CCA TS	<u><u>\$173,567</u></u>

2. Lost tax shield on salvage of vehicles, using the present value of CCA tax shield formula:

Salvage value	\$50,000
CCA	30%
Tax rate	26.5%
Discount rate	8%
	<hr/>
PV CCA TS	<u><u>\$10,461</u></u>

Recommendation

Based on the net present value (NPV) analysis, the project results in a positive NPV of \$1,288,921, indicating that the investment should be made.

For Assessment Opportunity #8 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a quantitative assessment of the new product line.

Competent – The candidate provides a reasonable quantitative assessment of the new product line using a net present value analysis and provides a recommendation.

Competent with distinction – The candidate provides a thorough quantitative assessment of the new product line using a net present value analysis and provides a recommendation.

Assessment Opportunity #9

The candidate calculates FFTY's weighted average cost of capital. This includes selecting appropriate comparable companies to use to determine cost of equity.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.2.5	Evaluates the entity's cost of capital	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.2 Communicates non-complex financial information logically, clearly, concisely

To determine FFTY's weighted average cost of capital (WACC), several steps are required.

1. Calculate the cost of equity using CAPM:

Because the company is private, FFTY must estimate its WACC using "peer" betas. In reviewing the information chosen, all public companies, only those companies that are most like FFTY should be used to determine the appropriate beta. In the table below, each of the selected companies is assessed as to how they compare to FFTY.

Comparison of selected companies to FFTY

Company	Business	Locations	Avg. Store Size (sq. ft.)	Similarities and Differences
Brone's Inc.	Grocery retailer and gas stations	1,500	45,000	Different in that it is a very large chain of grocery stores and gas stations, and store format is twice the size of FFTY; therefore, not included in the calculation of peer beta.
Best Foods Emporium	Retailer of organic and whole foods	150	25,000	Similar in that it sells organic and whole foods, has a small number of stores compared to other companies, and has a comparable store size to FFTY.

Company	Business	Locations	Avg. Store Size (sq. ft.)	Similarities and Differences
				Different in that it does not sell freshly prepared foods.
Himyl's Fresh Foods Inc.	Retailer of fresh foods and freshly prepared foods	195	28,000	Similar in that it sells fresh and freshly prepared foods, has a small number of stores compared to other companies, and has a comparable store size to FFTY.
My Favorite Food Corp.	Grocery retailer and restaurants	450	35,000	Different in that it has restaurants and sells groceries and the store size is larger than that of FFTY; therefore, not included in the calculation of peer beta.
Rosey's Sisters Food Corp.	Retailer of groceries and freshly prepared foods	395	30,000	Similar in that it sells freshly prepared foods and has a comparable store size to FFTY. Different in that it has a large number of stores; therefore, not included in the calculation of peer beta.
Worthy's Grocery Inc.	Grocery retailer and coffee shops	1,020	50,000	Different in that it is a very large chain of grocery stores and coffee shops and the store format is significantly larger than that of FFTY; therefore, not included in the calculation of peer beta.

The two most comparable companies are Best Foods Emporium and Himyl's Fresh Foods. To calculate the beta, we have used the average of these two betas.

	Beta
Best Foods Emporium	1.6
Himyl's Fresh Foods Inc.	1.3
Average	1.45

To calculate the cost of equity using CAPM:

$$= \text{Risk-free return (Rf)} + \text{Beta } (\beta) \times \text{Market risk premium (RPM)}$$

$$= 2.5\% + 1.45 (6\%) = 11.2\%$$

[Marking note: Candidates may pick different peers, but their answer must be supported.]

2. Calculate FFTY's debt/capital ratio:

$$D/V = 53,170,000 \div (53,170,000 + 29,978,000) = 0.64$$

3. Calculate the weighted average cost of capital:

$$WACC = D/V (Rd) (1 - T) + P/V (Rp) + E/V (Re)$$

$$Rd = 6\% \text{ (FFTY's current cost of long-term debt)}$$

$$T = 26.5\% \text{ as given}$$

There are no preferred shares issued and outstanding.

$$WACC = 0.64 (6\%) (1 - 0.265) + (1 - 0.64) (11.2\%) = 2.82\% + 4.03\% = 6.85\%$$

For Assessment Opportunity #9 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate FFTY's cost of capital.

Competent – The candidate calculates FFTY's cost of capital using a weighted average cost of capital model, with reasonable assumptions around the beta.

Competent with distinction – The candidate correctly calculates FFTY's cost of capital using a weighted average cost of capital model and discusses the companies considered in the beta calculation.

Assessment Opportunity #10

The candidate assesses the three proposed alternatives for hedging the foreign currency risk on the equipment purchase, calculates the final cost of each option, and makes a recommendation.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.5.1	Develops or evaluates financial risk management policies	B	A
5.5.2	Analyzes the use of derivatives as a form of financial risk management	C	B

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.2 Communicates non-complex financial information logically, clearly, concisely

To mitigate the exchange rate risk related to the purchase of the equipment, the company is considering three alternatives. The company will borrow all of the funds to make this purchase. Each alternative is discussed below.

All three alternatives look at the incremental cash flows required between April and October 1. As we are only assessing the incremental costs of each alternative, the implications of using additional financing after October 1 have been ignored.

1. Pay the supplier now with a 2% discount:

If FFTY pays for the equipment on April 1, 2021, when the exchange rate is expected to be USD \$1 = CAD \$1.22, the company will pay USD \$5 million \times 1.22 \times 98% = CAD \$5,978,000. If the company has insufficient cash to make the payment, it will have to borrow and pay interest from April 1 to October 1.

Assuming the company would need to borrow the full amount at an interest rate of 6% (its current cost of debt), the added interest cost from April 1 to October 1 would be $\$5,978,000 \times 6\% \times 183/365 = \$179,831$.

Total cost = $\$5,978,000 + \$179,831 = \$6,157,831$

The advantage of this method is that the total price is fixed, and the exchange risk is fully eliminated as of April 1, 2021 (although there is a risk that the forecast exchange rate could change between today and April 1). The company also loses the opportunity for any potential gains if the spot rate is lower in October than in April.

2. Enter into a forward contract for USD \$5 million:

If the company enters into a forward contract, FFTY agrees to purchase USD \$5 million for CAD \$6.4 million (USD \$5 million \times 1.28). Regardless of the spot rate on October 1, the company must deliver the Canadian dollars and purchase the U.S. dollars at the forward rate. The U.S. dollars are then used to pay the equipment supplier.

The advantage of the forward contract is that the exchange rate is fixed and the company will pay CAD \$6.4 million for the equipment. The risk of downside losses is eliminated. There is also no upfront cost to be incurred.

The disadvantage is that the company must deliver under the contract. If the spot exchange rate is lower than USD \$1 = CAD \$1.28, the company could have purchased the equipment for a lower cost if it had not entered into the forward contract. Therefore, the opportunity for any upside gains is eliminated.

3. Borrow in U.S. dollars:

A natural hedge occurs if a company borrows in U.S. dollars and, on an ongoing basis, generates revenues in U.S. dollars. These funds can be used to repay the loan without incurring foreign exchange gains/losses on either the funds borrowed or the revenue generated.

However, in this case, FFTY's ongoing U.S. dollar transactions are the purchase of inventory, which requires FFTY to pay suppliers in U.S. dollars. As such, their U.S. dollar transactions cannot act as a natural hedge against U.S. dollar borrowings.

Recommendation

It appears that paying the supplier today with the 2% discount is the lowest cost alternative, with a total cost of \$6,157,831 compared to the forward contract cost of \$6,400,000, as both alternatives will limit the exchange rate risk. FFTY should prepay its supplier and take advantage of the 2% discount.

For Assessment Opportunity #10 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss the alternatives for hedging the equipment purchase.

Competent – The candidate discusses the alternatives for hedging the equipment purchase.

Competent with distinction – The candidate thoroughly discusses the alternatives for hedging the equipment purchase and recommends a hedging strategy.

Assessment Opportunity #11

The candidate determines the company's current investment objectives; assesses the nature, risk, and return of the possible listed investments; and concludes on how each investment meets the objectives. The candidate reviews the current portfolio and recommends changes that should be made.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.2.2	Evaluates the entity's investment portfolio	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.2 Communicates non-complex financial information logically, clearly, concisely

In assessing the type of investments the excess cash should be invested in, there are four issues to address: FFTY's investment objectives; the nature, risk, and return of the investments currently available and whether any can be used to meet the objectives; the current mix of investments in the portfolio; and the changes necessary to meet the investment objectives.

Investment Objectives

Below is a list of possible investment objectives and what FFTY's investment objectives for this cash appear to be:

- **Preservation of capital:** Does the investor need to ensure that the original capital is not lost? FFTY wants to preserve this cash so that it is available to make future investments in the company.
- **Annual income:** Does the investor want to receive regular income annually from the investment, whether in the form of interest or dividends? This is not important to FFTY at this time; while it would like to receive some form of income on the investment, it is not reliant on the income.
- **Growth of capital:** Is the objective to grow the original capital for a certain period of years, to have more capital available at some future date? This objective is presently not important to FFTY.
- **Liquidity:** Do the investments need to be easily liquidated if cash is immediately required? This is an important objective for FFTY, as it will need to liquidate the investment when the time comes to use the cash for capital investments.

- Time horizon: How long will the amounts be invested — short-term or long-term? The time horizon is short, at 12 to 15 months at the most.

Based on the above analysis, it appears that the main investment objectives for FFTY are to maintain the original capital, be able to liquidate as the need arises, and earn income on the idle cash. Therefore, the company needs to invest in low-risk securities that can be quickly liquidated and that guarantee the original capital.

Available Investments

Investment	Nature	Risk and Return
Savings account	Cash is deposited into a savings account	Low risk Deposit guaranteed, subject to deposit insurance limit of \$100,000 (per bank) Liquidate immediately with no penalty Lowest rate of return of 0.5% annually
Three-year, non-redeemable GIC	Deposited with the bank; GIC is not redeemable for a three-year period	Investment is guaranteed, but only up to \$100,000 per bank Higher return than a savings account, with a similar level of risk GIC is not redeemable for three years, which does not match FFTY's 12- to 15-month investment horizon
S&P Index ETF	Index ETFs mirror the index that they track; therefore, their returns are dependent on the market. The holder may also receive dividends (monthly or quarterly), but dividends are likely to fluctuate based on the dividend payouts of the underlying companies.	Highest-risk option, as their value fluctuates with the market (ETFs earned a high return in 2020 due to the performance of the market, but this is not guaranteed in future years.)
Five-year private loan	Private loan to an established local business	While risk could be appropriate for the return, liquidity does not match 12- to 15-month investment horizon

Investment	Nature	Risk and Return
Money market funds (2020 return of 1.4%)	Represents pool of short-term securities, T-bills, commercial paper, and bankers' acceptances, managed by a fund manager	Risk is that the interest rate return on the fund fluctuates with market rates, and the original investment is not guaranteed Can easily be liquidated but may be less than the original investment, depending on market value at the time The 2020 returns were higher than the savings account, and annual returns have only fallen below 0.75% once in the past 10 years; however, the returns are lower than all of the other options except for the savings account
Publicly traded preferred shares	The value of the shares is dependent on the market, and the dividend is only paid when declared by the board.	Dividend income is not guaranteed but likely to be less volatile than the ETF The shares are likely to be somewhat liquid

Current portfolio mix

As the company's most important investment objective is to protect the original investment, having the funds in a savings account is secure. However, the savings account is paying a very low rate of interest. Other available investments will earn more interest and still protect the original investment.

Recommendation

Scott's preference to have all of the funds remain in the savings account results in minimal returns for FFTY, while Antonia's suggestion for high returns is not appropriate, given the capital preservation requirement.

The suggested portfolio mix is as follows:

Investments Available	Amount Invested
Savings account	\$1,500,000
Three-year non-redeemable GIC	0
S&P Index ETF	0
Five-year private loan	0
Money market funds	1,500,000
Publicly traded preferred shares	0
Total	\$3,000,000

This portfolio will protect the initial investment but also provide liquidity while earning interest income from between annual rates of 0.5% to 1.4% over the year.

For Assessment Opportunity #11 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate identifies the company's investment objectives and attempts to discuss their current portfolio/investments.

Competent – The candidate discusses the company's investment objectives and their current portfolio/investments and concludes on the appropriateness of the portfolio.

Competent with distinction – The candidate discusses the company's investment objectives and each type of investment, concluding on its appropriateness. The candidate also discusses the portfolio mix and provides a recommendation regarding a suggested portfolio mix.

Assessment Opportunity #12

The candidate evaluates the financial health of a franchisee and recommends ways that FFTY can assist in making improvements and avoid similar situations with future franchisees.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.1.1	Evaluates the entity's financial state	A	A
5.2.1	Evaluates the entity's cash flow and working capital	A	A
5.6.2	Advises a financially troubled entity	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed
 5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
 5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions
 6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
 6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
 6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
 7.1.2 Communicates non-complex financial information logically, clearly, concisely

[Note: Antonia is concerned about the financial viability of Franchisee #1 because it is behind in its payments to FFTY. A review of its statements and an evaluation of its financial health are required. Recommendations should be made for how FFTY can assist the franchisee and avoid similar situations arising with future franchisees.]

Calculations of Franchisee #1's ratios, as compared to the benchmark provided by FFTY, are as follows.

Ratios	Franchise #1	Benchmark
Cost of goods sold as a percentage of sales	61%	60%
Operating margin	0.8%	5%
Operating margin without start-up costs	4.9%	
Times interest earned (EBIT/interest)	0.78	4.0
Days in inventory	16.4	22
Current ratio	0.44	0.70
Total debt to assets	0.87	0.60
Minimum average sales per month for first year of operations	\$1,128,000	\$1,500,000

Discussion of the Ratios

- The cost of goods sold as a percentage of sales and the operating margin (after adjustment for the one-time start-up costs) are in line with the benchmarks. This implies that the franchisee's markup on its costs is similar to that of the industry.
- Monthly sales are well below the minimum amounts required to be viable, representing only 75% of the minimum amounts. This is far too low and has a negative impact on the times-interest-earned ratio. If sales were higher, the EBIT would be higher, increasing the times-interest-earned ratio.

- Days in inventory is lower than the benchmark, likely due to the fact that most of the inventory represents perishables, which must be kept fresh in order to comply with FFTY standards.
- The current ratio is too low because the company has little cash on hand and high payable balances.
- The leverage ratios are too high. The total debt-to-asset ratio and the long-term debt to long-term asset ratios are too high, indicating that the franchisee has too much debt and too little invested equity.

There are two factors contributing to the franchisee's poor financial position:

1. The sales per month are too low.
2. The company has too much debt. The long-term debt to long-term asset ratio indicates that the company was not adequately capitalized with equity contributions to finance the purchase of the furniture and fixtures and initial franchise fee.

Recommendation

FFTY should assist Franchisee #1 in increasing its sales to at least the minimum monthly amount of \$1.5 million. FFTY should investigate the reason for the low sales and suggest improvements, since it has significant experience in this area. In addition, since the owner of Franchisee #1 was an original manager of one of FFTY's corporate-owned stores, the low sales are not likely attributable to them lacking experience. The store should be closely monitored in the coming months to determine why sales are low. Reasons could be poor location, local competitors, customer service, store appearance, or the wrong product mix. If the sales per month increase, this will provide more cash flow and improve the debt ratios and times-interest-earned ratios.

The other issue relates to how the franchisees are capitalized to start their operations. For the existing situation with Franchisee #1, the franchise owner should be encouraged to invest more personal equity to reduce the debt outstanding. If Franchisee #1 gets into further financial difficulties, FFTY might have to loan it funds.

In reviewing and approving applications for new franchisees in future, FFTY should ensure that sufficient equity is contributed to the operations. Assuming that start-up furniture and fixtures is \$2.37 million (\$2,281,000 + \$84,000) and the initial franchisee fee is \$140,000, the maximum debt should be \$1.5 million (\$2.50 million × 60%), with the remaining financing coming from personal equity invested.

For Assessment Opportunity #12 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of some ratios or attempts to discuss some recommendations on how FFTY can assist its franchisees.

Competent – The candidate discusses some ratios and provides recommendations on how FFTY can assist its franchisees.

Competent with distinction – The candidate thoroughly discusses the franchisee ratios and provides many recommendations on how FFTY can assist its franchisees.

Assessment Opportunity #13

The candidate evaluates the Logistics proposal by assessing the impact of accepting the proposal on working capital and net warehousing costs and recommends whether to accept the proposal.

The candidate demonstrates DEPTH in the Finance role.

CPA Map Technical Competencies:		Core	E2 FIN
5.2.1	Evaluates the entity's cash flow and working capital	A	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.2 Identifies patterns from data analysis

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.2 Communicates non-complex financial information logically, clearly, concisely

Logistics Proposal

We have calculated the days in inventory, days in accounts payable, and impact on finance costs of the Logistics proposal. As FFTY currently pays 4% on its line of credit, this interest rate has been used in the following calculations.

Inventory

$$\text{Current days in inventory} = (\text{Average balance of inventory} \div \text{cost of goods sold}) \times 365 \text{ days}$$

$$= \{[(\$6,178,000 + \$5,735,000) \div 2] \div 86,860,000\} \times 365 = 25 \text{ days}$$

If FFTY reduces its inventory on hand by 25%, as promised by Logistics, the revised average inventory balance will be \$4,634,000 ($\$6,178,000 \times 75\%$).

$$(\$4,634,000 \div 86,860,000) \times 365 = 19.5 \text{ days}$$

$$\text{Reduction in inventory} = \$6,178,000 - \$4,633,500 = \$1,544,500$$

Assuming that the inventory reduction is maintained for the full year, finance cost savings will be \$61,780 ($\$1,544,500 \times 4\%$).

Warehouse costs

The proposed contract with Logistics requires a monthly payment of \$135,000, which is payable on the first day of the month.

Changes in timing of cash flows are as follows:

	Day 1	Day 30
Current cash flows		
Wages and benefits		(84,350)
Delivery vehicle lease		(16,700)
Warehousing costs		(38,000)
Total current cash flows		(139,050)
New cash flows	(135,000)	
Difference		4,050

Net cash savings on costs per month is \$4,050 $[(\$84,350 + \$16,700 + \$38,000) - \$135,000]$.

As \$135,000 must be paid 30 days earlier, the additional financing cost per month is \$444 ($\$135,000 \times 4\% \times 30/365$).

Net cash savings for the month: $\$4,050 - \$444 = \$3,606$

Total cash savings for expenses for the year: $\$3,606 \times 12 = \$43,272$

Total cash savings for the year for payables and inventory: $\$61,780 + \$43,272 = \$105,052$

Other considerations

- Faster delivery times will reduce the risk of stock-outs and improve franchisee and customer satisfaction.
- Reduced inventory on hand will reduce spoilage, which will reduce costs related to spoilage.
- By accepting Logistics' proposal, FFTY will lose in-house expertise in distribution and inventory management. If the contract does not work out, FFTY would need to change providers or re-establish its in-house distribution system, which is costly and requires time.

Given that Logistics' proposal will reduce inventory turnover time and generate savings in warehouse costs, we recommend proceeding with the proposal.

For Assessment Opportunity #13 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to evaluate the Logistics proposal.

Competent – The candidate evaluates the Logistics proposal and provides a recommendation on whether it should be accepted.

Competent with distinction – The candidate thoroughly evaluates the Logistics proposal and provides a recommendation on whether it should be accepted.

**DAY 2 – MARKING GUIDE – PERFORMANCE MANAGEMENT
FRESH FOOD TO YOU INC. (FFTY)**

To: Larry Osbourne
From: CPA
Subject: Various issues

See Common Marking Guide for the Common Assessment Opportunities #1 to #6.

Assessment Opportunity #7

The candidate evaluates the company's current operating environment using a SWOT analysis.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies (based on the 2020 CPA Competency Map):		Core	E1 PM
2.3.2	Evaluates the entity's internal and external environment and its impact on strategy development	B	A

CPA Map Enabling Competencies:

5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

Antonia and Scott have asked for a SWOT analysis, as follows:

Strengths	<ul style="list-style-type: none"> • FFTY has experienced management — Scott, Antonia, and Michelle all came from a nationwide competitor, so have experience in the grocery retail segment. • Michelle has specific experience in franchising, which will help FFTY's expansion through franchising. • FFTY owns two of its store locations and two warehouses, which gives it some tangible asset backing for financing or additional opportunities for sale and leaseback transactions. • FFTY's success is due to recognizing an unmet need and capitalizing on the emerging trend of healthy eating and prepared meals. • FFTY ensures that the customer has a unique shopping experience by having knowledgeable and friendly staff and providing a variety of food tasting stations. • FFTY's brand is becoming well-known in southern Ontario, which will help to sell franchises and grow its locations in southern Ontario.
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	<ul style="list-style-type: none"> • FFTY has a focused product offering of fresh, whole, and organic foods, which is a trend in the market, and this has helped FFTY differentiate itself from its competitors. • The company uses up-to-date technology to track sales and manage inventory. • FFTY has long-term supplier arrangements, which gives it a steady and reliable supply of fresh and organic foods. • It adheres to high quality standards for freshness and cleanliness, which consumers appreciate. • FFTY differentiates from its competitors in that 60% of its products are locally sourced and 30% of its perishables are organic. • The company is profitable, with a strong balance sheet. • FFTY has excess cash of over \$3 million.
Weaknesses	<ul style="list-style-type: none"> • With only 11 outlets, compared to significantly larger national competitors, FFTY is a small competitor. • The store size is only 28,000 sq. ft., which is smaller than many of its competitors. • FFTY has no customer loyalty program, yet many competitors benefit from this type of program. • The company has no private-label products, which could increase repeat business. • Scott and Antonia have limited experience in franchising and are reliant on Michelle. • FFTY has sold only two franchises to date, yet is relying on franchising to grow. • It is only locally known and has no brand-name recognition outside of southern Ontario.
Opportunities	<ul style="list-style-type: none"> • The specialty food market (fresh, whole, and organic) is expected to grow by 7% in 2021 and 2022. • Disposable income is expected to increase over the next five years, which should translate into higher sales for FFTY. • Consumers are expected to increase their spending on specialty foods. • Customer loyalty programs are increasing and encourage consumers to shop at the same store, which will stabilize sales. • Data mining and analytics are being used extensively to better understand customers. FFTY already has up-to-date technology that could be used to gather more customer-specific information. • Customers over the age of 40 are making healthier food choices, so this should be a target customer for FFTY. • There is an increasing demand for home delivery of freshly prepared foods and groceries for seniors. • There is an increasing demand for home delivery of freshly prepared foods for millennials.

Threats	<ul style="list-style-type: none"> • Customers do not shop at specialty food stores on a regular basis, making sales volatile. • The industry is very price competitive, with many different types of competitors — supermarkets, warehouse clubs, superstores, and other specialty food retailers. However, the strategy of these competitors is to be a one-stop shopping retailer. • The supermarkets have entered this niche market of selling fresh, whole and organic foods. Pricing will be more competitive, and FFTY may lose sales. • The four largest competitors have 70% of the market share, giving them substantial power in setting prices and negotiating lower input costs with suppliers. • The industry is further consolidating to achieve economies of scale, which means that the number of small competitors is declining, giving even more market share to the large competitors. • As a small-sized competitor, FFTY cannot achieve the economies of scale that nationwide competitors can. • While most customers are price sensitive, and lower selling prices have been historically used to attract customers, FFTY cannot compete on price; it has higher input costs, and charging lower prices will squeeze its gross margins. • Wages and energy costs are expected to increase. Since FFTY is a labour-intensive business, this will result in higher operating costs, which it may not be able to pass on to its customers. • FFTY will have to compete with other grocery stores and with other businesses for its franchisees.
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[Marking note: The candidates were instructed to limit their analysis to the elements they felt were most relevant. The preceding analysis goes beyond what was asked of candidates.]

For Assessment Opportunity #7 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate identifies elements of FFTY’s external and internal environment, but the analysis is shallow.

Competent – The candidate identifies several valid elements of FFTY’s external and internal environment.

Competent with distinction – The candidate identifies numerous valid elements of FFTY’s external and internal environment and provides an overall integrated response.

Assessment Opportunity #8

The candidate evaluates FFTY's current vision and mission, recommends changes to reflect that the company is now trying to attract franchisees, and prepares a list of core values.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Competency Technical Competencies:		Core	E1 PM
2.2.1	Assesses whether management decisions align with the entity's mission, vision, and values	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

[Note: Antonia has asked that FFTY's vision and mission be reviewed due to the addition of franchises, and that a list of core values be prepared. The candidate is to make recommendations for changes that will be attractive to franchisees.]

Current Mission and Vision

Vision: To be the largest Canadian-owned retailer of fresh, whole foods.

Mission: To support our local producer partners, and be the fastest growing retailer of whole foods by ensuring that customers are offered a unique experience.

To ensure success, FFTY will need to compete for, and attract, the best franchisees. To this end, FFTY needs to ensure that its vision, mission, and core values are in line with what franchisees are looking for. Once they have these franchisees, FFTY will have to instill a culture that is all-inclusive, respectful of franchisees' ideas, and supportive.

Franchisees are looking for companies that have a well-defined vision, mission, and core values, which include

- leadership and integrity;
- a well-known and articulated brand; and
- franchisees as an integral part of the business.

These are all items that should be included in the company's mission.

Vision

The current vision is clear, with a set objective. It is well defined, stating that the company wants to be the largest Canadian-owned retailer of fresh, whole foods. Franchisees can understand and accept this vision, and this will likely also tie into their goals of being part of this vision. However, the growth objective mentioned in the mission statement is expected to also be achieved through a franchising strategy, which is absent from the current vision statement.

Therefore, the vision should be changed as follows:

Vision: To be the largest Canadian-owned grocery chain of fresh, whole foods.

Mission

The current mission statement does not mention franchisees at all. It does state that FFTY wants to be the largest retailer of whole foods, which ties into being a leader. Missing is some indication of the importance of its franchisees. In addition, there should be a mention of its brand: that of being known for its product freshness.

Therefore, the mission should be changed as follows:

Mission: Our mission is to be the fastest-growing retailer of whole foods by having a brand known for its product freshness, ensuring our customers have a unique shopping experience, and recognizing that our local producer partners and franchisees are integral to our success.

Core values

Currently, the company has no core values. Core values should consist of principles that help the company achieve its vision and mission. Therefore, they should include the following (from Appendix I):

- Recognizing unmet needs and capitalizing on them
- Having knowledgeable and friendly staff
- Having a well-recognized and respected brand
- Having a standard of high quality for freshness and cleanliness
- Providing a unique shopping experience for customers

Core values should also include characteristics that franchisees will consider in selecting a franchisor, such as

- a well-defined support system;
- an appreciation of franchisees' contribution to the business (i.e., they are an integral part of the business);
- consultation with franchisees on important business decisions; and
- provision of an environment in which franchisees' entrepreneurial spirit can flourish.

Since it is important that a franchisee has shared goals, beliefs, and values with the franchisor, the franchisor should articulate what these are as part of its core values. Therefore, FFTY's core values should be as follows:

- Our food products are always fresh and of high quality.
- We treat our staff with respect and ensure they are well trained for their job.
- Our staff are friendly and knowledgeable.
- We educate our customers and encourage them to make healthy food choices by having in-store food tastings and demonstrations.
- We anticipate and meet the needs of our customers by continuously monitoring the market trends.
- We provide a franchisee culture of respect and mutual acknowledgment of each others' contribution to the overall success of FFTY. Franchisees' input will be sought on significant business decisions that have an impact at the store level.
- We provide ongoing training, support, and communication for our franchisees.
- We listen to any franchisees' complaints respectfully and act on them as required.
- We always act with integrity.

For Assessment Opportunity #8 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to revise FFTY's vision and mission due to the company now trying to attract franchisees OR prepares a list of the company's core values.

Competent – The candidate revises FFTY's mission and vision due to the company now trying to attract franchisees and attempts a list of the company's core values.

Competent with distinction – The candidate revises FFTY's mission and vision due to the company now trying to attract franchisees and supplies an adequate list of the company's core values.

Assessment Opportunity #9

The candidate prepares cash flows to evaluate the proposals to expand into fresh food delivery in order to assess whether the seniors market is better than the millennials market for initial development.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies:		Core	E1 PM
2.3.3	Evaluates strategic alternatives	B	A
3.4.1	Evaluates sources and drivers of revenue growth	B	A

CPA Map Enabling Competencies:

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

FFTY wants to determine which segment the company should initially target for its freshly prepared, hot-food delivery service. The seniors' and millennials' markets are very different in terms of the type of food ordered, marketing methods, use of technology, payment methods, and size and growth expectations.

Quantitative Analysis

We have completed a cash flow analysis for each segment.

Annual operating cash flows

	Seniors		Millennials	
	Low	High	Low	High
Number of deliveries	60,000	68,000	28,000	45,000
Average food sale per delivery	\$35.00	\$35.00	\$75.00	\$75.00
Revenue	2,100,000	2,380,000	2,100,000	3,375,000
Delivery charge \$8.00 per delivery	480,000	544,000	224,000	360,000
Total revenue	<u>2,580,000</u>	<u>2,924,000</u>	<u>2,324,000</u>	<u>3,735,000</u>
Expenses				
Cost of goods sold	1,050,000	1,190,000	1,050,000	1,687,500
Labour costs for cooks and drivers	740,000	740,000	560,000	560,000
Labour for telephone ordering	40,000	40,000		
Web updates and app development	350,000	350,000	520,000	520,000
Amortization	270,000	270,000	270,000	270,000
	<u>2,450,000</u>	<u>2,590,000</u>	<u>2,400,000</u>	<u>3,037,500</u>
Net operating profit	130,000	334,000	(76,000)	697,500
Taxes at 23.8%	(30,940)	(79,492)	18,088	(166,005)
After-tax annual operating cash flows	99,060	254,508	(57,912)	531,495
Add back amortization	270,000	270,000	270,000	270,000
Net cash flow for the first year	<u>369,060</u>	<u>524,508</u>	<u>212,088</u>	<u>801,495</u>

Conclusion on cash flow analysis

The seniors market has positive cash flow at both the low and high numbers of deliveries. In contrast, the millennials have low cash flow at the low number of deliveries, but a much higher cash flow at the higher number of deliveries. This indicates that the millennials market is more uncertain. In addition to the qualitative discussion below, FFTY needs to further assess the probabilities of the various levels of revenues in order to determine which market to initially target.

Qualitative Analysis

Develop initially for the seniors market

Pros:

- Because seniors are brand loyal, if FFTY can attract them as customers, they will likely become repeat customers.
- This segment is stable but not growing, so it is not attracting many competitors; there is currently only one main competitor.
- Seniors tend to live in the suburbs; therefore, for the same \$8 charge as for millennials, delivery times will be shorter.
- Seniors are a potential target market because their retirement incomes are increasing, they are no longer interested in cooking, and they are looking for healthy choices.

Cons:

- Seniors value price over quality and will, therefore, be more price sensitive and likely to spend less.
- FFTY will be competing with some non-profits that deliver meals to seniors for little or no cost.
- Seniors are on limited budgets and only spend about 2% of their food budget on prepared foods.

Develop initially for the millennials market

Pros:

- Millennials are willing to pay for quality whole foods that are locally sourced and value quality over price.
- Millennials favour delivery of food rather than going out to restaurants.
- Millennials have more spending power than seniors and spend up to 8% of their food budget (which is increasing as they earn higher wages) on prepared foods.
- Millennials are interested in delivery of freshly prepared foods.
- There does not seem to be a significant competitor offering a comparable service for millennials.

Cons:

- As many competitors, including nationwide grocers and restaurants, want the millennials' food spending dollars, this is an intensely competitive segment.
- Millennials are less brand loyal and enjoy a wide variety of foods, including specialty ethnic foods, increasing the number of competitors.
- Millennials tend to live downtown; therefore, delivery times may be longer due to traffic and delivery costs higher.

Fit with Strategy

Fresh food delivery is an opportunity in the industry that the company should pursue. It complies with the company's mission to sell fresh food to customers. In addition, with 60% of all meals expected to be delivered by 2030, it is critical for FFTY to offer these products and services. This also fits with the core value of anticipating customers' needs and developing products and services to meet those needs.

Recommendation

The company should offer fresh food delivery, initially targeting the seniors segment. This segment is not intensely competitive, and there is a small niche market of seniors who want freshly prepared whole foods. It is this limited market that FFTY should target.

[Marking note: A different conclusion could be reached but needs to be supported.]

For Assessment Opportunity #9 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a cash-flow analysis of the fresh food delivery proposal and a comparative qualitative analysis of the two potential markets.

Competent – The candidate prepares a reasonable cash-flow analysis of the fresh food delivery proposal and a reasonable comparative qualitative analysis of the two potential markets.

Competent with distinction – The candidate prepares a comprehensive cash-flow analysis of the fresh food delivery proposal and a comparative qualitative analysis of the two potential markets and realizes that the seniors market is the most appropriate.

Assessment Opportunity #10

The candidate explains controllable and non-controllable costs and determines what type of responsibility centre each department is. The candidate also discusses how each manager should be evaluated and recommends changes to the performance evaluation for the VP, Corporate-owned Stores and the VP, Franchising Operations.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies:		Core	E1 PM
3.6.2	Evaluates performance of responsibility centres	B	A

CPA Map Enabling Competencies:

- 5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization
- 5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
- 6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
- 6.3.2 Articulates limitations to recommendations

Antonia wants to know what type of responsibility centre each department currently is and how performance should be evaluated. She would also like an assessment of the current performance bonus calculations for the VP, Corporate-Owned Stores and the VP, Franchising Operations, and she wants to know whether any changes are required.

There are four possible types of responsibility centres:

Revenue centre: Managers of these centres have control over revenues only, so they would be evaluated based on revenues, generally through a comparison of actual revenue to revenue targets.

Cost centre: Managers of these centres have control over costs only, so they would be evaluated based on a comparison of actual costs to target costs. This could be broken down by prices and quantities, depending on what the manager has control over.

Profit centre: Managers of these centres have control over revenues and costs but not investments in operating assets, so they would be evaluated based on actual profit to target profit.

Investment centre: Managers of these centres have control over revenue, costs, and investments in related operating assets, so they would be evaluated based on return on investment or a residual income measure, which takes operating income of the centre divided by the average operating assets invested.

In FFTY's existing organizational structure, the types of responsibility centres for the managers, and what their performance evaluations should be based on, are as follows:

[Marking note: The first two columns are from the case.]

Manager	Responsibilities	Responsibility Centre
Manager, Marketing	Responsible for all marketing activities, including brand marketing and local-level marketing for individual stores	Cost centre: As there are no revenues or investments associated with this manager, the manager's evaluation should be based on a comparison of actual costs to target costs.
Manager, Product Purchasing	Responsible for product purchasing and negotiation of supplier contracts and shipping requirements Manages store inventory levels	Cost centre: As the manager has no revenue or investment responsibilities, the manager's evaluation should be based on a comparison of actual costs to target costs.
VP, Franchising Operations	Responsible for selecting franchisees, training and onsite support, and monitoring franchisee sales and purchases Receives a performance bonus based on a percentage of franchise revenues	Profit centre: As the manager has responsibility for store sales, purchases, and franchise fees, the manager's evaluation should be based on the net profit, as calculated below.
VP, Corporate-Owned Stores	See below	See below

Performance Bonus — VP, Corporate-Owned Stores (Dennis)

Currently, the performance bonus for the VP, Corporate-Owned Stores is based on a percentage of net profit of all the corporate-owned stores. However, since this VP has control over the initial investments in equipment and leasehold improvements, as well as revenues and costs, this department should be assessed as an investment centre.

Therefore, the VP should be assessed as follows:

Controllable margin ÷ Average operating assets

Controllable margin includes the controllable revenue and expenses listed in the table that follows.

Operating assets include accounts receivable and investments in equipment and leasehold improvements at the stores. The average is calculated by taking the average of the opening and closing balances of the net book values of these assets.

Excluded from the calculation of operating income are income taxes and interest costs.

For performance evaluation, the actual return would be compared to a target return.

For revenues and costs, the manager's performance should only be evaluated based on controllable items. In the following table, each element of the operating income used to evaluate Dennis's performance is assessed to determine if it is under his control. Only those that are labelled controllable should be included in the calculation of the operating profit used to determine his bonus.

Revenue — total revenue of all corporate-owned stores	Controllable: Although a portion of the revenues will depend on the economy and marketing, etc., the manager has influence over prices and quantities sold.
Less costs related to:	
Cost of goods sold related to the sales	As the purchase cost of the goods is determined by the purchasing division, the retail manager has control over the quantity but not the prices paid for the products; as this is partially controllable, it is included.
Distribution and shipping costs	Not controllable: The purchase manager determines what products will be shipped and from where; the retail manager has no influence over these costs.
Marketing and advertising – local costs	Not controllable: This is decided by the marketing department.
Wages	Controllable: The retail manager is responsible for employees working in the stores and helping managers determine the hours to be spent.
Hydro	There is a controllable component in terms of deciding how long to keep the lights on, the type of lighting, etc. However, the price, as well as some basic electricity needs, such as refrigeration, are not controllable.
Property taxes	Not controllable: This is set by the city.
Allocated costs of overhead for finance, human resources, and IT	Not controllable: The allocation and amount of total costs are determined by the finance, human resources, and IT managers.
Interest cost on capital invested in capital assets	This is specifically excluded from the return-on-investment calculation.

Based on the above analysis, the VP, Corporate-Owned Stores should be evaluated based on an actual versus targeted return on investment. To calculate this return, the numerator should be calculated based on controllable revenues and costs only, as follows: Revenue less: cost of goods sold; shelving and display costs; training and other supplies; wages; hydro; and maintenance and repairs.

Performance Bonus — VP, Franchising Operations (Michelle)

This manager's current performance bonus is based on a fixed percentage of franchise revenues received each year.

This manager has control over the amount of revenues and all costs. Therefore, this is a profit centre and the manager should be evaluated based on the operating profit generated, as follows:

Operating profit = Operating income – operating expenses

Operating income = Franchise revenues less: wages for all people involved in this department; occupancy office costs; supplies; travel; telephone; and all other costs to support and train the franchisees.

Excluded from the calculation of operating income are income taxes, interest costs, and any allocated overhead costs, as these are not controllable.

For performance evaluation, the actual profit would be compared to a target profit.

For Assessment Opportunity #10 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of how each manager should be evaluated and attempts to revise the performance measures used in the performance evaluation of the VP, Corporate-Owned Stores and the VP, Franchising Operations.

Competent – The candidate explains controllable and non-controllable costs, provides a reasonable discussion on how each manager should be evaluated, and recommends changes to the performance evaluation for the VP, Corporate-Owned Stores and the VP, Franchising Operations.

Competent with distinction – The candidate explains controllable and non-controllable costs, provides a complete discussion on how each manager should be evaluated, and recommends numerous valid changes to the performance evaluation for the VP, Corporate-Owned Stores and the VP, Franchising Operations.

Assessment Opportunity #11

The candidate identifies the root causes of each store's low operating income, assesses each manager's overall performance, and makes recommendations for improvement.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies:		Core	E1 PM
3.6.3	Evaluates root causes of performance issues	B	A

CPA Map Enabling Competencies:

5.1.1 Applies general business knowledge to enhance work performed

5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.2.1 Uses existing knowledge in new or different ways

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Antonia has asked for assistance in analyzing the performance of two store managers and wants to understand the cause of each store's poor performance. The table of performance measures for the two underperforming stores needs to be analyzed.

		Target	CO #1002	CO #1009
Financials	Annual increase in sales	3%	5%	-10%
	Gross margin percentage	35%	28.3%	36%
	Inventory turnover	20 times	21 times	19 times
	Percentage of sales of high-margin items	15%	4%	18%
	Wages as a percentage of sales	10%	8.8%	13.75%
	Operating margin	5%	3%	3.2%
Customers	Product returns as a percentage of sales	2%	2%	1%
	Number of customers complaints per week	10	8	4
Internal Business Processes	Percentage of sales of new products	10%	6%	12%
	Employee turnover	5%	25%	1%
	Average weekly hours for each employee	30	19	28
	Average hourly rate for employees (minimum for new employees is \$15; maximum for full-time experienced employees is \$20)	\$16.50	\$15.20	\$17.00
	Food and safety inspection failures	0	2	0

For both stores, there are two main issues: sales and cost of goods sold; and employees and wages.

CO #1002

Sales and cost of goods sold

Sales increased by 5% over last year, which is higher than the target of 3%. During the year, the store manager dropped the selling prices on commonly sold items to below the prices of a local competitor. This would entice customers to shop at the FFTY store rather than at the competitor's store. However, the store had only 6% of sales representing new products in comparison to the target of 10%. Therefore, it appears that dropping the prices did result in higher sales but not in the products the company wanted to sell.

Regarding cost of goods sold, the gross profit margin is only 28% compared to the target of 35%. In addition, the company had only about 4% of its sales in high margin items, compared to the target of 15%. Therefore, the lower gross profit margin is due to selling at lower prices and selling the wrong mix of products — that is, selling lower-priced items to attract price-sensitive customers.

Inventory turnover was slightly higher than targeted, at 21 times versus 20 times, so inventory management is good. The customer satisfaction metrics appear to be in line with the targets: product returns were 2% of sales, which matches the target, and weekly customer complaints were 8, which is less than the target of 10. However, the drop in price may have contributed to the increase in turnover, since volumes generally increase with price reductions, while margins are affected negatively.

Overall, lowering prices has attracted price-sensitive customers, which is not in line with the company's strategy of selling premium goods to customers willing to pay premium prices for fresh, whole foods.

These lower prices and gross margins have lowered the operating margin to only 3%, compared with the target of 5%.

Employees and wages

The wages (\$1,435,000) as a percentage of sales are 8.8%, which is less than the target of 10%. While this looks favourable and is partially due to sales being higher than targeted and wages being relatively fixed, there are some issues identified in the table of performance measures that are troubling. The employee turnover is very high, at 25% compared to the target of 5%. From the table, we see that the average number of hours per week per employee is only 19 hours compared to the target of 30 hours. The low number of hours per week is caused by the store manager reducing the number of hours for each employee, which has led to high turnover, resulting in more new employees and fewer long-time employees. The high percentage of new employees has caused the average hourly rate to be \$15.20 per hour in comparison to the target of \$16.50 per hour. Therefore, although the wage costs are lower than targeted, the reason for the lower costs is not sustainable and reflects systemic problems at the store. Having too many new employees with inadequate training could have also contributed to the store failing two food and safety inspections conducted during the year.

Dealing with employees in this manner also goes against the core values of the company, which include treating employees with respect and providing the training required for their job. This is a labour-intensive industry that uses low-skilled labour, but labour costs that are too low can hinder service and increase turnover.

Conclusion

The poor performance of the store is solely due to poor decisions made by the store manager. In addition, the store manager is not following corporate guidelines on the types of products to sell in the store and is performing poorly on most of the other metrics.

CO #1009Sales and cost of goods sold

Sales for the period are 10% lower than targeted. However, the store was closed due to a sewer backup that was caused by the municipality, not the store manager, and that resulted in a loss of sales of \$2,235,000. If sales are adjusted to include these lost sales, total sales would have been \$17,015,000 ($\$14,780,000 + \$2,235,000$).

The prior year sales are estimated at \$16,422,222 ($\$14,780,000 \div 90\%$). Therefore, with these lost sales, the sales growth would have been 3.6% [$(\$17,015,000 - \$16,422,222) \div \$16,422,222$], which is higher than the target.

Regarding cost of goods sold, the gross margin percentage is 36% [$(\$14,780,000 - \$9,459,000) \div \$14,780,000$], which is slightly better than the target. This is likely due to the store selling a higher percentage of high-margin items (18% versus the 15% target) and having 12% of sales representing new products, versus the target of 10%.

The inventory turnover is slightly lower at 19 times, in comparison to 20 times as the target, but this could have been affected by the store being closed. The customer satisfaction metrics are much better than the targets.

Employees and wages

The company continued to pay its employees while the store was closed due to the sewer backup, and it also paid extra for their help in the cleanup. This resulted in \$340,000 being spent on overtime. Therefore, due to the lower sales and the overtime, wages as a percentage of sales are higher, at 13.75%. If the overtime is removed and sales are adjusted to include the closed period, the adjusted wages as a percentage of sales are 9.9% [$(\$2,032,000 - \$340,000) \div \$17,015,000$], which is in line with the target of 10%.

From the table of financial measures, employee turnover is low (1% compared to the target of 5%), which is favourable, and the average number of hours per week per employee is in line with the target (31 hours versus 30 hours). The slightly higher number of hours is a result of the overtime hours put in by the employees. The overtime pay also causes the average hourly rate to be higher, at \$17.00 per hour versus the target of \$16.50 per hour.

The operating margin of 3.2% is below the target of 5% due to the loss of sales.

Conclusion

The poor performance of this store is due to events beyond the store manager's control. The manager has followed the corporate guidance as required and has performed above targets on all the other metrics.

For Assessment Opportunity #11 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to identify the root causes of each store’s low operating income and attempts to assess each manager’s overall performance.

Competent – The candidate reasonably identifies the root causes of each store’s low operating income and assesses each manager’s overall performance.

Competent with distinction – The candidate identifies the root causes of each store’s low operating income and thoroughly assesses each manager’s overall performance.

Assessment Opportunity #12

The candidate evaluates a proposed supplier contract and provides a quantitative analysis of the new proposed contract. The candidate discusses the pros and cons of the contract and makes a recommendation to accept the contract or not.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies:		Core	E1 PM
3.5.1	Performs sensitivity analysis	A	A

CPA Map Enabling Competencies:

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

Antonia has been working with Riverside to secure a long-term dairy product supply contract. We have analyzed, quantitatively and qualitatively, the impact of accepting this contract.

Quantitative Analysis

Analysis of the gross profit margin on the dairy product sales over the life of the contract is as follows:

	2021	2022	2023	2024	2025	2026	2027
	\$	\$	\$	\$	\$	\$	\$
New Contract							
Dairy sales	16,000,000	16,320,000	16,646,400	16,979,328	17,318,915	17,665,293	18,018,599
Cost of sales – Riverside		(10,000,000)	(10,000,000)	(10,000,000)	(10,200,000)	(10,404,000)	(10,612,080)
Cost of sales – Note 1		(2,203,200)	(2,247,264)	(2,292,209)	(2,338,053)	(2,384,815)	(2,432,511)
Gross profit margin	16,000,000	4,116,800	4,399,136	4,687,119	4,780,861	4,876,478	4,974,008
Gross profit margin percentage		25%	26%	28%	28%	28%	28%
Current Contract							
Dairy sales	16,000,000	16,320,000	16,646,400	16,979,328	17,318,915	17,665,293	18,018,599
Cost of sales	(12,000,000)	(12,240,000)	(12,484,800)	(12,734,496)	(12,989,186)	(13,248,970)	(13,513,949)
Gross profit margin	4,000,000	4,080,000	4,161,600	4,244,832	4,329,729	4,416,323	4,504,650
Gross profit margin percentage		25%	25%	25%	25%	25%	25%
Difference		36,800	237,536	442,287	451,132	460,155	469,358

Note 1: $\$2,000,000 \times 1.08 \times 1.02 = 2,203,200$

(8% increase due to reduced volumes and 2% annual increase)

With the Riverside contract, the margin varies slightly to 28%. In contrast, if FFTY stays with its current four suppliers, the gross margins are 25%. The Riverside contract results in higher profits each year, with the highest being \$469,358 more profit in 2027. The calculations above were made under the assumption that FFTY would purchase from Riverside the minimum amount required by the contract.

Qualitative Analysis

Pros of the contract

- The price of the dairy products is fixed for three years and then only increases at the rate of inflation, which is expected to be 2%.
- A procurement manager will work with FFTY to ensure that any issues are immediately dealt with.
- Confirmation of the delivery date will be received within one day of ordering.
- If quality specifications are not met, Riverside will immediately replace the product, at its cost.
- Riverside will be responsible for any defective product sales.
- Riverside will deliver directly to the stores. Currently, four of the suppliers either ship to the warehouse or require FFTY to pick up, so this will save distribution and warehousing costs for FFTY.
- As the company grows with franchisees, there may be an opportunity to increase the purchases from Riverside, with favourable pricing.

Cons of the contract

- There is a minimum annual purchase of \$10 million. If the company does not reach the minimum in any one year, FFTY can either purchase the shortfall or pay a penalty equal to 50% of the value of the shortfall.
- The minimum order period is no less than 15 days. Although this is the current time for Riverside, all other suppliers are between seven and 12 days.
- FFTY must provide estimates of dairy product purchases and advise of any changes that occur in order for Riverside to plan for production and deliveries.
- FFTY must pay invoices within 25 days; this is five days sooner than the 30-day terms it currently has with all its dairy product suppliers. This results in \$137,000 more cash that will be required ($\$10 \text{ million} \div 365 \times 5 \text{ days}$), which increases interest costs. These additional costs have not been included in the forecasts.
- About 30% of the current products will no longer be available, which might impact customers' shopping experience and could impact sales levels overall.
- The product choices for customers will be reduced from three or four to one, which might also impact customers' shopping experience.
- Purchases from the other local suppliers will be greatly reduced. In the past, the company shared its purchases among the four local suppliers. Reducing purchases from other suppliers may not be in line with the company's mission statement of supporting local producers.
- The company currently has contracts with the remaining four suppliers. If these contracts are broken, FFTY will incur penalties. These have not been included in the forecasts.

Recommendation

The yearly savings with the Riverside contract are significant and, by 2027, result in \$469,358 more pre-tax profit per year. However, this appears to be contrary to the company's strategy and brand of buying locally, since FFTY's mission statement specifies that its mission is to support local producer partners. This contract also reduces the types and choices of products available for customers. With reduced choices, the company may lose its customer base. We suggest that the company consider increasing dairy prices to ensure that profits do not decline with the current suppliers.

We recommend that FFTY not accept the proposed contract.

For Assessment Opportunity #12 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a quantitative analysis of the new proposed contract or performs a qualitative analysis of the proposal.

Competent – The candidate performs a quantitative analysis of the new proposed contract and performs a qualitative analysis of the proposal.

Competent with distinction – The candidate performs a quantitative analysis of the new proposed contract, performs a thorough qualitative analysis of the proposal, and provides a recommendation.

Assessment Opportunity #13

The candidate evaluates the pros and cons of implementing a customer loyalty program and calculates the impact of implementing such a program on the company's operating profit.

The candidate demonstrates DEPTH in the Performance Management role.

CPA Map Technical Competencies:		Core	E1 PM
3.4.1	Evaluates sources and drivers of revenue growth	B	A

CPA Map Enabling Competencies:

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

Customer Loyalty Program

Michelle has suggested that a customer loyalty program be introduced in the corporate-owned stores.

A calculation of the difference between operating profits for corporate owned stores, with and without the loyalty program, is as follows:

(in thousands of dollars)

Net profit before operating costs with loyalty program

Forecasted sales for 2021	158,000	
5% increase due to loyalty program	<u>7,900</u>	
Total sales	165,900	A
Less reduction in sales due to loyalty points awarded	(3,318)	B = 2% * A
Sales from points not redeemed	<u>1,493</u>	C = 45 % * B
Net sales reported	164,075	D = A+B+C
Cost of goods sold		
Corporate owned stores at 57%		
Cost of goods sold on items originally sold - at 57%	(94,563)	E = 57% * A
Cost of good sold in sales using points - at 57%	1,040	F = 57 % * (B+C)
Additional administration costs - given	(250)	G
Net profit before other operating costs	<u>70,302</u>	D+E+F+G

Net profit before operating costs without loyalty program

Forecasted sales for 2021	158,000
Cost of good sold (57%)	(90,060)
Net profit before other operating costs	<u>67,940</u>
Added profit (loss) due to customer loyalty program	<u><u>2,362</u></u>

Incremental approach

	Additional sales generated by the program	7,900
Less:	Forgone sales due to the redemption of points: 0.02 X 165,900	(3,318)
Plus:	Points expired 0.45 * 3,318	<u>1,493</u>
	Additional sales net of points redeemed	6,075
	Gross profit on these sales	2,612
	Additional administration costs - given	<u>(250)</u>
	Added profit (loss) due to customer loyalty program	<u><u>2,362</u></u>

If a customer loyalty program is introduced, the corporate stores will have a net increase in profits of \$2.362 million. The calculation above was made under the assumption that the points being used at the stores would be for sales that would otherwise not have been made.

If we assume that the points being used are at the stores would be for sales that would otherwise still have been made, the increase in profits would become \$1.322 million as shown in the following table:

(in thousands of dollars)

Net profit before operating costs with loyalty program

Forecasted sales for 2021	158,000	
5% increase due to loyalty program	7,900	
Total sales	<u>165,900</u>	A
Less reduction in sales due to loyalty points awarded	(3,318)	B = 2% * A
Sales from points not redeemed	<u>1,493</u>	C = 45 % * B
Net sales reported	164,075	D = A+B+C
Cost of goods sold		
Corporate owned stores at 57%		
Cost of goods sold on items originally sold - at 57%	(94,563)	E = 57% * A
Additional administration costs - given	(250)	G
Net profit before other operating costs	<u>69,262</u>	D+E+G

Net profit before operating costs without loyalty program

Forecasted sales for 2021	158,000
Cost of good sold (57%)	(90,060)
Net profit before other operating costs	<u>67,940</u>

Added profit (loss) due to customer loyalty program 1,322

Incremental approach

	Additional sales generated by the program	7,900	
Less:	Forgone sales due to the redemption of points: 0.02 X 165,900	(3,318)	H
Plus:	Points expired 0.45 * 3,318	<u>1,493</u>	I
	Additional sales net of points redeemed	6,075	
	Gross profit on the additional sales 0.43 * 7,900	3,397	
	Sales forgone by the use of points	(1,825)	H+I
	Additional administration costs - given	<u>(250)</u>	
	Added profit (loss) due to customer loyalty program	<u><u>1,322</u></u>	

Advantages

- Many grocery retailers have customer loyalty programs, and FFTY will now be able to compete for customers who value these programs.
- Operating profits will increase significantly.
- This will allow FFTY to do low-cost target marketing on specific products.
- Customer loyalty plans will increase traffic flow to the stores.
- This will allow FFTY to collect personal buying habits for each customer, which can be used for data analytics.
- Implementing customer loyalty programs will eliminate one of the company's weaknesses.
- Speciality stores such as FFTY tend to have sporadic customers, and a customer loyalty program will encourage consumers to shop at the same store, which will stabilize sales.

Risks

- Head office will bear the administration costs, which are expected to be \$250,000 but could be higher.
- Sales may not increase by at least 5%, so there may, therefore, be a net cost for the company and higher net costs for the franchisees.
- When points are redeemed at a corporate store, the system will have to handle the inter-store transactions for the purpose of evaluating the individual stores' performance.
- Customers are becoming concerned about privacy and may resent the tracking of their purchases and buying habits.
- Customers also resent targeted marketing, so this may deter customers.

- FFTY's target customer may not embrace the loyalty program.
- There is a risk that, if the program is not properly administered, customers' perception of the company may be diminished rather than enhanced.

Fit with vision, mission, and strategy

FFTY wants to be the largest Canadian-owned retailer of fresh, whole foods and to provide customers with a unique shopping experience. If properly employed, a customer loyalty program should attract customers and help FFTY increase its brand name, to help meet its objective of being the largest Canadian retailer in this niche. By gathering customer-specific information as customers use the loyalty card, FFTY can use that information to provide unique shopping experiences.

However, FFTY has strategically opted to grow through a franchising network. The fact that this program is only available to customers using the corporate stores will potentially transfer sales from franchised stores to corporate stores, which is likely to be detrimental to FFTY in its attempts to attract new franchisees.

Conclusion

FFTY should implement a customer loyalty points program, but it should be implemented for the franchised stores as well as for the corporate stores.

For Assessment Opportunity #13 (Performance Management), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate the impact of the proposed customer loyalty program on FFTY's operating profit or to perform a qualitative analysis of the proposal.

Competent – The candidate calculates the impact of the proposed customer loyalty program on FFTY's operating profit and performs a qualitative analysis of the proposal.

Competent with distinction – The candidate calculates the impact of the proposed customer loyalty program on FFTY's operating profit, performs a qualitative analysis of the proposal, and provides a recommendation linked to FFTY's overall strategy.

**DAY 2 – MARKING GUIDE – TAXATION ROLE
FRESH FOOD TO YOU INC. (FFTY)**

To: Thomas, Crawford & Powell LLP Partner

From: CPA

Subject: Income tax matters for FFTY

See Common Marking Guide for the Common Assessment Opportunities #1 to #6.

Assessment Opportunity #7

The candidate calculates the capital cost allowance (CCA), taxable capital gain, and terminal loss on dispositions.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies (based on the 2020 CPA Competency Map):		Core	E4 TAX
6.2.2	Advises on taxes payable for a corporation	B	A

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

I have calculated CCA for the year, as follows:

		Class 1	Class 8	Class 10	Class 12	Class 13	Class 50
		Building	Furniture & equipment	Delivery vehicles	Computer software	Leasehold improvements	Computer hardware
	Note	4%	20%	30%	100%		55%
UCC opening		\$45,790,200	\$16,754,300	\$180,000	\$56,890	\$17,360,000	\$75,300
Additions			4,063,000			5,300,000	
Disposals	a, b	(12,560,000)		(100,000)			
Software expensed	c				120,000		
AIIP adjustment	d		2,031,500		0		
Base for CCA		33,230,200	22,848,800	80,000	176,890	22,660,000	75,300
CCA	e	(1,329,208)	(4,569,760)		(176,890)	(3,062,900)	(41,415)
Terminal loss	f			(80,000)			
Reverse AIIP adjustment		0	(2,031,500)		0	0	0
UCC closing		\$31,900,992	\$16,247,540	0	0	\$19,597,100	\$33,885

Total CCA (sum of the "CCA" row) is \$9,180,173.

Notes:

a) Disposal of building

The fair market values of the land and building were \$1.5 million and \$13.5 million, respectively, so the proceeds related to the sale of the building were \$13.5 million. The original cost of the building was \$12.56 million. This is, therefore, the lesser of cost and proceeds on disposal, which is deducted from the undepreciated capital cost (UCC).

A capital gain is incurred on this disposition, as follows:

	Land	Building	Total
Proceeds of disposition	\$1,500,000	\$13,500,000	
Original cost	(1,400,000)	(12,560,000)	
Capital gain	100,000	940,000	
Taxable capital gain (50%)	\$50,000	\$470,000	\$520,000

b) Disposal of delivery vehicles

The delivery vehicles were all sold for \$100,000, which, based on the opening UCC, appears to be less than the cost. It should be confirmed whether any were sold for greater than their original cost, but that seems unlikely, so it is assumed that \$100,000 is the lesser of the cost and proceeds.

c) Computer application software additions

Computer software purchases were expensed through the income statement in 2020. However, as computer software is a capital item, it must be reversed from net income for tax purposes and deducted through Class 12. Since the accelerated investment incentive eliminates the half-year rule on Class 12 for this year, the full amount is deductible in the year. However, it is important to include this amount in the CCA reconciliation, because CCA is elective and should be claimed correctly.

d) Accelerated investment incentive property (AIIP)

An adjustment has been made to add one-half of net acquisitions, to calculate the accelerated investment incentive, which is limited to 100% of capital cost.

e) CCA on leasehold improvements

CCA is straight-line, with 150% on new additions for the accelerated investment incentive. CCA on Class 13 is based on straight-line over the lease term, which cannot be less than five years. In this case, the lease term is 10 years, and this has been used.

Original capital cost of opening balance	22,679,000	
CCA for 2020 1/10		2,267,900
New additions	5,300,000	
150% x 1/10 of new additions.		795,000
Total CCA on leasehold improvements		<u><u>3,062,900</u></u>

f) Terminal loss

As the company sold the rest of its delivery trucks during the year, there are no remaining assets in the class. A terminal loss can be claimed for the remaining balance of UCC.

For Assessment Opportunity #7 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate CCA or ending UCC.

Competent – The candidate provides a reasonable calculation of CCA and ending UCC.

Competent with distinction – The candidate provides a thorough calculation of CCA and ending UCC.

Assessment Opportunity #8

The candidate calculates taxable income.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.2.2	Advises on taxes payable for a corporation	B	A

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

		<u>Note</u>
Income before taxes before revisions	\$9,510,000	
Revisions from Common Assessment Opportunities		
<i>Investment in LOB</i>		
		AO#1
Investment income to be recognized	225,000	
Reversal of dividend income	(85,000)	
<i>Revenue</i>		
		AO#2
Adjustment for optional franchise fees	(90,000)	
<i>Sale-leaseback</i>		
		AO#3
Amortization	(232,635)	
Interest on lease obligation	(278,252)	
Reversal of rent	400,000	
Adjustment for deferred gain	(3,933,333)	
<i>Non-monetary transaction</i>		
		AO#4
Reduce sales revenue/increase marketing expense (net)	0	
Revised net income	<u>\$5,515,780</u>	
Tax adjustments		
Amortization	6,302,000	1
Investment income from LOB	(225,000)	2
Dividend income from LOB	85,000	3
Franchise fees – revenue deferred	90,000	4
Franchise fees – revenue reserve allowed	(90,000)	4
Additional amortization on leased asset	232,635	5
Interest on the lease obligation	278,252	5
Lease costs on building	(400,000)	5
Gain on sale of land and building	(4,000,000)	6
Adjustment for gain on sale	3,933,333	6
Loss on sale of delivery trucks	150,000	6
Computer software that should be capitalized	120,000	7
Terminal loss	(80,000)	8
CCA	(9,180,173)	8
Charitable donations	112,000	9
Meals – 50% x 130,000	65,000	10
Membership dues	20,000	11
Add back leasing costs for Dennis's automobile	16,800	12
Leasing costs deductible for Dennis's automobile	(5,880)	13
Life insurance	40,000	14
Penalties and interest on late income tax payments	35,000	15
Taxable capital gains on land and building	520,000	8
Net income for tax purposes	<u>\$ 3,534,747</u>	

Charitable donations	(112,000)	9
Dividends	(85,000)	3
	<u> </u>	
Taxable income	<u><u>\$ 3,337,747</u></u>	

For Assessment Opportunity #8 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate the taxable income.

Competent – The candidate provides a reasonable calculation of the taxable income.

Competent with distinction – The candidate provides a thorough calculation of the taxable income.

Assessment Opportunity #9

The candidate discusses adjustments to accounting income to calculate taxable income.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.2.2	Advises on taxes payable for a corporation	B	A

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Notes:

1. Amortization is not deductible since it is a capital expense.
2. Because LOB is a separate legal entity, the investment income from LOB using the equity method is not taxable to FFTY and has, therefore, been excluded.
3. Intercorporate dividends received are not taxable but must be included in net income for tax purposes before being deducted in taxable income.
4. For tax purposes, revenue received or receivable is included in taxable income, and this would include the franchise fees. During the year, FFTY received total franchise fees of \$400,000, and all the fee revenue should be recognized in 2020. However, a reserve may be claimed for revenue related to services not yet performed (paragraph 20(1)(m)). Using a similar rationale as for accounting purposes, we can assume that the amount of fees received for which no service has yet been performed is \$90,000.
5. The lease for the building is not capitalized for income tax purposes; the lease payments are deductible as paid. Therefore, the entries to capitalize the lease must be reversed. The amortization and interest are added back, and the lease payments are deducted as a period cost.
6. The adjustment to the gains on sale from the sale-leaseback and gains and losses on the equipment and delivery trucks are reversed as these are capital transactions subject to a separate tax treatment (adjusted through UCC and capital gains/losses, calculated separately for tax purposes).
7. The computer software, included in general and administration expenses, is added to Class 12, as discussed above.
8. See AO#7.
9. Charitable donations, included in general and administration expenses, are not deductible in determining net income for tax purposes but are deductible from taxable income within limits (section 110.1). The limit is 75% of net income for tax purposes. The amount of these charitable contributions is less than 75%; therefore, the donations are fully deductible.
10. Meals, included in general and administration expenses, are only 50% deductible under section 67.1.
11. Membership dues for the dinner club, included in general and administration expenses, are not deductible under paragraph 18(1)(l).
12. The company leases an automobile, and the leasing costs must be adjusted. The total lease costs, net of employee reimbursement, are included in the general and administration costs and should be reversed for income tax purposes so they can be recalculated.

13. The deductible lease costs are calculated below, as per section 67.3. See note A below.
14. Life insurance premiums, included in general and administration expenses, are not deductible since they are for the shareholder, and there is no indication that this is required for financing.
15. Penalties and interest on late payments on income tax instalments are not deductible.

Note A: Calculation of the deductible amount of lease payments

The deductible amount is the least of the following:

1. The actual amount of the lease payments in the year:

$$= 12 \times \$1,700$$

$$= \$20,400$$

2. The amount determined using the basic cumulative formula:

$$\begin{aligned} &\text{Total days from beginning of lease is 458 days (October 1, 2019, to December 31, 2020)} \\ &= (\$800 \times 458/30) - \$1,483 \text{ (given)} - [2\% \times (\$15,000 - \$1,000) \times (458/366)] - (\$300 \times \\ &\quad 15 \text{ months}) \\ &= \$12,213 - \$1,483 - \$350 - \$4,500 \\ &= \$5,880 \end{aligned}$$

3. The amount determined using the formula:

$$\begin{aligned} &= [(\$20,400 \times \$30,000) \div (0.85 \times \$65,000^1)] - [2\% \times (\$15,000 - \$1,000) \times (366/366)] - \\ &\quad \$3,600 \\ &= \$11,077 - \$280 - \$3,600 \\ &= \$7,197 \end{aligned}$$

¹ Greater of the manufacturer's suggested retail price and \$35,294

Therefore, the amount deductible for the lease payments is \$5,880.

Other Notes

Mileage paid

Based on the information provided, the rate paid by FFTY is based on CRA's prescribed rates and, therefore, is deductible by FFTY.

Non-monetary transactions

With respect to the transaction with Design Webmasters Corp. (DWC), FFTY obtained \$310,000 of web services in exchange for \$290,000 of groceries. Fair value should be used for the exchange. Both amounts appear to be defensible: FFTY would have charged a third party \$290,000, and DWC would have charged a third party \$310,000. Fortunately, both the revenues and the web design expense would be recorded in income in the same year, so even if we change the amount back to the \$310,000 originally used, there will be no impact on net income for tax purposes or taxable income.

For Assessment Opportunity #9 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some of the adjustments to taxable income.

Competent – The candidate discusses several of the adjustments to taxable income, including some of the more in-depth discussions.

Competent with distinction – The candidate discusses most of the adjustments to taxable income, including several of the more in-depth discussions.

Assessment Opportunity #10

The candidate calculates Part I and Part IV taxes payable for the year and the ending balance of the RDTOH accounts, as well as the Capital Dividend Account.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.2.2	Advises on taxes payable for a corporation	B	A
6.3.2	Evaluates income taxes payable for an individual	B	A

CPA Map Enabling Competencies:

5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

Small Business Deduction (SBD)

In determining whether FFTY qualifies for the SBD, the formula in subsection 125(5.1) is relevant. The \$500,000 business limit is reduced by the annual business limit reduction. This is calculated as

$A \times B \div \$11,250$, where:

A = Annual business limit = \$500,000

B = 0.225% of the excess of previous year's total taxable capital employed in Canada over \$10 million

Taxable capital employed in Canada (section 181.2) = debt + equity – investment allowance, from 2019:

Bank line of credit	\$ 642,000
Current portion of long-term debt	3,000,000
Long-term portion of long-term debt	61,170,000
Equity	22,733,000
Less cash and cash equivalents (Note 1)	(678,000)
Net	<u>\$ 86,867,000</u>
Less limit	(10,000,000)
Excess	<u>\$ 76,867,000</u>
0.225% of the excess (0.00225)	<u><u>\$ 172,951</u></u>

Note 1: This is assumed to all be in investments; however, at least some is likely in cash. Even with claiming the full amount in investment allowance, the taxable capital limit is still clearly exceeded.

Since the result of \$172,951 is higher than \$11,250, the business limit is ground down completely, and FFTY is not eligible for any SBD.

Since the SBD is ground down to zero by the taxable capital alone, we have not determined the adjusted aggregate investment income SBD grind, as it would be redundant.

Taxable Income Allocation

Aggregate investment income	
Taxable capital gain	\$520,000
Interest income	10,000
Total	<u>\$530,000</u>
Active business income	<u>2,807,747</u>
Total taxable income	<u><u>\$3,337,747</u></u>

Taxes Payable

				<u>Notes</u>
Base rate at 38%	38%	1,268,344		
Federal tax abatement	10%	(333,775)		
Additional refundable tax		56,535		1
General rate reduction		(365,007)		2
Part I federal tax payable		<u>626,097</u>		
Part IV tax payable on LOB dividend	118,055 x 18%	21,250		
Provincial taxes		<u>383,841</u>		3
Total taxes payable		<u><u>\$ 1,031,188</u></u>		

Notes:

1. Additional refundable tax is 10 2/3% of the lesser of aggregate investment income and taxable income less the small business deduction.

Aggregate investment income		\$ 530,000
Taxable income	\$ 3,337,747	
Less: small business deduction	<u>0</u>	3,337,747
Lesser:		\$ 530,000
Additional refundable tax	10 2/3%	\$ 56,535

2. General rate reduction

Taxable income	\$ 3,337,747
Amount eligible for SBD	0
Aggregate investment income	<u>(530,000)</u>
Full rate taxable income	2,807,747
Rate	<u>13%</u>
General rate reduction	<u><u>\$ 365,007</u></u>

3. Provincial taxes

Taxable income	\$ 3,337,747
Less eligible for SBD	<u>0</u>
	3,337,747
Rate	<u>11.5%</u>
	<u><u>\$ 383,841</u></u>

Refundable Dividend Tax on Hand (RDTOH) Balances

The refundable dividend tax on hand (RDTOH) balances are amounts that can trigger a dividend refund inside the corporation when dividends are paid by the corporation to its shareholders. To prevent indefinite deferral of tax on investment income inside corporations, they accumulate additional taxes paid by the corporation on its investment and dividend income.

RDTOH balances are divided into eligible RDTOH (ERDTOH) and non-eligible RDTOH (NERDTOH). The 2020 ending balances, and thus opening balances for 2021, are calculated as follows:

Eligible refundable dividend tax on hand (ERDTOH)

ERDTOH – opening	\$ 60,000
Part IV taxes payable on dividends	<u>21,250</u>
Balance – end of year	<u><u>\$ 81,250</u></u>

Non-eligible refundable dividend tax on hand (NERDTOH)

NERDTOH – opening	0
Refundable portion of Part I tax (Note 1)	<u>162,533</u>
Balance – end of year	<u><u>\$ 162,533</u></u>

Note 1 – Refundable portion of Part I tax is the least of the following amounts [subsection 129(4), definition of NERDTH]:

i. 30 2/3% of aggregate investment income	\$ 530,000	30 2/3%	\$ 162,533
ii. 30 2/3% of taxable income less amount eligible for SBD			
Taxable income	3,337,747		
Less amount eligible for SBD	0		
	<u>3,337,747</u>	30 2/3%	1,023,687
iii. Part I federal tax payable			626,097
Least of the three amounts is			\$ 162,533

Capital Dividend Account

The capital dividend account is a special account from which dividends can be paid free of tax to shareholders. It ensures that the non-taxable status of certain income is retained when paid out in dividends to the shareholders. Capital dividends are not taxable to the shareholder who receives them.

The capital dividend account includes the non-taxable portion of capital gains realized over time. The non-deductible portion of capital losses is subtracted from the balance. Any capital dividends received from other corporations are added, but regular cash dividends received from other corporations are excluded. The non-taxable portion of gains on the sale of eligible capital property is added, for sales that occurred prior to the changes in the eligible capital property regime. The account also includes life insurance proceeds received, net of the adjusted cost base of the policy. Any capital dividends paid or payable are deducted from the account. Other kinds of dividends do not affect the capital dividend account.

Based on the information provided, the balance in the capital dividend account at January 1, 2021, is calculated as follows:

Sale of building – non-taxable portion of net capital gain (\$8,630,000 - \$7,850,000) × 50%	\$ 390,000
Sale of securities in 2016 – non-taxable portion of net capital loss (\$730,000 - \$960,000) × 50%	(115,000)
Sale of securities in 2018 – non-taxable portion of net capital gain (\$567,000 - \$432,000) × 50%	67,500
Total balance – January 1, 2020	342,500
Add non-taxable portion of net capital gain in 2020	520,000
Balance – December 31, 2020	\$ 862,500

Based on a balance of \$862,500, FFTY could pay out capital dividends of this amount to its shareholders on a tax-free basis. Doing so may be a tax-effective alternative to the shareholder loans proposed later.

For Assessment Opportunity #10 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a calculation of taxes payable or RDTOH or CDA.

Competent – The candidate prepares a reasonable calculation of taxes payable, RDTOH, and CDA.

Competent with distinction – The candidate prepares a thorough calculation of taxes payable, RDTOH, and CDA.

Assessment Opportunity #11

The candidate discusses how interest and penalties are charged by CRA, calculates the instalments that should be paid for 2021, and recommends a system to ensure payments are made on time in future.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.1.2	Assesses reporting systems, data requirements and business processes to support reliable tax compliance	B	A
6.4.1	Evaluates adherence to compliance requirements	B	A

CPA Map Enabling Competencies:

3.4.1 Establishes project plans, including goals, tasks to complete, resource requirements and timelines

5.2.1 Uses existing knowledge in new or different ways

5.2.2 Uses brainstorming or other techniques to generate ideas

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.1.1 Identifies and articulates issues within areas of work responsibility

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Interest and Penalties Charged for 2019

FFTY was charged penalties and interest on late payments of income taxes and wants to avoid these in the future. CRA can charge interest on late payments of all kinds, penalties on late instalment payments, and penalties on late-filed tax returns.

FFTY had \$1.142 million in taxes payable on its 2019 income tax return, which was filed on August 17, 2020. As the T2 corporation income tax return is due six months from the end of the corporation's taxation year, the return should have been filed by June 30, 2020. The CRA likely assessed penalties for late filing, equal to 5% of the tax unpaid at the filing due date (\$142,000 after applying the \$1 million paid in May 2020) plus an additional 1% for each complete month for which the tax return was late.

However, if the corporation was charged a penalty for any of the three preceding tax years, CRA can double this penalty to 10% for late filing plus 2% of the 2019 balance owing for each full month late, up to a maximum of 20 months.

In addition, FFTY could be subject to the large corporation penalty under section 235, which assesses the penalty as 0.0005% of taxable capital employed in Canada plus 0.25% of Part IV tax payable, for each month late, up to a maximum of 40 months.

Penalties would also have been applied for failing to make instalment payments on time. It appears that FFTY has been profitable for some time, given its substantial retained earnings. If it had a balance owing of more than \$3,000 in 2018, which seems likely, it would have been required to make instalment payments. The instalment payments for 2021 have been calculated below, but FFTY was likely required to make instalment payments for both 2019 and 2020. The entire balance due for 2019 was paid when the return was filed in August 2020, which means that instalments were not paid on time. This would have incurred substantial penalties. The penalty starts as the higher of \$1,000 or 25% of the instalment interest that would have been paid if the taxpayer had not made instalment payments at all.

While I do not have any information with respect to instalments for 2020, it is possible that no instalment payments were made for 2020 as well, so there may also be penalties and interest associated with this failure to pay.

Finally, because FFTY does not qualify for any small business deduction, in addition to its instalments for 2019, any final payment (balance due less instalments paid) is due two months after the year end. This would have been February 29, 2020. Interest will be charged on any late payments of the balance due, starting on this date. Interest is also charged on both penalties described above, as well as on the late-paid instalments.

Instalment Payments for 2021

The company has three methods that can be used for calculating its monthly instalments.

1. Current-year method: Monthly instalments of 1/12 of the estimated Part I taxes payable for 2021. We do not know whether income taxes for 2021 will increase or decrease compared to prior years, so this method is not recommended.

2. Prior-year method: Monthly instalments of 1/12 of the 2020 Part I taxes payable:

$$\begin{aligned} &= (\$1,031,195 - \$21,250) \div 12 \\ &= \$84,162 \text{ each month} \end{aligned}$$

3. Second prior-year method: Two instalments, each equal to 1/12 of the amount of 2019 taxes payable, and 10 instalments, each equal to 1/10 of the amount of 2020 taxes payable less the instalments already paid:

$$\begin{aligned} &= \text{January and February 2021 instalments} = 1/12 \times \$1,142,000 = \$95,167 \\ &= \text{March to December instalments} = (\$1,031,195 - \$21,250 - \$95,167 \times 2)/10 = \$81,961 \end{aligned}$$

The least amount of these three methods is the second option, which is, therefore, the recommended choice.

System to Ensure Payments Are Made on Time

The company has a variety of government payments that must be paid on time to avoid penalties. FFTY must make payments for income tax instalments, final balance owing on income taxes, and GST/HST remittances. The company also must file year-end returns for income tax and monthly returns for GST/HST. Even if the company is unable to make payments on time, returns should be filed on a timely basis, to minimize late-filing penalties.

FFTY should invest in a technological solution that will allow the company to set up the payment and filing deadline dates at the beginning of each year. The system will remind the controller when the deadlines are approaching to ensure that deadlines are met. There are a variety of simple and inexpensive options the company can implement to ensure that penalties do not arise. For example, CRA has a mobile app that is available to manage business account requirements, which could be downloaded and installed. Alternatively, a calendar program such as Outlook could be used, requiring all the deadline dates to be entered at the beginning of the year, with reminders to be sent a few days earlier. Another alternative could be for the controller to set up automated email reminders of payment and filing deadlines. Finally, the IT system at FFTY may be able to be programmed to provide reminders of payment and filing deadlines.

Conclusion

Interest and penalties are not deductible for income tax purposes. Bank interest paid on business expenses is tax deductible, however, so it may be less expensive for the company to borrow to pay for its business expenses, and to make instalment and tax payments on time. In addition, if FFTY makes these payments on time, it will incur no penalties. Therefore, as soon as possible, the company needs to establish a process to ensure that the income tax instalments and any balance owing are paid on time. The controller should have this responsibility and could implement any one of the suggested options.

For Assessment Opportunity #11 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate explains the interest and penalties, attempts to calculate the instalments, or identifies some systems solutions to ensure future payments and returns are on time.

Competent – The candidate explains the interest and penalties and either calculates the instalments or discusses some systems solutions to ensure future payments and returns are on time.

Competent with distinction – The candidate explains the interest and penalties, calculates the instalments, and discusses some systems solutions to ensure future payments and returns are on time.

Assessment Opportunity #12

The candidate discusses the implications of the loans and calculates the imputed interest that would be taxed for each. The candidate discusses the implications of various benefits to be provided to the employees.

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.3.2	Evaluates income taxes payable for an individual	B	A
6.3.3	Analyzes specific tax-planning opportunities for individuals	B	B
6.6.2	Analyzes income tax implications of compensation planning between a shareholder and a closely-held corporation	C	B

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

Proposed Shareholder LoansLoan to Ross Lee

FFTY will lend Ross \$300,000, to be used to invest in his company, Next Opportunity Inc. The loan will be for five years and will bear interest of 0.5% annually. Interest is payable annually, and the principal is only due on the maturity date of the loan. The loan will be advanced on April 1, 2021.

Under subsection 15(2.1), a connected person is one that is not at arm's length with a shareholder of FFTY. A spouse is an example of a connected person. Because Ross is Antonia's spouse, he is, therefore, connected to a shareholder of FFTY and subject to the provisions of subsection 15(2).

The general rule in subsection 15(2) is that when loans are made to shareholders or persons connected to shareholders, the amount of the loan is included in the net income of the recipient (Ross, in this case) in the year in which the loan is made (2021, in this case). There are exceptions to this rule, but this type of loan does not qualify for any exceptions. The taxes on this income inclusion will be substantial, and Ross may need to borrow a significantly higher amount in order to fund the tax liability.

Since the loan proceeds have been included in Ross's net income, there is no imputed interest benefit.

When the loan is repaid five years from now, in 2026, the total amount of the repayment will be deductible on Ross's return (under paragraph 20(1)(j)).

Since Ross has used the loan to invest in his corporation, he will be able to claim the 0.5% interest he pays as an investment expense deduction on his personal tax return. This amount would be \$1,500 ($\$300,000 \times 0.5\%$) annually.

Loan to Scott McMaster

FFTY will lend Scott \$500,000, to be used to purchase a new home. The loan will be advanced on May 1, 2021. Principal in the amount of \$50,000 is repayable annually on May 1 until the loan matures in 2031. The loan bears interest at an annual rate of 0.5%, which is payable monthly.

Under subsection 15(2.4), there are exceptions to having to include the principal received on the loan as income in the year of receipt. One exception is for a loan to a shareholder who is an employee, where the loan is used to purchase a residence to live in. For this exception to apply, Scott must be receiving this loan as an employee and not as a shareholder and will need to demonstrate this.

To demonstrate this, CRA would first determine whether any other employees at FFTY have been offered the same benefit. This does not appear to be the case. Scott could still prove he received this because he is an employee if it could be shown that employees at a similar level in other corporations receive this benefit. If this proof can be found, the loan could be exempt from income inclusion.

If the loan is not exempt from inclusion:

If the loan is not exempt from subsection 15(2), in that it was not given as an employee benefit, the balance outstanding at the end of the first year must be included in income. Under subsection 15(2.6), a short-term loan that is repaid within one year after the end of the corporation's taxation year does not have to be included in income. Therefore, if Scott repays \$50,000, only \$450,000 needs to be included in his income in 2021. There would be no deduction for repayment of the \$50,000 under paragraph 20(1)(j), as that amount was not included in income.

However, there is still an imputed interest benefit on the short-term loan of \$50,000 for the period in which it was outstanding.

The imputed interest benefit for 2021 will be:

\$50,000 × 8/12 × 1% (May 1 to December 31)	\$	333
Less amount paid (\$50,000 × 8/12 × 0.5%)		<u>(167)</u>
Taxable benefit	\$	<u>166</u>

There will be no imputed interest benefit on the remaining \$450,000, which has been included in income. When Scott repays the remaining \$450,000, there would be a deduction available in the year of repayment, under paragraph 20(1)(j).

If Scott does not intend to repay the loan, it would be more beneficial to have the loan re-characterized as a dividend, since he would owe less personal tax due to the dividend tax credit.

If the loan is exempt from inclusion:

If the loan is exempt from inclusion as income, by meeting the exception in subsection 15(2.4), there is still a benefit that will be taxed to Scott, which is the imputed interest benefit on the loan. The imputed interest is calculated at the prescribed rate, which is currently 1%, less any amounts of interest actually paid.

Therefore, the imputed interest benefit for 2021 will be:

\$500,000 × 8/12 × 1% (May 1 to December 31)	\$	3,333
Less amount paid (\$500,000 × 8/12 × 0.5%)		(1,667)
Taxable benefit	\$	<u>1,666</u>

Because the loan would be seen to be given to an employee, if the criteria in subsection 15(2.4) are met, this benefit is treated as employment income. The rate used for this benefit will be set for the first five years and will be no higher than the 2% prescribed rate at the time the loan was issued, following the rules in subsections 80.4(4) and (6). If the prescribed rate falls, the lower rate can be used for the calculation.

Employee Benefits

FFTY is considering a variety of benefits that have been suggested by employees.

Employee discount

All employees will be provided with a 10% discount on all products sold in the FFTY stores. Generally, a discount on merchandise that is available to all employees is not treated as a taxable benefit, under CRA administrative policy. The only issue here is that the discount cannot result in a value below cost; otherwise, the loss would be a taxable benefit.

FFTY will not be able to deduct the discount from its income but will only be taxed on the amount of revenue it receives, which has the same effect.

Non-cash awards

Non-cash awards will be given, up to \$500 for five-year anniversaries and then increasing by \$500 for each fifth anniversary date. The non-cash award will be an item selected by the employee from a list of 10 items.

A non-cash award that is given for length of service and is not more than \$500 annually is not a taxable benefit. However, an anniversary non-cash award that has a value greater than \$500 will result in a taxable benefit for the amount that is in excess of \$500. Therefore, for a 10-year anniversary award of \$1,000, \$500 will be a taxable benefit for the employee. Similarly, a non-cash award with a value of \$1,500 for the 15-year anniversary will result in a taxable benefit to the employee of \$1,000.

The award payments are deductible for the company.

TFSA contributions

FFTY will contribute 5% of an employee's wages annually to the employee's tax-free savings account (TFSA).

Any contributions made by FFTY to an employee's TFSA will be a taxable benefit for the employee, since this is no different than a cash payment. Subsequent income earned inside the TFSA will not be taxable to the employee. Taxes must be withheld from these payments, as with other taxable benefits.

Depending on the salaries of the employees, it is also possible that this benefit will cause employees to exceed their TFSA limit. TFSA limits are increased by a fixed amount each year based on regulation, whereas making contributions based on salaries will vary from year to year. Making a contribution to a TFSA in excess of the limit will cause the employee to incur significant over-contribution taxes, so any such plan should be carefully structured, and employees should be required to confirm their agreement with any such payments and take responsibility for any over-contributions. It may be simpler to set up a regular pension (using an RPP) or to pay cash bonuses to employees, both of which will achieve a similar goal without the complication of the TFSA.

The payments will be deductible for FFTY as an employment benefit laid out for the purpose of earning business income.

Disability insurance

FFTY is considering a group disability insurance plan, which can be funded in one of three ways: FFTY pays all the premiums; the employee pays all the premiums; or the premiums are shared by FFTY and the employee.

Employer contributions to a disability insurance plan are not a taxable benefit to the employee if any benefits from the plan received by the employee are taxable upon receipt, the premiums are paid on a periodic basis, and the benefits are received when an employee becomes disabled and is unable to work and earn employment income. The premiums will be a deductible expense for FFTY.

If FFTY pays any part of shared premiums, rather than paying them all itself, FFTY's portion is still not a taxable benefit to the employee, and the benefits when received are taxable to the employee. However, when an employee receives benefits that are taxable, they can deduct from this income any amounts that they had paid prior to becoming disabled. The portion of the premiums paid by FFTY will be a deductible expense for FFTY.

If the employee pays 100% of the premiums, there is no impact to FFTY. The employee will receive the benefits when paid out on a tax-free basis, but the employee will not be able to claim any deductions with respect to the premiums they pay.

From the employee’s perspective, in the short term, they may prefer that FFTY pay some or all of the premiums. These are not a taxable benefit to the employee, and when (if) the benefits are received, they will be taxable and included in the employee’s taxable income at that time. However, from a long-term perspective, employees may prefer to pay the premiums themselves, in order to ensure the tax-free receipt of future benefits.

For Assessment Opportunity #12 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss the tax consequences of the shareholder loans or the employee benefits.

Competent – The candidate discusses the tax consequences of the shareholder loans and some of the employee benefits.

Competent with distinction – The candidate discusses in depth the tax consequences of the shareholder loans and several of the employee benefits.

Assessment Opportunity #13

The candidate explains GST/HST implications on specific items and calculates the GST/HST return (for January).

The candidate demonstrates DEPTH in the Taxation role.

CPA Map Technical Competencies:		Core	E4 TAX
6.7.2	Analyzes GST obligations of a person	C	B
6.7.3	Calculates net tax for a person	C	B
6.7.5	Analyzes GST implications from tax planning for shareholders and a closely held corporation	C	B

CPA Map Enabling Competencies:

5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

GST/HST Return

Calculation of the GST/HST return for the month of January is as follows:

<i>GST/HST collected</i>		
Sales	$(\$14,700,000 - \$7,200,000) = \$7,500,000$ $\times 13\%$	\$ 975,000
Franchise fees received	$\$180,000 \times 13\%$	23,400
Total GST/HST collected		\$ 998,400
<i>Input tax credits (ITCs)</i>		
Purchases (not cost of goods sold)	$(\$10,700,000 - \$4,200,000) = \$6,500,000$ $\times 13\%$	845,000
Operating costs (Note 1)	$\$1,737,490 \times 13\%$	225,874
Rent	$\$1,568,000 \times 13\%$	203,840
New furniture and fixtures (Note 2)	$\$10,400,000 \times 13\%$	1,352,000
Total input tax credits		2,626,714
Net GST/HST payable (refund)		\$(1,628,314)

Notes:

- Operating costs include some items on which input tax credits cannot be claimed. The calculation below is, therefore, for the net operating costs on which input tax credits can be claimed:

Total operating costs for taxable items	\$ 1,753,000
Less lease costs (Note 3)	(1,210)
Less dining club memberships	(1,800)
Less meals (50% × \$25,000)	(12,500)
	<hr/>
Net amount	<u>\$ 1,737,490</u>

2. Even though it is a capital item, the furniture and fixtures purchase is eligible for an ITC. Capital items are eligible for ITCs at the time of purchase, not as they are depreciated over a useful life. It is also not relevant that the invoice has not yet been paid.
3. An input tax credit can only be claimed based on the proportion of deductible lease costs. Based on the amount deductible for 2020, assuming that Dennis is still reimbursing FFTY \$300 per month, the non-deductible amount per month should be:

Actual lease cost	\$ 1,700
Deductible portion (\$5,880/12)	<u>(490)</u>
Non-deductible portion	<u>\$ 1,210</u>

For the financing costs (interest expense) and salaries and wages, no ITC is available as these are exempt supplies for GST/HST purposes.

Proposed Benefits — Implications for GST/HST

Employee discount: GST/HST will be collected on the amount of the actual sale, which will be at the discounted amount.

Non-cash awards starting at a value of \$500: No ITC can be claimed on property or services acquired for the exclusive personal consumption, use, or enjoyment of an employee or an employee's relative. Therefore, no ITC can be claimed on this benefit.

TFSA contributions: Any contributions made by FFTY to an employee's tax-free savings account will be a taxable benefit for the employee. Since these are wages, no ITC is available.

Disability plan: There is no GST/HST on insurance premiums and, therefore, no ITC available on these costs. *[Marking note: Candidates are not responsible for knowing the Ontario-specific rules regarding taxes on insurance plans.]*

For Assessment Opportunity #13 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to calculate the GST/HST return or identifies some GST/HST impacts of the employee benefits.

Competent – The candidate provides a reasonable calculation of the GST/HST return and identifies some GST/HST impacts of the employee benefits.

Competent with distinction – The candidate provides a thorough calculation of the GST/HST return and discusses some GST/HST impacts of the employee benefits.

APPENDIX D

**SEPTEMBER 15, 2021 – DAY 3 SIMULATIONS,
SOLUTIONS AND MARKING GUIDES**

**COMMON FINAL EXAMINATION
SEPTEMBER 15, 2021 – DAY 3**

Case #1**(Suggested time: 90 minutes)**

Adam and Elizabeth Moon, a married couple in their early 60s, own two businesses. FenceCo is a fence-building and installation company that they have owned equally since its incorporation (Appendix I). ABC Feeder Inc. (ABC) manufactures animal feed for farms and resells types of third-party feed. Elizabeth founded ABC 18 years ago when she invested \$40,000 in common shares. In 2016, she sold half of her ABC shares to Adam. The Moons are directors of both companies, and are not involved in day-to-day operations.

It is March 21, 2021. You, CPA, are a sole practitioner recently engaged by the Moons to provide tax and business advice.

Elizabeth is considering adding another revenue model for FenceCo, and asks to quantitatively and qualitatively analyze it and to recommend a course of action (Appendix II).

Having decided to sell their shares of ABC, the Moons ask you to value the business based on normalized net income, using the industry standard multiplier of five. Elizabeth provides you with excerpts from ABC's year-end financial statements and notes (Appendix III). The Moons ask you to calculate the taxes payable on the sale, using your recommended selling price, and assuming that the shares are qualified small business corporation (QSBC) shares.

The Moons would like your advice on some investment options for the sale proceeds (Appendix IV). They would also like a recommendation, an explanation for your choice, and a discussion of the tax implications of each option.

Finally, some managers strongly believe that FenceCo should enter the U.S. market using its existing business model and have suggested an action plan (Appendix V). Elizabeth wonders if this expansion is a good fit with FenceCo's strategic objectives.

APPENDIX I FENCECO – INFORMATION

FenceCo operates in Canada's four largest cities. The company measures sales volume by feet of fence installed, and its standard is to install, on average, one post for every six feet of fence.

In 2015, FenceCo developed new fence-post technology that is faster and results in a more stable fence than its former method which required drilling holes and locking the post with concrete or crushed stone. Since 2016, FenceCo has only used its own posts, which are manufactured in FenceCo's plant in Toronto. The business is considered capital-intensive because it relies on the use of trucks and equipment.

For the year ended December 31, 2020, FenceCo's revenue was \$18,423,000 and the cost of sales was \$13,760,000. Cost of sales is comprised of the cost of materials and installations, including installation wages. The sales for 2021 are forecast to be about the same as the 2020 actuals. The company currently averages \$45 of revenue per foot installed.

FenceCo has an office in each city, with a general manager. The installers are experienced and their employment contracts guarantee work from April to November. FenceCo's employees are all laid off for the rest of the year, except for, in each city, the general manager, a small sales team and one installer who performs warranty repair.

The Moons' strategic objective is to grow FenceCo as fast as possible in its existing markets and significantly increase profits, and then sell it in two or three years at the highest possible price. They would like to do this without major capital investment while minimizing risk.

APPENDIX II
FENCECO – ADDITIONAL REVENUE MODEL

In 2022, FenceCo's management team wants to start to license its new fence-post technology to third-party contractors in its existing markets. The contractors would use the new method to install fencing for their own customers. Contractors would pay a licensing fee of \$3 per foot to FenceCo and would have to purchase the fence posts exclusively from FenceCo. FenceCo would price the posts to generate a gross profit of \$17 each, and the contractors would pay shipping costs.

Management believes that total sales made through these contractors would amount to 210,000 feet in 2022, and 248,500 feet in 2023.

Management estimates that, of all footage sold through third-party contractors with the new revenue model, 1% would come from footage that FenceCo would have otherwise sold to, and installed at, its own clients.

Fixed annual selling and administration costs for this project are estimated at \$94,000 and variable administration costs at \$0.11 per foot.

APPENDIX III
ABC – EXCERPTS FROM UNAUDITED FINANCIAL STATEMENTS

ABC Feeder Inc.
Balance Sheet
As at December 31, 2020
(in thousands of Canadian dollars)

Assets	
Cash	\$ 105
Accounts receivable	550
Inventory	391
Prepaid expenses	40
	<u>1,086</u>
Property, plant and equipment	778
Less: Accumulated depreciation	376
	<u>402</u>
	<u>\$ 1,488</u>
Liabilities	
Accounts payable	\$ 370
Accrued expenses	26
	<u>396</u>
Mortgage payable	315
	<u>711</u>
Shareholders' equity	
Common shares	40
Retained earnings	737
	<u>777</u>
	<u>\$ 1,488</u>

APPENDIX III (continued)
ABC – EXCERPTS FROM UNAUDITED FINANCIAL STATEMENTS

ABC Feeder Inc.
Income Statement
For the year ended December 31, 2020
(in thousands of Canadian dollars)

Revenue	\$	17,453
Cost of sales		14,730
		2,723
Expenses		
Administration, marketing, and sales		2,090
Amortization and depreciation		35
Other		77
		2,202
Net income before taxes		521
Income taxes		115
		406
Net income	\$	406

Notes from Elizabeth:

- ABC's suppliers announced significant price increases, effective January 1, 2021. Because the increases cannot be fully passed on to customers, ABC's overall gross margin percentage is expected to decrease by 1.25 percentage points, even if sales remain stable.
- In February 2021, ABC began charging shipping costs to customers to match its competitors' actions, resulting in an increase in its gross margin percentage of 0.7 percentage points.
- We have a history of good employee relations, with no terminations until 2020, when the plant manager was replaced; severance costs were \$94,000. The recruiting fee for their successor was \$50,000.
- Sales are expected to remain stable in the foreseeable future. There are several possible purchasers for ABC, both from within and outside the industry. Disposal of ABC's shares would cost \$15,000 in legal fees.
- The director fees paid to us by ABC are double the amount that directors of similar-sized companies would normally receive.
- ABC has rented an off-site executive meeting space since January 2020 for \$4,000 per month, which it uses occasionally for company meetings. A potential buyer will probably discontinue renting this space.

APPENDIX IV
INVESTMENT OPTIONS AND ADDITIONAL INFORMATION

Historically, the Moons have invested their extra funds in guaranteed investment certificates (GICs), which currently earn about 2.2% annually, and in other businesses.

Elizabeth said: “We would like more free time for our hobbies, and plan to retire in two or three years. We would like average returns with moderate risk on investment of the after-tax proceeds from selling ABC. We have discussed investing in GICs, bonds earning about 4% annually, the stock market and/or cryptocurrency. We are also considering buying a residential rental property from my cousin at a very good price. In the past three years, the house was rented out for 29 months and was vacant for seven months. During those three years, annual repair costs were \$1,300, \$9,200, and \$2,400, respectively. We need help determining which of these investment options are suitable.

“We have not yet filed our 2020 personal tax returns and made no RRSP contributions in 2020 or 2021. Should we be putting the entire proceeds from the sale in our RRSPs? Please explain the income tax treatment for each of the investment options and calculate our 2021 RRSP deduction limits.”

Although she does not intend to do so in the future, Elizabeth has previously been an angel investor in several high-tech companies. In 2015, she used \$234,000 of her lifetime capital gains exemption, which she had not used previously. ABC has always been a small business corporation (SBC), and Elizabeth used the lifetime capital gains deduction for the sale of her ABC shares to Adam in 2016, at their estimated market value at the time of \$450,000. Selling costs were \$5,000. Adam and Elizabeth elected not to use the spousal rollover for the transaction.

The Moons have never reported any rental losses and Adam has never had any capital gains. Adam earns \$48,000 annually for part-time work as an executive director of a local art gallery.

Adam and Elizabeth provided the following additional information for 2020.

	Adam	Elizabeth
Director fees – ABC	\$ 10,000	\$ 10,000
Interest on GICs	\$ 3,000	\$ 3,000
Dividends – ABC	\$ 34,000	\$ 34,000
Dividends – FenceCo	\$ 205,000	\$ 205,000
RRSP deduction limit	\$ 15,780	\$ 11,425

APPENDIX V
MANAGERS' PLAN FOR U.S. EXPANSION

- Six to eight different cities would be targeted for expansion.
- To fulfil the expected U.S. demand, the fence posts would be manufactured in newly-built manufacturing facilities in the U.S.
- It would take three years to reach normal operating levels.
- A strong return on investment can be expected in the longer term; the initial forecast shows that the U.S. segment would start becoming profitable after three years.

MARKING GUIDE 3-1
FENCECO
ASSESSMENT OPPORTUNITIES

To: Adam and Elizabeth Moon
From: CPA
Re: Your requests

Assessment Opportunity #1 (Breadth and Depth Opportunity)

The candidate quantitatively analyzes the new revenue model for the fence business.

The candidate demonstrates competence in Management Accounting.

CPA Map Competencies

3.4.1 Evaluates sources and drivers of revenue growth (Core – Level B)

CPA Map Enabling Competencies:

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

Analysis of New Revenue Model

I have performed the following quantitative two-year analysis of the new licensing model in the four cities where the company is active.

The purpose is to determine the incremental annual cash impact of third-party contractors using the company's technology for a licensing fee of \$3 per foot, with FenceCo selling them the fence posts and with shipping extra.

I first determined the company's current overall cost of sales of 74.69% and gross profit of 25.31%. The company installed 409,400 feet of fence; this represents the current and forecast sales volume without any new revenue models. I noted that the company makes an overall margin of \$11.39 per foot.

Current revenues	\$18,423,000	
Current cost of sales	<u>13,760,000</u>	74.69%
Gross profit	\$ 4,663,000	25.31%
Revenue per foot	\$45.00	Given
Calculated annual feet	409,400	
Margin per foot	\$11.39	

I then determined the expected footage of sales to the contractors using FenceCo's technology, which leads to the licensing fee revenue and fence post sales profits.

From this, the "cannibalization," or lost sales, by FenceCo must be subtracted, net of cost of sales saved.

Finally, the net of the above inflows and outflows must be compared to the fixed and variable costs of running the licensing operation.

	<u>2022</u>	<u>2023</u>	<u>Note</u>
Contractor feet	210,000	248,500	
Licence fee per foot	\$ 3	\$ 3	
Licence revenue	\$ 630,000	\$ 745,500	
Posts manufactured	35,000	41,417	1
Margin per post average	\$ 17	\$ 17	
Incremental margin	\$ 595,000	\$ 704,083	
Lost margin on cannibalization	\$ (23,919)	\$ (28,304)	2
Fixed licensing sales and admin costs	\$ (94,000)	\$ (94,000)	
Variable licensing admin costs	\$ (23,100)	\$ (27,335)	3
Bad debts and warranty costs			4
Net change	\$ 1,083,981	\$ 1,299,945	
Net per foot	\$ 5.16	\$ 5.23	5
Total board feet, installed and licensed	617,300	655,415	6
% increase over base year	50.8%	60.1%	7

Notes:

- 2022: 210,000 feet ÷ 6 feet per post = 35,000 posts
2023: 248,500 feet ÷ 6 feet per post = 41,417 posts
- 2022: 210,000 feet × 1% × \$11.39 margin per foot = \$23,919
2023: 248,500 feet × 1% × \$11.39 margin per foot = \$28,304

3. 2022: $\$0.11 \times 210,000 \text{ feet} = \$23,100$
2023: $\$0.11 \times 248,500 \text{ feet} = \$27,335$
4. To be determined
5. 2022: $\$1,083,981 \div 210,000 \text{ feet} = \5.16
2023: $\$1,299,945 \div 248,500 \text{ feet} = \5.23
6. 2022: $\$18,423,000 \div \$45 + 210,000 \text{ feet} - (210,000 \text{ feet} \times 1\%) = 617,300 \text{ feet}$
2023: $\$18,423,000 \div \$45 + 248,500 \text{ feet} - (248,500 \text{ feet} \times 1\%) = 655,415 \text{ feet}$
7. 2022: $(617,300 \text{ feet} - (\$18,423,000 \div \$45)) \div (\$18,423,000 \div \$45) = 50.8\%$
2023: $(655,415 \text{ feet} - (\$18,423,000 \div \$45)) \div (\$18,423,000 \div \$45) = 60.1\%$

The new licensing model is expected to make a positive contribution to FenceCo's operating income of \$1,083,981 in 2022 and \$1,299,945 in 2023. Consideration could be given to doing sensitivity analysis on the key variables. These variables are more than likely the percentage market take-up with contractors and the cannibalization factor. Consideration should also be given to the available capacity, given the increased post manufacturing.

Warranty costs and carrying costs of post inventory have not been considered.

For Assessment Opportunity #1 (Management Accounting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to provide a quantitative analysis of the new revenue model.

Competent – The candidate provides a quantitative analysis of the new revenue model.

Competent with distinction – The candidate provides a thorough quantitative analysis of the new revenue model.

Assessment Opportunity #2 (Breadth and Depth Opportunity)

The candidate provides a qualitative discussion of the new revenue model and makes a recommendation.

The candidate demonstrates competence in Management Accounting.

CPA Map Competencies

3.4.1 Evaluates sources and drivers of revenue growth (Core – Level B)

CPA Map Enabling Competencies:

1.3.1 Maintains a skeptical mindset when performing assigned work

1.3.2 Recognizes bias, uncertainty and ambiguity in the information and assumptions that underlie assigned work

2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work

2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

There are many pros and cons to this new licensing revenue model.

Advantages of the new licensing model include the following:

- The fence technology seems to be already known in these cities.
- There might be some spin-off sales; if the contractors are not able to meet the demand, their customers may come directly to FenceCo.
- FenceCo's technology will get more exposure, which should be positive.
- FenceCo could earn a profit per foot of 45% ($\$5.16 \div \11.39) of the current profit per foot, with no major sales or installation effort, risk, or additional investment.
- Other than for the posts, there will be no warranty issues when compared to existing installation sales.
- There is lower litigation risk versus installing more fences; what goes wrong will usually be the contractor's problem.

- Although there will be some new selling, general and administrative (SG&A) costs associated with the new licensing model, the current SG&A costs could be reduced; FenceCo is likely to deal with fewer contractors directly for the same amount of sales volume, and the contractors will deal with the customers/homeowners.
- This new licensing model would help to grow the business as fast as possible in Canadian markets, where current sales forecasts are flat. As the goal is to sell the company in two to three years at the highest possible price, this will help increase the selling price. Potential buyers of the company include licensees; upon seeing how well the technology works, they may want to acquire it along with the business. This is a major positive and ties into the strategy.
- Profits significantly increase with the licensing model, with an increase of \$1.1 million in 2022 and \$1.3 million in 2023, potentially attracting buyers in the two- to three-year time frame.
- The licensing approach grows revenue without any capital investment.

There are the following disadvantages:

- Working directly with competitors could be dangerous in the long run. For example, the reporting of the fence footage could be understated or FenceCo's unique technology could be replicated.
- If the cannibalization of existing sales is higher than forecast, the impact could be negative.
- When contractor sales are added to FenceCo's own post needs, there could be capacity problems at the fence post plant.
- Management and sales lack experience with the new licensing model, which could lead to production shortages for posts due to the inability to make accurate demand forecasts. This could lead to FenceCo having to lay off its experienced installation team.
- Since the installations would be performed by the contractors and FenceCo would have little or no control over the quality of their work, the FenceCo brand could be tarnished by quality issues out of its control.
- If the contractors' work is not up to the clients' expectations, FenceCo's reputation might be negatively affected.
- There might be issues with obtaining or enforcing patents for the new technology.
- The new licensing model may result in a manufacturing capacity problem for posts, which could be resolved by new capital investment, but this would be inconsistent with the overall strategy.

The company could also replicate this model in other Canadian cities, in the U.S., and around the world. Doing so would take more effort because it would be outside the four cities in which the company already does business. However, it would provide access to markets not currently served.

There may be other ways to expand the business using the post technology. For example, a company could pay a fixed fee plus a smaller licensing fee, or perhaps just a large flat amount. FenceCo could also simplify the model by charging more for the posts and have no licensing fee.

The model relies upon the licensed contractors honestly reporting the full number of feet for licensing fee purposes. However, there could be a financial incentive for them to under-report.

This risk could be mitigated by analyzing reported feet versus posts purchased. Another option is an audit clause, where FenceCo's accountants, FenceCo's external accountant, or the licensee's accountants provide a report on board feet installed in some form or review the relevant records.

The agreements with the contractors should be cancellable in case cannibalization is higher than expected or there are other unforeseen problems.

Recommendation

Given the positive financial results and the fact that the advantages outweigh the disadvantages, I recommend proceeding with the project.

For Assessment Opportunity #2 (Management Accounting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some of the qualitative factors.

Competent – The candidate discusses some of the qualitative factors, mentioning both pros and cons, and provides a recommendation.

Competent with distinction – The candidate discusses many of the qualitative factors, mentioning both pros and cons, and provides a recommendation.

Assessment Opportunity #3 (Breadth Opportunity)

The candidate performs a valuation of ABC.

The candidate demonstrates competence in Finance.

CPA Map Competencies

5.4.2 Applies appropriate methods to estimate the value of a business (Core – Level B)

CPA Map Enabling Competencies:

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.2 Identifies patterns from data analysis

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

In the context of your desire to sell the business for the highest possible amount, you have requested a valuation of ABC. I believe you would want an optimistic valuation to present to possible buyers of the business, to the extent this is justifiable.

I have used the capitalized earnings approach, which takes the company's expected earnings and capitalizes them, effectively valuing the company based on its future earnings. This method is appropriate since the earnings have been steady and are close to cash (minimal amortization or change in balance sheet working capital), and it presumes that large capital cash investments are not needed.

You provided me with the December 31, 2020, financial statements to base the valuation on. I would prefer to look back at more history and look forward with well-supported forecasts. However, since they are not available, I will work with the information provided.

I have taken the 2020 pre-tax income from the financial statements and made the following adjustments to determine the maintainable earnings going forward:

- You said the director fees were twice the normal amount, so I have removed \$10,000.
- Although terminations and hiring are normal practice for a corporation, the termination of the plant manager in 2020 generated a significant cost of \$94,000, and the recruiting cost to replace that individual in 2020 was \$50,000. Therefore, in trying to establish ABC's maintainable earnings, I think it is reasonable to adjust for these items.
- The executive meeting space rental cost of \$48,000 (\$4,000 per month) has been removed, as the buyer of the business will likely not continue using it. I have not assumed the executives will seek a commensurate salary increase.
- The change in the cost caused by the price increases must be factored in. Because the increases cannot be fully passed on to customers, the gross margin has been adjusted for a reduction of 1.25 percentage points ($\$17,453,000 \times 1.25\%$).
- As customers will absorb more of the shipping costs beginning in early 2021, I have made an adjustment for shipping costs, with the impact being 0.7% of revenue ($\$17,453,000 \times 0.7\%$).
- I deducted income tax expense at your 2020 rate of 22%, to get after-tax maintainable earnings.

The earnings are assumed to continue into perpetuity, so they are capitalized with the given industry multiplier of 5.

This results in a going concern capitalized earnings value of \$2.4 million for the business, as follows:

Purpose: To perform a capitalized earnings valuation of ABC

	Dec. 31, 2020
Income before taxes	\$ 521,000
Adjustments:	
Excess director fees	10,000
Non-recurring termination cost – plant manager	94,000
Recruiting cost	50,000
Executive meeting space rental	48,000
Margin change due to increased prices (Note 1)	(218,163)
Shipping now absorbed by customers (Note 2)	122,171
	<u>627,008</u>
Income taxes (Note 3)	138,399
Maintainable earnings	<u>488,609</u>
Multiplier (given)	<u>5</u>
Capitalized earnings valuation	<u>\$ 2,443,045</u>

Notes:

1. $\$17,453,000 \times 1.25\%$
2. $\$17,453,000 \times 0.7\%$
3. Assume same rate as 2020 ($\$115,000 \div \$521,000 \times \$627,008$)

To compare the assets at market value with the going concern earnings valuation, it would also be a good idea to perform an adjusted book value valuation.

You could ask a little more than our valuation amount for the business so that the buyer feels they have achieved something by negotiating a lower price.

If a buyer wanted to buy assets rather than shares, this would change the situation and would need to be discussed further.

For Assessment Opportunity #3 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a capitalized earnings valuation of the business.

Competent – The candidate provides a capitalized earnings valuation of the business.

Competent with distinction – The candidate provides a thorough capitalized earnings valuation of the business.

Assessment Opportunity #4 (Breadth Opportunity)

The candidate discusses the taxation of the planned sale of ABC.

The candidate demonstrates competence in Taxation.

CPA Map Competencies

6.3.2 Evaluates income taxes payable for an individual (Core – Level B) – *for capital gains reserve and LCGE [AMT is Level C within this competency]*

6.6.3 Analyzes income tax implications of the purchase and sale of a CCPC (Core – Level B)

CPA Map Enabling Competencies:

2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Taxation on the Sale of ABC

You have asked how much income tax will be payable on the sale of ABC's shares at the valuation price. If a vendor requests an asset sale, this will be a very different calculation.

It appears from the files that since Adam has never triggered any capital gains, he has his entire lifetime capital gains exemption (LCGE) available to completely shield his capital gain on the sale of ABC.

Elizabeth used \$234,000 of her LCGE limit in 2015 and \$425,000 (\$450,000 – \$5,000 selling costs – \$20,000 cost base) in 2016 when she sold her shares in ABC to Adam. This leaves \$233,218 available for her use (\$892,218 – \$425,000 – \$234,000).

The taxable capital gains are 50% of the capital gains (which are sales price minus selling costs).

The taxes payable for a 2021 sale for you both would be as follows:

Elizabeth

Estimated proceeds on sale (valuation)	\$	2,443,045	
Elizabeth's share	\$	1,221,523	50%
Selling costs (estimated)		7,500	50%
Adjusted cost base		20,000	paid \$40,000 originally
Capital gain	\$	1,194,023	
Taxable capital gain	\$	597,012	50%
Remaining lifetime capital gains deduction		116,609	50% of \$233,218
Taxable income from sale	\$	480,403	
Taxes	\$	235,397	49%

Adam

Estimated proceeds on sale (valuation)	\$	2,443,045	
Adam's share	\$	1,221,523	50%
Selling costs (estimated)		7,500	50%
Adjusted cost base		450,000	Purchased from Elizabeth
Capital gain	\$	764,023	
Taxable capital gain	\$	382,012	50%
Lifetime capital gains deduction		382,012	
Taxable income from sale	\$	0	50%
Taxes	\$	0	49%

Taxes are assumed to be at 49%, given that the Moons are both in the top tax bracket. The precise tax rate for their province should be determined to calculate the exact amounts.

Adam may be subject to alternative minimum tax (AMT) in 2021. Any AMT would be carried forward and potentially recoverable in the following seven years.

For Assessment Opportunity #4 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a calculation of the tax on the sale of the shares.

Competent – The candidate calculates the tax on the sale of the shares, analyzing the applicability of the LCGE.

Competent with distinction – The candidate calculates the tax on the sale of the shares, thoroughly analyzing and calculating the applicability of the LCGE.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate discusses investment options for the cash to be received from selling ABC.

The candidate demonstrates competence in Finance.

CPA Map Competencies

5.2.2 Evaluates the entity's investment portfolio (Core – Level B)

CPA Map Enabling Competencies:

4.3.6 Recognizes limits to professional competence

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

Investment of Proceeds of ABC

You have asked what to do with the proceeds expected to be yielded from the sale of ABC. Based on the valuation I performed, the amount is expected to be about \$2.4 million before tax. Income taxes were calculated for each of you, above, which leaves net proceeds of about \$1 million for Elizabeth and just over \$1.2 million for Adam.

I have considered your objectives:

- You would like more free time for certain hobbies.
- You want to realize average returns with moderate risk. I have taken this as a given, but please note that, since you want to retire in two or three years, you may want to consider investments with lower returns and lower risk, to reduce the risk of large fluctuations that could spoil your retirement plan.

I have only looked at the options you mentioned, and remind you that I am not a professional investment advisor. All these options have higher risk than GICs but should provide higher returns on average, because of the risk-to-return trade-off.

Residential rental property

This option requires some effort to maintain the property, which conflicts with your desire for more leisure time. That said, you may have more time once you retire, or you could hire someone to do the work. Neither of you has experience with residential property management and maintenance, although you do have some limited experience with a commercial building.

This option is likely riskier than GICs or bonds as, for example, there is the risk of no tenants or of property damage by tenants. Your cousin's experience illustrates this risk. Before proceeding, you should find out why the maintenance costs were so high the year before last (\$9,200), and why it was vacant for seven of the past 36 months. There are other residential rental properties in the market. You do not have to buy from your cousin if this is not the right property.

Additional considerations are that a rental property does not represent a very diversified risk and is not very liquid.

Bonds

Bonds provide fixed returns of interest and are typically lower-risk than stocks and residential rental property. You can buy into bond funds or hire an advisor to invest in bonds for you. There is capital appreciation and depreciation risk during times of interest rate changes.

Stocks

Unless you are relying on a personal investment fund manager, investing in the stock market requires significant time and expertise. Based on what you have told me, I do not believe you have the time or expertise. The more varied the stocks are that you buy, the lower your risk. An alternative is for you to invest through mutual funds, where you pay a management fee. The portfolio follows the funds' objectives rather than being tailored to your specific objectives, although the use of a robo-advisor may help to balance the objectives of the funds with your personal financial objectives. Returns would be in the form of capital gains and dividends. If high-risk stocks are avoided, risk would be medium.

Cryptocurrency

Cryptocurrency is new and higher than medium risk. There is higher volatility in values. Although cryptocurrencies are quite secure, if the blockchain codes were ever broken, you could lose everything. There is arguably no underlying value versus the stock market, real estate, and bonds; therefore, I do not recommend it as an investment option.

RRSPs

You are asking if you should invest the proceeds from the sale of ABC into your RRSPs, perhaps because you are concerned about your retirement income. The advantage of RRSP contributions is that they reduce your income taxes now since they are tax deductible, and when you take the money out in retirement, you will likely be in a lower tax bracket. RRSPs are not a type of investment in and of themselves. They are instead a type of tax-sheltered account that holds different kinds of investments. Stocks, bonds, and mutual funds could all be held inside RRSPs, so the decision of whether to use an RRSP is a tax decision, not an investment decision.

Investment horizon and tolerance to risk are closely related. You should determine the timing of your cash needs in order for me to advise you better on the most suitable recommendation.

Summary and Recommendations

I recommend that you use up all your RRSP room and stick to stocks and bonds. This will help meet your objectives of having more free time and reasonable returns with not too much effort. A diversified portfolio is recommended, given your lower tolerance for risk as you get closer to retirement. You noted that Elizabeth was once an angel investor but does not intend to do that in the future. That is a wise decision since such investments would be considered high risk.

This recommendation is for the near term, this year. The strategy should be revisited in the future.

For Assessment Opportunity #5 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate provides a general discussion of the options.

Competent – The candidate discusses some of the options, considering risks and the client's stated objectives, and makes recommendations.

Competent with distinction – The candidate discusses most of the options, considering risks and the client's stated objectives, and makes recommendations.

Assessment Opportunity #6 (Breadth Opportunity)

The candidate discusses the tax treatment of the investment options.

The candidate demonstrates competence in Taxation.

CPA Map Competencies

6.3.2 Evaluates income taxes payable for an individual (Core – Level B)

6.3.3 Analyzes specific tax-planning opportunities for individuals (Core – Level B)

CPA Map Enabling Competencies:

2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

RRSPs

As mentioned previously, RRSPs are a type of tax-sheltered account rather than a type of investment. Contributions are deductible from your income in the year in which they are made, or in the prior year for contributions made in the first 60 days of the year.

Invested amounts grow tax-free while in this vehicle and are only taxed when the funds are withdrawn from the RRSP.

You have said that you would like to put more money in RRSPs. You have limited “earned income” — that is, salary and business income — and, therefore, limited RRSP room, which is basically 18% of earned income. Investment income, including income from stocks, bonds, GICs, or the vendor takeback loan, as well as capital gains, is never earned income. I have estimated your RRSP deduction limit for 2021 as follows:

	Adam	Elizabeth
RRSP deduction limit for 2020	\$ 15,780	\$ 11,425
Contributions deducted for 2020	0	0
Estimated earned income:		
Director fees	\$ 10,000	\$ 10,000
Employment	48,000	0
	<u>\$ 58,000</u>	<u>\$ 10,000</u>
18% of earned income	<u>10,440</u>	<u>1,800</u>
RRSP deduction limit for 2021	<u>\$ 26,220</u>	<u>\$ 13,225</u>

You have enough cash now to immediately make your RRSP contributions, and I recommend maximizing these in the next couple of years when your income is higher — especially for Elizabeth, who will have significant income associated with the sale of ABC.

You can only contribute to RRSPs prior to December 31 of the year in which you turn 71, at which point you are required to convert RRSPs to RRIFs. It is not uncommon for RRSP holders to convert an RRSP into a RRIF before this time, as they get older and require funds. RRIFs are subject to annual minimum withdrawal amounts.

You could increase your RRSP room by increasing salaries to yourselves rather than paying yourselves dividends. However, a salary versus dividend analysis is beyond the scope of this report.

In addition, because rental income is considered earned income for RRSP purposes, if you choose to proceed with the rental property investment, it will help increase your earned income so you can contribute more to RRSPs. However, rental losses decrease earned income, so if the property is likely to incur losses, this will not be an effective strategy.

Tax Implications of the Investment Opportunities

Stocks

Half (50%) of realized capital gains on the increase in value of stock market investments are taxable and do not qualify for the LCGE. Half of realized losses are deductible against the current-year taxable capital gains, and any excess can be carried back up to three years or forward indefinitely as net capital losses.

Dividends have a lower effective tax rate because they are grossed-up and subject to a dividend tax credit.

GICs and bonds

The interest income from GICs and bonds is taxed at the marginal tax rate on the earlier of two dates: when received or the anniversary date.

Cryptocurrency

The increase in value of cryptocurrency will likely be taxed as income or capital gains, depending on the intention for the investment. This is an emerging area of taxation, which I will have to monitor. These gains would not qualify for the LCGE.

Rental property

There are two aspects to the rental property: rental income and capital appreciation. Rental income is taxed as incurred, and rental losses are deductible from other income. The property itself can be depreciated for tax purposes, using capital cost allowance (CCA). Losses cannot be created or increased using CCA.

When the property is sold, any CCA claimed will likely be recaptured and fully taxed on sale if the property increases in value.

Any sale of the property for more than its initial cost will also be treated as a capital gain and taxed at 50%, which is not eligible for the lifetime capital gains deduction.

Although Elizabeth's cousin is not related to Adam, for income tax purposes they may be considered non-arm's length. Because the cousin is offering you a special price on the property based on the nature of your relationship, this is especially likely to be the case. If it is determined that you are not transacting at arm's length, there is a risk that CRA will conclude that Elizabeth's cousin sold the property to you at less than its real fair value at the time. In that case, CRA will not provide a matching adjustment to your cost basis, which will lead to double taxation.

For Assessment Opportunity #6 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss some of the tax issues.

Competent – The candidate discusses several tax issues.

Competent with distinction – The candidate discusses most of the tax issues in depth.

Assessment Opportunity #7 (Breadth Opportunity)

The candidate discusses FenceCo's plan to enter the U.S. market from a strategic perspective.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Competencies

2.4.1 Analyzes key operational issues including the use of information assets and their alignment with strategy (Core – Level B)

CPA Map Enabling Competencies:

2.1.1 *Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work*

2.1.3 *Identifies the strategic impact of internal decisions and external influences on project plans and initiatives*

2.2.1 *Assists in identifying and monitoring risks within areas of work responsibility*

6.1.1 *Identifies and articulates issues within areas of work responsibility*

6.1.2 *Uses qualitative and quantitative techniques to clarify the nature of problems*

6.1.3 *Demonstrates skepticism, objectivity, due care and persistence when identifying issues*

6.2.1 *Maintains an objective and questioning mindset to avoid biased analyses*

6.2.4 *Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives*

6.3.1 *Uses evidence and judgment to recommend and justify solutions or conclusions*

6.3.3 *Applies decision criteria to choose among viable alternatives*

7.1.1 *Targets message content and tone to meet audience needs within areas of work responsibility*

7.1.2 *Communicates non-complex financial information logically, clearly, concisely*

Alignment between Strategy and Issues

Some general managers have suggested entering the U.S. market using the current business model. I have looked at the proposed suggestion to enter the U.S. market in terms of whether it aligns with your strategy.

I understand that your overall strategy for FenceCo is as follows:

- You want to grow the business as fast as possible in its existing markets and to double profits.
- You want to sell the business in two or three years at the highest possible price.
- You want to minimize risk.
- You do not want to make major capital investments.

Growing the Business in Its Existing Markets and Doubling Profits

The current forecasts for the U.S. expansion seem to suggest that the first two or three years will not be profitable. This goes against your objective of doubling FenceCo's profits in the next two or three years before selling. The U.S. market is also very different than your current markets, which goes against your objective to grow within the company's existing markets.

Risk

Furthermore, the U.S. market will likely be more litigious, which is another strategy misfit because it involves additional risk. FenceCo has no experience in the U.S., and the larger market may be more competitive, which is also a risk factor. The expansion would also add foreign exchange risk.

Capital Investments

Expanding to the U.S. through the current model means more capital investment in terms of trucks, driving equipment, small tools, and offices, as well as the new manufacturing facilities. Therefore, the payback would likely be slow and would go against your objective to grow without major capital investment.

Conclusion

Overall, I would not recommend a U.S. expansion as proposed. It is prone to problems and not very consistent with your stated strategy. That said, expanding to the U.S. using the new licensing model may be more feasible if FenceCo licenses its technology to American contractors and manufacturers and receives a royalty, without investing in a plant.

For Assessment Opportunity #7 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address the assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss the plan to enter the U.S. market with respect to the strategic objectives.

Competent – The candidate discusses the plan to enter the U.S. market with respect to the strategic objectives and makes a recommendation.

Competent with distinction – The candidate thoroughly discusses the plan to enter the U.S. market with respect to the strategic objectives and makes a recommendation.

**COMMON FINAL EXAMINATION
SEPTEMBER 15, 2021 – DAY 3**

Case #2

(Suggested time: 80 minutes)

HSE Inc. (HSE) is a small public company with a December 31 year end. In 2020, HSE's Board of Directors (board) decided to outsource the payroll function and selected PayPerfect (PP).

Since starting on January 1, 2021, PP underperformed significantly in its contractual obligations. Due to errors made by PP, some employees were paid too much, too little, or not at all, causing financial difficulties and considerable stress for many. As a result, approximately 5% of HSE's employees quit and some have sued HSE. The incident attracted a great deal of media attention and has caused HSE's stock price to fall to a five-year low.

On July 1, 2021, HSE terminated PP's contract and hired additional, temporary staff in Human Resources (HR) to administer the payroll function in-house until a replacement for PP was found.

On September 30, 2021, a mediation agreement was reached between HSE and PP, requiring PP to reimburse HSE for certain costs that resulted from non-compliance of the contract (Appendix I).

It is November 15, 2021. You, CPA, work in HSE's finance department. Your boss, Tessa Molito, tells you: "A junior employee has performed a preliminary calculation of the costs to be reimbursed (Appendix II). Please explain any required adjustments and revise the calculation. As you can see, we have incurred significant additional expenses. I worry that HSE will run into cash flow issues in the next few months. Please look at some short-term financing options and make a recommendation (Appendix III).

"The mediation agreement requires that audit procedures be performed on all the costs that are part of HSE's claim. Please provide a list of procedures the external auditor is likely to perform, indicating the documentation we should have available.

"Understandably, morale is low, so we would like to offer additional benefits to our employees, starting in January 2022 (Appendix IV). For each item, please determine the tax consequences, for both the employees and HSE.

"The board emailed some details of the process that was used to select PP, and would like our input on how to improve that process (Appendix V).

"Finally, management has provided me with their draft Management Discussion and Analysis (MD&A) section related to PP (Appendix VI). Please review both the MD&A section and the accounting treatment for the lawsuit, and let me know if you have any concerns."

**APPENDIX I
EXCERPTS FROM MEDIATION AGREEMENT**

PP will reimburse HSE for all costs incurred between July 1, 2021, and December 31, 2021 (when PP's replacement is expected to be found) that were directly related to PP not performing its contractual obligations. Such costs only qualify for reimbursement if they are paid by HSE by March 31, 2022. The following limitations apply:

Item	Limitation
Capital assets	Maximum of \$20,000
Additional wages and benefits	Benefits are limited to the package available to employees at the time of their hiring
Space requirements for extra staff	To the extent the space is needed and not already available in HSE's existing facilities

APPENDIX II
PRELIMINARY CALCULATION OF COSTS TO BE REIMBURSED BY PP

Item (July 1, 2021 to Dec. 31, 2021)	Claim Amount
Salaries for 10 additional HR staff @ \$50,000/year × 6/12 months	\$ 250,000
Benefits package for 10 additional HR staff	70,000
Additional benefits (Appendix IV)	40,000
10% of HR manager's salary (for oversight of new HR staff)	7,500
10 computers and software for HR staff	12,000
Leased space (Note 1)	18,000
Leasehold improvements for leased space	14,000
Hiring and training costs (Note 2)	100,000
Estimated lawsuit payout (Note 3)	720,000
Total	\$ 1,231,500

Notes:

1. HSE had 300 square feet of available space, whereas 1,200 square feet was needed for the additional HR staff. HSE found a 1,500 square-foot space for rent for \$3,000/month, starting July 1, and is now using that space for the 10 additional staff.
2. These costs are related to the 10 new HR employees and 60 other newly-hired staff in early July 2021, stemming from resignations in the first half of 2021.
3. On October 15, 2021, some employees filed a lawsuit against HSE for \$800,000. Our lawyers believe there is an 80% chance that HSE will have to pay out the full amount, and a 20% chance that HSE will only have to pay half. \$720,000 is calculated as $80\% \times \$800,000 + 20\% \times \$400,000$. The court date for the lawsuit is set for February 2022.

APPENDIX III FINANCING OPTIONS

HSE estimates that it needs about \$600,000 to meet its cash requirements for the next six months. The following options are being considered.

Option 1

Factoring Ltd. (Factoring) is willing to purchase \$750,000 of accounts receivable at 90% of the invoiced amount. The receivables purchased would normally be due in 180 days, which are standard terms in the industry. HSE's uncollectible amount from this category of receivables has historically been 4%. Customers would pay Factoring directly after the receivables are purchased. Factoring has expressed an interest in purchasing more accounts receivable from HSE in the future.

Option 2

Loans Mart Inc. (LMI) is willing to lend HSE \$600,000. Repayment terms are \$250,000 annually for the next three years, with no early repayment permitted. Because no collateral is necessary, LMI has an extensive application process. It requires HSE to provide information on all senior management personnel and board members, including personal net worth and annual salary. LMI also requires full access to HSE's internal financial records for the past five years. Once these actions are taken, if all is satisfactory, the loan will be approved.

Option 3

HSE could start an account on BusinessFund Corp. (BusinessFund), an e-commerce company that facilitates crowdfunding. HSE would post its financing requirements and its promised rate of return, and anyone with a BusinessFund account can decide how much of the total to lend to HSE. BusinessFund charges a fee of 1% of the total financing requirement.

APPENDIX IV
POTENTIAL ADDITIONAL BENEFITS

Management is considering:

- paying every employee a \$3,000 bonus, intended to be directed toward their RRSP or TFSA.
- providing free counselling for any employee needing help coping with the stress caused by the payroll issues.
- providing, at no cost to the employee, a choice of either a public transit pass, or a pass to fee-based downtown parking lots, depending on their preference.
- paying for membership to an elite social club; as many clients and potential clients are members, this would also benefit HSE.

APPENDIX V
EMAIL FROM CHAIR OF THE BOARD

To: Tessa Molito
Subject: Vendor selection process

At the September 2020 board meeting, we discussed and approved outsourcing the payroll function.

A member of the board drafted the request for proposals (RFP); as it was done very quickly, the member may not have consulted with anyone else. That RFP was submitted for approval by the board, through electronic voting, by the end of September. The majority approved the RFP and it was released on September 30. Some board members later commented that they had some concerns about the RFP but there was no opportunity for discussion or debate.

Four vendors, including PP, submitted proposals by the October 15 deadline, and other vendors contacted us requesting an extension. PP's proposal was the lowest price, but by very little.

PP drafted the service contract and submitted it to us on October 30. We only checked that the rate on the contract was the same as the proposal, approved it at the November 4 board meeting and had the CEO sign it within the week. It was only later we learned that other customers have had issues with PP in the past.

APPENDIX VI
DRAFT YEAR-END MANAGEMENT DISCUSSION AND ANALYSIS SECTION

Payroll Issues and Dispute with PP

At the beginning of 2021, HSE outsourced its payroll services to PP. PP has been non-compliant with its contractual obligations. As a result, HSE incurred a total of \$1,231,500 in additional expenses related to this issue. As per HSE's mediation agreement with PP, all costs incurred by HSE will be reimbursed by PP in 2022; as a result, there is no financial impact on HSE in current or future years. There has also been no impact on employee morale.

Certain employees have launched a class action lawsuit against HSE for the financial difficulties and stress encountered by them as a result of the payroll issues. As we believe this lawsuit is without merit, no amount has been accrued for this lawsuit.

MARKING GUIDE 3-2
HSE INC. (HSE)
ASSESSMENT OPPORTUNITIES

To: Tessa Molito
From: CPA
Subject: Your requests

Assessment Opportunity #1 (Breadth and Depth Opportunity)

The candidate recalculates the amount claimable under the mediation agreement.

The candidate demonstrates competence in Management Accounting.

CPA Map Competencies:

3.2.1 Develops or evaluates data and information inputs for operational plans, budgets, and forecasts (Core – Level A)

3.2.2 Prepares, analyzes, or evaluates operational plans, budgets, and forecasts (Core – Level A)

CPA Map Enabling Competencies:

1.3.1 Maintains a skeptical mindset when performing assigned work

1.3.2 Recognizes bias, uncertainty and ambiguity in the information and assumptions that underlie assigned work

1.3.3 Investigates as necessary to clarify tasks and results and escalates appropriately

1.4.1 Performs work carefully, thoroughly and competently in accordance with relevant technical and professional standards

1.5.2 Performs assigned work with an independent state of mind to minimize bias and undue influence

5.2.1 Uses existing knowledge in new or different ways

5.2.2 Uses brainstorming or other techniques to generate ideas

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

7.1.2 Communicates non-complex financial information logically, clearly, concisely

I have reviewed the junior's preliminary calculations and have made the following revisions:

	<u>Reimbursable</u>	<u>Non-reimbursable</u>	<u>Note</u>
10 additional HR staff	\$ 250,000		1
Benefits package for 10 additional HR staff	70,000		1
Additional perks to be provided		\$ 40,000	2
10% of HR manager's salary		7,500	3
10 computers and software for HR staff	12,000		4
Leased space	10,800	7,200	5
Leasehold improvements	8,000	6,000	6
Hiring and training costs	14,286	85,714	7
Lawsuit payout	?		8
	<hr/>	<hr/>	
Total	<u>\$ 365,086</u>	<u>\$ 146,414</u>	

Notes:

1. These costs are specifically permitted under the mediation agreement.
2. I omitted the cost of additional perks to be provided to employees to boost morale because the mediation agreement limits the claim to only those benefits in place at the time of hiring. The additional perks will be provided in 2022, and which perks to provide has not yet been decided. These costs are not eligible.
3. Although the HR manager's time is directly related to PP not performing its obligations, I have omitted the salary allocation of the HR manager since this is not additional wages. PP is unlikely to pay anything that is not incremental to HSE's existing costs.
4. As the new employees need computers and software, the computers and software relate directly to the hiring of the additional HR staff. These costs would be eligible.
5. The claim for the leased space is limited to the portion needed, in excess of what HSE had available. As HSE needed 1,200 square feet and had 300 square feet available, it only needed 900 additional square feet. HSE rented a 1,500 square foot space; therefore, \$1,800 ($\$3,000 \times 900/1,500$) is claimable each month.
6. The leasehold improvements are directly related to the leased space and would be considered a capital asset. However, in conjunction with the computers and software claims, the total amount is over the \$20,000 limit allowed by the mediation agreement. Therefore, only \$8,000 of the \$14,000 is reimbursable.

7. The hiring and training costs are related to both the 10 additional HR employees and to 60 other HSE employees. The staff resignations were potentially due to financial stress caused by the payroll issues but could also have been due to other reasons. The cost of hiring and training new staff to replace the resigned individuals could arguably be an indirect cost of the payroll issues and might not be claimable. We should confirm with the lawyers whether these costs qualify. The cost to hire and train the 10 new HR employees is, however, claimable. For now, I have only included the cost of hiring and training the 10 new HR employees, which is \$14,286 (10/70 employees × \$100,000).
8. The lawsuit payout amount is currently unknown. Since reimbursement is only for costs incurred up until December 31, 2021, and paid before March 31, 2022, and as the court date is in February 2022, it is unclear whether this qualifies for reimbursement. If it does not qualify under this mediation agreement, HSE could begin new legal proceedings in the new year to seek reimbursement from PP for these costs.

For Assessment Opportunity #1 (Management Accounting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to recalculate the amount claimable under the mediation agreement.

Competent – The candidate provides a recalculation of the amount claimable under the mediation agreement.

Competent with distinction – The candidate provides a thorough recalculation of the amount claimable under the mediation agreement.

Assessment Opportunity #2 (Breadth Opportunity)

The candidate analyzes the quantitative and qualitative considerations of various short-term financing options.

The candidate demonstrates competence in Finance.

CPA Map Competencies:

5.2.3 Evaluates sources of financing (Core – Level B)

CPA Map Enabling Competencies:

1.3.1 Maintains a skeptical mindset when performing assigned work

1.4.1 Performs work carefully, thoroughly and competently in accordance with relevant technical and professional standards

1.5.2 Performs assigned work with an independent state of mind to minimize bias and undue influence

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.2.2 Identifies patterns from data analysis

6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.2 Communicates non-complex financial information logically, clearly, concisely

HSE is considering several short-term financing options. Both quantitative and qualitative factors need to be considered.

Quantitative Analysis

Quantitatively, the best way to compare these options is to determine their effective interest rates:

- Option 1 (Factoring): As HSE has historically had 4% of uncollectible debt from this category, it would have been able to collect 96% of the receivables it will sell to Factoring, which amounts to \$720,000. Instead, it will receive 90% of the balance, or \$675,000. Therefore, the annual implied rate of return is 13.78% (given $N = 0.5$, $PV = \$675,000$, $FV = \$720,000$).
- Option 2 (LMI): The implied interest rate of the loan is 12.04% (given $N = 3$, $PMT = \$250,000$, $PV = \$600,000$).
- Option 3 (BusinessFund): HSE could set the interest rate at whatever amount it would like. An additional \$6,000 (1% of \$600,000) would have to be factored into the cost related to BusinessFund's fee.

From a strictly quantitative perspective, Option 3 is best as HSE can set a rate that is lower than the other two options. However, we should also consider the qualitative factors.

Qualitative Analysis

Option 1 (Factoring) provides the most flexibility in terms of the amount required, as HSE can sell additional accounts receivable if necessary, given Factoring's interest in future amounts. This is helpful if HSE's original estimate is incorrect and more cash is needed in the short term. Also, because Factoring would process the purchased accounts receivable, the accounting department may have more capacity than was originally expected and could, perhaps, help out with some of the additional payroll-related work. However, a disadvantage is that HSE currently projects that it needs only \$600,000 of funds, and the initial amount Factoring proposes to purchase will yield \$675,000, which means that HSE will be financing more than it needs and, thus, paying more interest than necessary. There is also a risk that HSE's reputation and relationship with its customers may be affected if the collection company uses methods that inconsistent with HSE's.

Option 2 (LMI) is a typical, traditional loan. Its main advantage is that there is no collateral. The main disadvantage is that there are no early payment options. HSE requires funds for only about six months but will need to pay interest on the amount for three years, which will cost much more than if it borrows on a six-month term only. The application process also appears to be quite onerous and invasive; it is unreasonable to ask for the net worth of all senior management and board members, especially since they are not personally guaranteeing the loan. The need to provide five years' worth of financial records is also unreasonable.

Option 3 (BusinessFund) has the most flexibility in terms of interest rate; however, it is unlikely that HSE can offer an interest rate significantly below those of the other options, since LMI has likely considered HSE's risk profile before offering its interest rate. If HSE offers a rate that is significantly lower than what is reasonable for its risk profile, it risks not getting enough lenders to acquire the \$600,000 needed. Even if HSE offers a fair interest rate, the possibility that the full \$600,000 may not be funded is a significant risk. Also, shareholders and customers might perceive that HSE has no other financing options and is in financial distress. As the fee is based on the full funding requirement and not on what is actually loaned to HSE, the fee could end up representing a significant portion of the loan amount. For example, if HSE received only \$200,000 in loans, the fee would effectively become 3% of the loaned amount.

Recommendation

I recommend that HSE sell its accounts receivable to Factoring. It offers significant flexibility in terms of the amount financed, and the interest rate is only slightly higher than that of the traditional loan, which is largely offset by HSE not needing to pay interest for an extra two and one-half years. LMI's application process is far too onerous, and there are too many risks involved with BusinessFund to make it a viable alternative.

For Assessment Opportunity #2 (Finance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate provides a quantitative or qualitative analysis of the financing options.

Competent – The candidate provides a quantitative and qualitative analysis of the financing options and makes a recommendation consistent with their analysis.

Competent with distinction – The candidate provides a thorough quantitative and qualitative analysis of the financing options and makes a recommendation consistent with their analysis.

Assessment Opportunity #3 (Breadth Opportunity)

The candidate proposes procedures the external auditor is likely to perform for the costs claimed.

The candidate demonstrates competence in Assurance.

CPA Map Competencies:

4.3.6 Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement (Core – Level B)

CPA Map Enabling Competencies:

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.2.1 Uses existing knowledge in new or different ways

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

To substantiate the reimbursement claim that HSE will file, the external auditors will likely perform the following procedures.

They will read a full copy of the mediation agreement to ensure they understand all the conditions within and to determine which costs are eligible and ineligible. To ensure proper understanding, the auditors may need to engage an expert, such as a lawyer, to review the agreement.

They will want to obtain evidence of the 10 additional HR staff being hired by reviewing documents such as employment contracts, job postings, offer letters, and tax forms and noting the start dates and salaries. They may review the board minutes or minutes of a management meeting for approval to hire additional staff to address the payroll issues. They may review these individuals' job descriptions to ascertain that their job is to process payroll, if such information is not available in the employment contract or offer letter.

They will want to obtain evidence of the amounts the 10 additional HR staff were being paid from their date of hire until December 31, 2021. They may review payroll records, cancelled pay cheques, or direct deposit notices. They may also request to see the employees' T4s. Since the additional staff are all salaried employees, the auditors may perform an overall analytic based on the annual salaries in the employment contracts or payroll system, pro-rated for six months.

To verify the benefit amounts being claimed, they may request to see a list of benefits offered to employees on their date of hire (these may be included in the employment contract) and compare this to the list submitted for reimbursement, to ensure that nothing additional is being claimed. They would verify the amounts on the list of benefits paid for the additional staff, tracing rates back to agreements or invoices for benefits (such as group health and dental plans, life insurance plans, disability plans, or other benefits) and ensuring that only the benefits paid by the employer for the six-month period for those staff are included in the schedule (not benefits funded by employee deductions). They will also recalculate the value of employer CPP and EI in relation to the gross salary amounts for the additional employees for the six-month period.

They will ask to see the invoices for the computers and software and will review them for the purchase dates, amounts, and employee(s) for which they were purchased.

They will ask to see a copy of the lease to note the dates, monthly amount, and amount of space. They may want to physically view the space to confirm that the new employees are indeed occupying it and to see how much of the new space is being occupied for this purpose (checking if 1,200 square feet was really needed). They will want to discuss with HSE management the amount of space that HSE had available (the 300 square feet) and perhaps view that space and the rest of HSE to ensure the space was indeed 300 square feet and that no other space was available.

The auditors will ask for the invoice(s) for the leasehold improvements to note the date incurred and amount and to see if the invoice identifies the space being modified, to ensure that it is indeed the leased space. The auditors may want to physically see the improvements.

The auditors will request the invoices supporting the hiring costs (e.g., costs to advertise job postings, interview costs such as travel, and any fees paid to hiring agencies). For the costs associated with the training course(s), they will want to see the course attendee lists to ensure the additional HR staff attended. They may want to substantiate the other 60 new hires (e.g., check the date of hire in the payroll system) and recalculate the amount that pertains to the 10 HR employees (i.e., costs \times 10/70). We do not know if the training was provided internally or externally. External costs would be easy to verify: course registration fees would be supported by an invoice or registration application form and the cancelled cheque, or if a consultant was hired to teach the course or it was held at an external venue, costs such as consultant fees, training room, meals, and travel could be verified to invoices. Internal costs would be harder to substantiate as being incremental in nature. For example, if the course was taught by existing employees in the office, there may be no incremental costs.

In the unlikely situation that the lawsuit is settled in February and paid out by March 31, 2022, and thus included in the reimbursement claim, the auditors will want to see all correspondence with lawyers and the court. They will also examine the board minutes discussing the resolution of the lawsuit and the transfer of funds to the former employees. Regardless of whether the lawsuit is settled, a legal letter should be sent to the lawyers to confirm the status, lawsuit amount, and likelihood of settlement, if not already settled.

For Assessment Opportunity #3 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some procedures the external auditor is likely to perform.

Competent – The candidate discusses several procedures the external auditor is likely to perform.

Competent with distinction – The candidate discusses many procedures the external auditor is likely to perform.

Assessment Opportunity #4 (Breadth Opportunity)

The candidate discusses the tax consequences of the potential perks.

The candidate demonstrates competence in Taxation.

CPA Map Competencies:

6.2.2 – Advises on taxes payable for a corporation (Core – Level B)

6.3.2 – Evaluates income taxes payable for an individual (Core – Level B)

6.3.3 – Analyzes specific tax-planning opportunities for individuals (Core – Level B)

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

RRSP/TFSA Bonus

This benefit would be deductible to HSE in the year accrued as long as it is paid within 180 days of the end of the taxation year (that is, it would be a 2021 deduction if announced before December 31, 2021, and paid before June 30, 2022). The bonus payments would be deductible to HSE as a cost of doing business (compensation-related).

The bonus payments would be taxable to the employees as employment income in the year received. If an employee has deduction room in their RRSP and chooses to contribute the \$3,000 to their RRSP, the employee will receive an equivalent tax deduction, meaning they essentially will not be taxed immediately on the receipt of the \$3,000. The employee will also enjoy tax-deferred compounding of the investment income earned on the \$3,000 while it remains in the RRSP. The employee will only be taxed on the \$3,000 and the investment income earned when they withdraw it from the plan, at which time it will be taxed as other income.

Paying the bonus in 2022 to the employees may also be useful for timing purposes. If HSE pays it in 2021, employees may have already maximized their RRSP contributions for the year. However, if HSE pays it within the first 60 days of 2022, and if they have not yet maximized their 2021 contributions, it can be put towards that. If they have already reached their 2021 contribution limit, a contribution in early 2022 can be put towards their 2022 deduction without incurring the penalty for having contributed more than \$2,000 over the limit.

If the employee instead chooses to contribute it to their TFSA, they will not receive a tax deduction in the year received, so they will have to pay tax on the \$3,000. That said, the investment income earned on the contribution to the TFSA will enjoy tax-free compounding while it remains in the plan, and the employee can withdraw it from the plan tax-free (i.e., the investment income earned in the TFSA will never be taxed).

Whether an RRSP or TFSA contribution is preferable depends on an individual employee's income level and tax rate. Should HSE choose to pay this bonus, it could provide some basic tax planning advice to employees, to help guide them in their decision.

Counselling

The counselling services provided for stress caused by the payroll issues would not be a taxable benefit to the employees, as these are specifically exempted through ITA 6(1)(a)(iv) (counselling services for physical or mental health).

The counselling services would be deductible to HSE as a cost of doing business (compensation-related).

Parking Permits

Employer-paid parking permits are normally a taxable benefit to employees at their fair market value (CRA Administrative Policy – Guide T4130).

The only exceptions are as follows:

- An employee has a disability.
 - This may apply to some of HSE's employees, but presumably not all.
- The parking is provided to the employee for business purposes, and the employee has to regularly use their own automobile for their duties.
 - I am unsure whether this applies to any HSE employees, but as the choice is between a parking permit and a public transit pass, whichever the employee prefers, it appears that automobiles are not needed in the course of their duties. This exception would, therefore, also not apply.
- The business operates from a shopping centre or industrial park where parking is available to both employees and other people.
 - This is not the case. You mention that your office buildings are downtown and the parking permit would be provided for a paid lot.
- The employer provides scramble parking (significantly fewer spots than employees who want parking).
 - Again, there is no evidence that this is the case. If an employee has a paid permit to a downtown lot, they are presumably guaranteed a space.

As a result, this would be a taxable benefit to employees.

It would be deductible as a business expense to HSE as a cost of doing business (compensation-related).

Public Transit Pass

Employer-paid transit passes are a taxable benefit to the employee at their fair market value, unless they are employees of a transit company, in which case, special rules apply (CRA Administrative Policy – Guide T4130). I do not know if HSE is a transit company; if it is, the transit company rules will apply.

It would be deductible as a business expense to HSE as a cost of doing business (compensation-related).

Membership to Elite Social Club

Whether membership to the elite social club is a taxable benefit to the employee will depend on whether it can be clearly demonstrated that HSE is the primary beneficiary of the membership. If the networking with clients and potential clients is significant, this may be possible. If so, the membership is not a taxable benefit. If this cannot be demonstrated, the fair value of the membership would be taxable to the employee. This will likely be determined on an employee-by-employee basis. For example, employees who work in maintenance are not likely to engage in networking with clients at the club, but corporate sales staff might.

As specifically prohibited by ITA 18(1)(l), club dues are not deductible to an employer, regardless of whether the employer is the primary beneficiary.

For Assessment Opportunity #4 (Taxation), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses the tax consequences of some of the perks.

Competent – The candidate discusses the tax consequences of several of the perks.

Competent with distinction – The candidate discusses the tax consequences of most of the perks.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate recommends improvements to the board for its RFP process.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Competencies:

2.1.1 – Evaluates the entity's governance structure (policies, processes, codes) (Core – Level B)

2.5.1 – Designs an effective risk management program and evaluates its impact on shareholder value (Core – Level B)

CPA Map Enabling Competencies:

2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of the problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

RFP Drafting

Weakness: The RFP was drafted by a board member without consultation with others and was then submitted to the board for approval.

Implication: There are two issues with this. First, it is unusual for a board member to draft the terms of the RFP, given that HSE is a public company and the board should be there to provide oversight. When board members perform operational tasks, this results in a) them potentially reviewing and approving their own work; and b) taking away time that could be spent by board members on oversight functions. Second, HSE's needs from the payroll provider did not appear to have been discussed with anyone before the RFP was drafted. HSE may have had specific needs that might not have been reflected in the RFP.

Recommendation: Employees from HSE, such as the HR manager, or a consultant hired by HSE should draft RFPs. To ensure that all needs have been captured in the RFP, the responsible individual should ensure that adequate consultation has been performed with stakeholders.

Electronic Voting

Weakness: The draft RFP was approved by a majority electronic vote.

Implication: Electronic voting is an effective mechanism for less important motions or motions for which discussion has already occurred and a decision is required between board meetings. However, it does not allow for appropriate discussion to take place or for concerns to be raised by board members. A vote during an in-person meeting or by videoconference would have allowed for a discussion period, where concerns and/or improvements could have been addressed. It is possible that certain board members may have raised the issue that stakeholders had not been consulted or that the period for submission was too short (see next issue).

Recommendation: A policy should be established regarding what types of motions can be voted on electronically and which motions need to be voted on in a live forum where discussion can occur. This could be based on the nature of the motion (e.g., significant departmental change) and/or on a dollar figure (e.g., \$50,000 or less). If important decisions need to be made quickly, the board could use videoconference meetings as an alternative.

Submission Deadline

Weakness: The deadline for submission of proposals was two weeks after the RFP was released.

Implication: Vendors need enough time to a) see the post; b) discuss among themselves whether, and how much, to bid; and c) develop a submission document. Additional vendors wished to bid but did not have enough time and asked for an extension; this indicates that the window of opportunity was too short. As a result, better vendors may have been eliminated from the process.

Recommendation: Deadlines for submission must provide sufficient time for vendors to respond effectively. A four- to six-week window would be more appropriate.

Decision Criteria

Weakness: It appears only one criterion, price, was used to select the vendor, since it seems PP was selected because their proposal had the lowest price. There also appears to have been no research done on the vendors before a selection was made.

Implication: The RFP process used would not effectively determine whether PP was the best vendor for the job. As evidenced by the problems experienced with PP, the cheapest bid does not usually equal the best quality. The decision criterion used likely led to HSE choosing the wrong vendor for the project. In addition, if HSE does not perform research on the vendors, it could hire companies with undisclosed issues, such as other customers having had problems with PP in the past.

Recommendation: A review of each vendor's proposal should be undertaken to first eliminate any vendors who do not meet the pre-determined minimum requirements (the "must-haves"). Remaining vendors should then be assessed based on pre-determined key decision criteria (the "nice-to-haves," price, etc.). HSE could determine which elements are most important, and those could be weighted more heavily in the analysis. It should perform a background and reference check on the selected vendor before a contract is issued or signed.

Service Contract Review

Weakness: The service contract was only checked to ensure that the rate on the contract was the same as on the proposal, and was then approved by the board and signed by the CEO in a very short time period.

Implication: The contract is the legal document that specifies exactly what the vendor must provide, as well as the price. This commits the company to the work, and the fact that it was not read in detail could have been the cause of some of the payroll issues.

Recommendation: All service contracts need to be read in detail, preferably by a lawyer, before being approved and signed. This is done to verify the information included in it and to identify any missing information, such as clear penalties or a reimbursement policy in the event that contractual obligations are not met.

For Assessment Opportunity #5 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate discusses some of the RFP process weaknesses.

Competent – The candidate discusses some of the RFP process weaknesses and suggests ways to improve the RFP process.

Competent with distinction – The candidate discusses several of the RFP process weaknesses and suggests ways to improve the RFP process.

Assessment Opportunity #6 (Depth and Breadth Opportunity)

The candidate discusses the accounting treatment for the lawsuit provision and the potential reimbursement from PP, and the MD&A disclosure related to the dispute with PP.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 – Evaluates treatment for routine transactions (Core – Level A)

1.4.3 – Analyzes and provides input in the preparation of management communications (e.g., management discussion and analysis (MD&A)) (Core – Level B)

1.4.4 – Interprets financial reporting results for stakeholders (external or internal) (Core – Level A)

CPA Map Enabling Competencies:

6.1.3 *Demonstrates skepticism, objectivity, due care and persistence when identifying issues*

6.2.1 *Maintains an objective and questioning mindset to avoid biased analyses*

6.2.4 *Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives*

6.3.1 *Uses evidence and judgment to recommend and justify solutions or conclusions*

6.3.3 *Applies decision criteria to choose among viable alternatives*

7.1.1 *Targets message content and tone to meet audience needs within areas of work responsibility*

7.1.2 *Communicates non-complex financial information logically, clearly, concisely*

Lawsuit Provision

The MD&A disclosure notes that no amount has been accrued for the employee lawsuit. A lawsuit payout meets the definition of a provision under IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*:

14 *A provision shall be recognised when:*

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

Met: The past event is the incorrect payroll amounts that caused the financial hardships for these employees. They occurred in the first half of 2021.

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

Met: Per IAS 37.23, “an outflow of resources or other event is regarded as probable if the event is more likely than not to occur; i.e., the probability that the event will occur is greater than the probability that it will not.” This can be interpreted to be at least 50%. The lawyer has indicated that there is an 80% probability of having to pay out \$800,000 and a 20% probability of having to pay out \$400,000. Therefore, there is more than a 50% chance that an amount will have to be paid.

(c) a reliable estimate can be made of the amount of the obligation.

Met: Per IAS 37.40:

*Where a **single obligation is being measured**, the **individual most likely outcome may be the best estimate of the liability**. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.*

Even though the possible range of payout is between \$400,000 and \$800,000, and HSE may want to accrue only the most conservative amount, the lawsuit is a single obligation, and its most likely outcome (80% chance) is a payout of \$800,000. This amount should be accrued.

HSE will likely be pursuing PP for any lawsuit payout. Per IAS 37:

53 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

54 In the statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

It is not known whether PP will reimburse HSE for the lawsuit or how much the amount will be (since the lawsuit has not yet been settled). As discussed previously, if the mediation agreement does not cover the lawsuit, HSE may be able to initiate its own lawsuit against PP. However, the outcomes of these events are not yet known. Therefore, the potential reimbursement for the lawsuit would not be considered “virtually certain,” and no amount should be recorded for this until further information is obtained.

MD&A Disclosure

It is management’s decision as to what to discuss in an MD&A; however, the information included in it should be complete, fair, and not misleading, which is not always the case.

First, only a total amount of expenses is disclosed in HSE’s MD&A, but a variety of expenses are included in the amount. The breakdown of the expenses is valuable information and likely material for the decisions-makers. For example, the decision-makers would be interested to know that there is an amount included for a lawsuit reimbursement and that capital expenditures were included. In addition, this amount will have to be revised since it currently overstates the reimbursement that may be obtained from PP (see above).

The disclosure notes that all costs incurred by HSE will be reimbursed by PP. This is misleading since the mediation agreement contains certain restrictions (e.g., reimbursement limits, benefits can only relate to ones in place at the time of hiring, etc.), which should be disclosed in the MD&A.

It is also misleading to note that there is no financial impact for HSE for the current or future years. Aside from the fact that not all costs incurred will be reimbursed (causing a financial impact in the current year), the fact that the payroll issues have garnered significant media attention and have caused HSE's stock price to fall to a five-year low will clearly have a significant financial impact for HSE. This should be disclosed.

The MD&A notes that there has been no impact on employee morale. This is misleading as HSE is considering offering benefits to employees to address employee morale. In addition, this is internally inconsistent with the disclosure, because the MD&A also notes that employees have launched a class action lawsuit. This sentence should be removed.

Finally, while the disclosure mentions the outstanding lawsuit from employees, there are two issues. One is that the rationale to justify not accruing the amount is misleading. Given the financial difficulties and considerable stress that the payroll issues caused for many of the employees, the lawsuit likely has some merit. In addition, the MD&A does not provide any detail regarding the potential amount to be paid and the likelihood of payment. Again, in order to provide users with complete information, these items should be disclosed.

For Assessment Opportunity #6 (Financial Reporting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts a discussion of the financial reporting issues.

Competent – The candidate provides a discussion of the financial reporting issues.

Competent with distinction – The candidate provides a thorough discussion of the financial reporting issues.

**COMMON FINAL EXAMINATION
SEPTEMBER 15, 2021 – DAY 3**

Case #3

(Suggested time: 70 minutes)

Amped Transit Ltd. (Amped) is a private company in Vancouver, British Columbia, with three silent shareholders. It operates a dockless, electric-kick scooter and e-bike sharing service (Appendix I).

It is January 20, 2022. You, CPA, a consultant hired by Amped, recently met with its CFO, Leo Chevalier.

Leo begins: “I am concerned that we have been accounting for our property, plant and equipment (PP&E) incorrectly. The scooters have required a lot of maintenance, and many have gone missing. In addition to discussing the financial reporting considerations, I would like suggestions for ways to improve the controls in our PP&E processes (Appendix II).

“Also, we recently conducted a pilot project where we placed some of our bikes in a resort town (Appendix III). Given the results, should we move more bikes to resort locations or keep them in the current, urban, locations?

“Please also design some performance measures that would allow our shareholders to monitor whether Amped’s operational results align with its strategic objectives.

“Finally, to help Amped obtain future financing, the shareholders are considering having an audit performed for the first time for the 2021 fiscal year. Please explain some of the factors that impact audit risk and any first-time audit considerations that an auditor would address.”

After your meeting, you noted some online user reviews (Appendix IV).

APPENDIX I BACKGROUND INFORMATION

Amped was incorporated on January 1, 2016. By investing heavily in PP&E, it has grown rapidly. To encourage continued growth, a management bonus plan has been in place since 2020. It is based on a percentage of the revenues from normal operations reported on Amped's IFRS financial statements.

Amped cares about environmental, social, and corporate governance factors. Its strategic objectives are to:

- provide an efficient and safe network of electric transportation across Canada
- reduce waste and energy usage
- maintain efficient and effective supply-chain management
- differentiate the company through innovation and unique product offerings
- grow and provide stable returns to shareholders

Since shared, dockless, scooters and bikes became popular in 2019, competition has increased. Some of the many new entrants are existing companies with brand recognition.

While Amped anticipated each scooter lasting three years, recently the scooters are being replaced every two years, partly due to the availability of newer technology, and partly due to theft and damage. The #scooterfail trend of riders posting videos of scooter stunts on social media has resulted in considerable damage to scooters. Last year, several destroyed GPS devices were found in a park, without the scooters. There are also several scooters on Amped's records that have been thrown into rivers and are therefore irretrievable.

Amped's bikes do not have the same issues; their wheels have an additional locking mechanism that renders them immobile if the software is not activated.

Batteries make up a significant portion of the cost of the bikes, and battery performance is a key success factor. The drivetrain (motor, chain, and gear mechanism) is also a significant component of the cost of the bikes; keeping it maintained is essential to ensuring user safety.

APPENDIX II PROPERTY, PLANT AND EQUIPMENT PROCESSES

Purchasing

Amped operates in several major Canadian cities. Each city has an office location responsible for managing its own purchases. Amped's head office suggests technical specifications and leaves the choice of suppliers and placement of orders to the location office. Many locations use the same suppliers, but this is not mandated. During 2021, the Toronto location began ordering scooters from the U.S. and experienced some foreign exchange losses due to fluctuations in the exchange rate.

Receiving

The location office accountant emails the number of units (bikes and scooters) ordered to head office, and records the purchase cost as a debit to PP&E and a credit to accounts payable when the units are received at the warehouse. The locations use Excel spreadsheets instead of the PP&E tracking module in the general ledger system.

All units are shipped by the suppliers to the Vancouver warehouse, where a GPS device is installed and the units are added to the mobile application. The units received are not checked against the units ordered or inspected. The Vancouver warehouse ships the units to the location office noted by the supplier. The location office receives the units, activates them in the app and puts them into service. Last year, a shipment meant for the Calgary location was sent to the Toronto location in error. It took one month before the shipment was found and redistributed to Calgary.

Payment

Head office processes all supplier payments based on the payable balance in the general ledger. Supplier invoices remain at the location office so that suppliers can be contacted for questions or warranty issues.

Year-end procedures

Each location calculates and records depreciation expense for the units annually. Under Amped's policies, scooters and bikes are depreciated on a straight-line basis over three and six years, respectively. The PP&E subledger includes all scooter, bike, and GPS device purchases since inception of the company.

APPENDIX III RESORT TOWN OPERATIONS

Pilot Project

The Victoria, British Columbia, location, an urban area, suggested that Amped might make more profit on its bikes if some were moved to resort towns. From February 1 to July 31, 2021, Amped relocated 100 bikes from Victoria to the resort town of Fernie, British Columbia. As the bikes are all usable in winter weather, they were consistently used throughout this period. When used in Victoria, these bikes had an annual contribution margin of \$600,000.

While in Fernie, each bike averaged nine trips per operational day and earned average revenue of \$2.50 per trip. Each bike operated 90% of the available days; the rest of the time, they were being serviced. A maintenance worker can maintain a maximum of 100 bikes per year. In Fernie, Amped was able to pay their maintenance worker \$45,000 annually whereas a similar worker in urban areas is paid \$75,000. Over the course of the trial, replacement parts in Fernie averaged \$50 per bike.

Additional Information

While bike frames last an average of six years, batteries need to be replaced every three years. To maintain safe operation of the bikes, the drivetrain is replaced every 5,000 kilometres. The distance is measured by the bike's internal software.

Bikes are periodically redistributed to better locations in town by part-time staff, who are paid hourly. Annual redistribution costs are \$200 per bike.

Head office allocates \$30,000 of shared services costs, such as IT support, accounting, and marketing, to each location.

**APPENDIX IV
USER REVIEWS**

Marie A. – Ottawa

“Great idea, but my scooter’s battery was dead!”

Neal J. – Fernie

“I love the e-bikes! We need them in other resort towns like Whistler and Banff!”

Amanda M. – Fernie

“I want to use this service, but it’s so popular that I can never get a bike when I need one.”

Ines Z. – Montreal

“My scooter broke mid-ride, but at least the app let me report the incident so it can be fixed.”

Tina Q. – Calgary

“Where are all the scooters? They are never in the spot they are supposed to be. Love the bikes though.”

MARKING GUIDE 3-3
AMPED TRANSIT (AMPED)
ASSESSMENT OPPORTUNITIES

To: Leo Chevalier
From: CPA
Re: Amped Transit

Assessment Opportunity #1 (Breadth and Depth Opportunity)

The candidate assesses the accounting treatment for the property, plant and equipment (PP&E).

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

CPA Map Enabling Competencies:

6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

You are concerned with the accounting for PP&E. Amped uses IFRS, so these are the standards we will use.

Depreciation

There are two major issues with the depreciation being claimed on the scooters and bikes. Scooters and bikes are currently depreciated on a straight-line basis over three and six years, respectively.

Useful life of scooters

Scooters were expected to last three years, so the amortization period of three years was reasonable. Recently, however, the scooters are having to be replaced every two years. This is due to several reasons, including technological obsolescence, the #scooterfail trend, and abuse (which I will discuss later).

With respect to amortization periods, IAS 16 states:

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 *The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.*

The useful life of the scooters should be reviewed at year end. IAS 16.56 identifies that useful life should consider not only the asset's economic benefits but also the *expected* usage and *expected* physical wear and tear, as well as technological obsolescence. Based on current usage, it appears that useful life based on expected usage is now two years, not three years. Accordingly, this standard suggests that Amped will have to account for the change as a change in an accounting estimate following IAS 8.

With respect to changes in accounting estimates, IAS 8 specifies:

36 *The effect of a change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively by including it in profit or loss in:*

- (a) *the period of the change, if the change affects that period only; or*
- (b) *the period of the change and future periods, if the change affects both.*

37 *To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.*

38 *Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events and conditions from the date of the change in estimate. A change in an accounting estimate may affect only the current period's profit or loss, or the profit or loss of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's profit or loss and therefore is recognised in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised as income or expense in those future periods.*

Accordingly, the useful life of the scooters should be revised to two years, on a prospective basis. Additional depreciation will likely need to be deducted in the current period to reflect the new useful life, and this will be a current-year expense on the statement of profit and loss. IAS 8.39 requires this change in accounting estimate to be disclosed in the financial statements.

Componentization of bikes

IAS 16 requires significant parts of an item to be depreciated separately:

43 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.

The bikes appear to have three significant components: the frame, the battery, and the drivetrain. Currently, the entire bike is being depreciated over six years. However, we know that this is the useful life of the frame only. Batteries need to be replaced every three years, and the drivetrain needs to be replaced every 5,000 kilometres of use, which is measured using the bike's internal software.

Therefore, each component of the bike should be depreciated separately. The frames can continue to be depreciated over six years. Batteries should be depreciated over three years, as that is their known useful life.

With respect to the drivetrain, IAS 16 provides some guidance on depreciation methods:

60 The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

62 A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

Since we know that the drivetrain is replaced based on the number of kilometres it is used, it would be most appropriate to choose the units-of-production method to depreciate the drivetrain on a per-kilometre basis.

Since these two discrepancies (failure to componentize; use of the wrong useful life/depreciation method for the different components of the bikes) represent an error in applying IFRS rather than a change that occurred during the year, these should be accounted for as “errors” under IAS 8:

41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity’s financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).

42 Subject to paragraph 43, 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.

Therefore, a retrospective adjustment is required: the financial statements for prior periods should be restated to reflect the correct depreciation methods, and the details of the restatement should be disclosed. Where it is impractical to determine the effects of the error, paragraph 43 provides an exception, but these corrections only require a mathematical exercise.

Derecognition of Assets

It was stated that Amped has several scooters on its records that are known to have been thrown into rivers and cannot be retrieved. In addition, there appear to be other lost assets, such as the scooters with the destroyed GPS devices. The PP&E subledger includes all scooter and bike purchases since inception of the company, implying that these assets are all being carried on the books despite no longer existing.

IAS 16 provides guidance on derecognition of assets:

67 The carrying amount of an item of property, plant and equipment shall be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless IFRS 16 Leases requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

Therefore, after implementing the PP&E tracking module (discussed later), Amped should perform annual physical counts of its assets and reconcile these to the asset module, removing any that cannot be found and recording a loss for the remaining carrying amount of any assets that are lost.

For Assessment Opportunity #1 (Financial Reporting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss the accounting treatment for the property, plant and equipment.

Competent – The candidate discusses the accounting treatment of the property, plant and equipment.

Competent with distinction – The candidate thoroughly discusses the accounting treatment of the property, plant and equipment.

Assessment Opportunity #2 (Breadth Opportunity)

The candidate assesses the PP&E processes and provides recommendations.

The candidate demonstrates competence in Assurance.

CPA Map Competencies:

4.1.1 Assesses the entity's risk assessment processes (Core – Level A)

CPA Map Enabling Competencies:

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

2.2.2 Recognizes the importance of internal controls within areas of work responsibility

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.1.1 Identifies and articulates issues within areas of work responsibility

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

Reconciliation of Units Ordered to Units Received

Weakness: When units are received at the Vancouver warehouse, they are not checked to ensure that the number and type of units received matches the number and type of units ordered.

Implication: Amped might be sent an incorrect number or type of units, which would not be identified, and the locations may be operating with the wrong number or type of equipment.

Recommendation: Once the units are received, the quantity should be verified and agreed to the number ordered (e.g., via the email from the location office accountant). Any backorders should be tracked and followed up by head office and/or the relevant location office.

Reconciliation of Units Received to Units Recorded

Weakness: Entries to record purchases are based on the supplier invoices for bikes and scooters, which do not appear to be checked by the location office for accuracy of units received (i.e., the right model of bike, price, or quantity) by comparing them to the receiving records. Locations may not have access to receiving records, which would be at the Vancouver warehouse.

Implication: Entries to record purchases of PP&E and accounts payable in the general ledger system may be inaccurate.

Recommendation: Before recording the purchases in the general ledger system, the accountant in the location office should verify the accuracy of the supplier invoices to the orders to ensure that the right units were received and the right prices were charged. They should also verify the mathematical accuracy of the supplier invoices, including the taxes and shipping fees charged. They should document on the supplier invoices that they have checked all these things.

Reconciliation of Units Received to Units Invoiced

Weakness: Supplier invoices for bikes and scooters are not sent to head office, so they cannot be matched to receiving reports.

Implication: Head office cannot verify that bikes and scooters invoiced match the number and models of units received in the Vancouver warehouse.

Recommendation: Copies of supplier invoices should be sent to head office (after being checked by the location office accountant) so that head office can match units invoiced to units received.

Reconciliation of Units Invoiced to Units Paid

Weakness: Head office processes all supplier payments based on the payables balance in the general ledger without checking that the invoiced units and amounts are accurate.

Implication: Amped may pay for units that it has not received, it may pay for the wrong models received, or it may pay for units at prices that differ from what was ordered.

As head office never receives invoices or reconciles them to the physical goods received, it could be paying fictitious invoices.

Recommendation: Head office should only pay suppliers after receiving notice from the location office that the accountant has verified the accuracy of models and prices on the invoice, and after checking that the invoiced amounts relate to units that Amped has received at the Vancouver warehouse.

Review of Estimated Useful Life

Weakness: There appears to be no review of the estimated useful lives of assets on a regular basis.

Implication: As discussed earlier, amortization and PP&E values are inaccurate.

Recommendation: The useful lives of the assets should be analyzed regularly through review of the assets and industry information, and amortization rates adjusted accordingly.

Reconciliation of Excel with General Ledger

Weakness: The company uses Excel spreadsheets to track PP&E. It is not clear if the company is reconciling PP&E in Excel to PP&E in the general ledger.

Implication: Amped would not know if the costs recorded exist or are complete. Use of Excel is prone to errors, and it would be difficult to trace the source of errors if they occurred. This could result in an understatement or overstatement of PP&E.

Recommendation: Amped should use the PP&E tracking module in the general ledger system to track its PP&E. If the PP&E tracking module does not match the PP&E control account in the general ledger system, Amped should follow up on the discrepancy.

Lack of Componentization

Weakness: When recording PP&E in the general ledger system, the location office accountant is not recording the bike components (i.e., frame, battery, and drivetrain), which need to be depreciated differently.

Implication: Depreciation expense and the net book value of PP&E are not accurate.

Recommendation: Assuming that the PP&E tracking module in the general ledger system allows for the breakdown of PP&E into components, the location office accountant should record the components in the system and record depreciation properly for each component.

Head office, which also has access to the general ledger system and related modules, should check that depreciation is computed accurately for all locations.

Scooters Are Easy to Steal

Weakness: Scooters are stolen after the GPS devices are detached.

Implication: This increases costs due to the need to replace scooters and reduces revenue since there are fewer scooters available for rent (as indicated by the user reviews in the app).

Recommendation: To reduce the risk of theft and related financial costs of replacing the scooters, attach the GPS devices more securely or install an immobilizer on the scooter wheels, similar to those on the bikes.

Orders Are Not Centralized

Weakness: Each location orders its own bikes and scooters.

Implication: Some bikes and scooters might not meet specifications, resulting in safety concerns and potential losses to the company. In addition, the Toronto location incurred some foreign exchange losses this year that could have been avoided through appropriate hedging or vendor selection.

Recommendation: Amped should centralize the purchasing function. This will allow it to optimize purchasing decisions and ensure that the correct bikes and scooters are obtained.

This also streamlines the accounting processes, allowing for easier matching of orders, receiving reports, and invoices, thereby improving the accuracy of payables and payments to suppliers. In addition, it centralizes the recording of PP&E in the PP&E tracking module and presents an opportunity to reallocate units from other cities that may have lower demand.

Technical Specifications Not Followed

Weakness: Amped suggests technical specifications for unit orders, but no one checks to ensure the units ordered meet the specifications.

Implication: Inferior products could be purchased and deployed, which could create safety issues and lead to injured users and lawsuits.

Amped received feedback about scooters breaking down mid-ride and having dead batteries. Both of these issues could be caused by the purchase of inferior products. This may affect Amped's reputation and decrease revenue.

Recommendation: When the bikes are received at the head office warehouse, they should be inspected for compliance with specifications. Centralizing the purchasing function or using a list of pre-approved suppliers and products would also help reduce this risk.

Transit of Bikes between Locations

Weakness: Bikes are being sent from the Vancouver warehouse to incorrect locations.

Implication: Locations will not get the needed bikes on time, resulting in lost revenue. Shipping costs will also be increased due to Amped having to re-route the bikes from one location to another.

Recommendation: The warehouse should validate the details of the received goods to the initial email containing the order information. They should also confirm the city prior to sending the units to the location office.

For Assessment Opportunity #2 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss some of the weaknesses in the PP&E process.

Competent – The candidate discusses some of the weaknesses in the PP&E process.

Competent with distinction – The candidate discusses several of the weaknesses in the PP&E process and provides valid recommendations.

Assessment Opportunity #3 (Breadth and Depth Opportunity)

The candidate analyzes the profitability of the resort town proposal.

The candidate demonstrates competence in Management Accounting.

CPA Map Competencies:

3.5.2 Evaluates sustainable profit maximization and capacity management performance (Core – Level A)

CPA Map Enabling Competencies:

6.1.1 Identifies and articulates issues within areas of work responsibility

6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

6.3.2 Articulates limitations to recommendations

6.3.3 Applies decision criteria to choose among viable alternatives

7.1.2 Communicates non-complex financial information logically, clearly, concisely

Resort Town Proposal

First, we must calculate the contribution margin on the bikes in resort towns. Although the pilot was done over six months, it is reasonable to extrapolate to a yearly basis, since the bikes were used in both summer and winter months.

Annual revenue per bike

Average revenue per trip	\$2.50
Average number of trips	9 per operational day
Total revenue per bike per day	\$22.50 (9 × \$2.50)
Number of days operational	328.5 (365 × 90%)
Total annual revenue per bike	\$7,391.25 (328.5 × \$22.50)

Annual costs per bike

Capital costs are a sunk cost as the bikes already exist and would be relocated.

Replacement parts	\$100 (\$50 × 2 periods)
Redistribution costs	\$200
Total annual costs per bike	\$300

Fixed costs

Repairs and maintenance: A maintenance worker in the resort town is paid \$45,000 per year, whereas in the city they would be paid \$75,000, so there is an incremental savings of \$30,000 associated with the move.

Opportunity cost: The foregone revenue of operating the bikes in the city instead is \$600,000. Therefore, total fixed costs of a relocation would be \$570,000 per year (\$600,000 – \$30,000).

Head office allocation is not included since this is not a directly attributable cost. Taxes are not included since they do not affect the decision.

Annual contribution margin

$$(\$7,391.25 - \$300) \text{ per bike} = \$7,091.25 \times 100 \text{ bikes} = \$709,125$$

Since the net fixed costs are \$570,000, moving 100 bikes yields an annual increase in net profit of \$139,125.

This move would, therefore, be a good option for the company to pursue. We should also consider some qualitative factors in this analysis:

- Repairs and maintenance are step costs. If Amped were to, for example, move 150 bikes, there would be no savings in the city, and Amped would incur an extra \$45,000 in costs at the resort town.
- Feedback shows that individuals are requesting additional bikes and locations, which means there is an opportunity to expand both with the number of bikes and the number of locations. This could increase the overall profit.
- The bikes are a revenue source across multiple seasons, evidenced by usage in all six months of the pilot period. However, because the pilot project was only undertaken for six months, seasonality might be more of an issue than we realize. In addition, the novelty of a new service could have had an impact on the average number of rides.
- These assumptions were tested in only one location for a short period. Although there is interest in other resort locations, Amped may not achieve the same positive results.
- There may be an impact on Amped's mission and/or brand recognition. So far, the company has focused on urban areas, and the move to resort towns may affect the way the business is perceived (as a tourist attraction rather than an urban mobility solution).
- There is expansion risk associated with this change. Amped is experiencing numerous problems in its current operations, as evidenced by the controls discussed previously and several negative online user reviews, and these will only be magnified by expanding the number of locations served.
- It is possible that capital costs could differ between cities and resort towns. For example, the useful life of the drivetrain of the bikes is based on kilometres ridden on the bike, and trips in resort towns might be shorter or longer than trips in cities. To confirm the assumptions made, further details on the usage of bikes should be obtained.
- This analysis has been performed based on moving bikes from cities to resort towns. Since both options appear to be profitable, Amped could consider buying new bikes and placing them in resort towns rather than relocating profitable bikes from the city.

Based on the analysis above, I believe it is feasible to pursue this business opportunity.

For Assessment Opportunity #3 (Management Accounting), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to analyze the profitability of the resort town proposal.

Competent – The candidate analyzes the profitability of the resort town proposal.

Competent with distinction – The candidate analyzes the profitability of the resort town proposal in depth and provides a recommendation.

Assessment Opportunity #4 (Breadth Opportunity)

The candidate provides performance measures to monitor whether Amped's operational results align with its strategic objectives.

The candidate demonstrates competence in Strategy and Governance

CPA Map Competencies:

*2.3.1 Evaluates the entity's strategic objectives and related performance measures
(Core – Level B)*

CPA Map Enabling Competencies:

5.2.1 Uses existing knowledge in new or different ways

5.2.2 Uses brainstorming or other techniques to generate ideas

5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Efficient Transportation

An efficiency measure would be the amount of time a user takes to get from one location to another or the relative cost for a customer using Amped's product compared to other transportation options.

- Time: Amped can compare trip times on a scooter or bike versus regular walking, driving, or transit times for similar routes, to see how scooter or bike times compare.
- Cost: Amped can compare trip costs on a scooter or bike versus transit fares or average driving costs.
- Uptime: Amped can measure the availability of scooters and bikes for users who want to access them by measuring the number of hours each scooter/bike is available (that is, not being used by someone else and not broken) and determining an average. This could also be measured geographically (for example, by neighbourhood) to determine users' ability to access a scooter or bike when needed.

Safe Transportation

Amped can record the number of accidents reported to the company via the app and classify them as injury and non-injury. Amped can then track these values period over period or compare them to peers or other publicly available data.

Waste Reduction

Amped can measure current waste output (office waste, warehouse, and location waste) by tonne. Amped can then set new goals to reduce the amounts and can provide updates on its measures.

Similar metrics could be taken for “trashed” scooters, such as those damaged due to #scooterfail activities.

To ensure that it continues to make this a priority, Amped could also measure the number of waste reduction initiatives in the company.

Energy Usage Reduction

Amped can compute net energy usage, such as kWh of electricity, by locations and units for a period, such as one month. It can then set goals to reduce consumption and provide updates on its measures.

To ensure that it continues to make this a priority, Amped could also measure the number of energy-usage reduction initiatives in the company.

Efficient and Effective Supply-Chain Management

Amped can hire experts to complete a supply-chain audit, for which a pass/fail determination or “number of findings” can be used as a measure. Amped can then track progress on findings.

Amped could also measure total kilometres shipped from suppliers, which would also help measure energy efficiency.

Differentiation through Innovation

Amped can track ideas received internally on ways to innovate its products and processes, as well as ideas received externally through online user reviews. The overall number of ideas can be measured, as well as those that are put into production at the company.

Differentiation through Unique Product Offerings

Amped can benchmark the number of product offerings against its competitors. It can then identify which products are industry standard and which ones, such as e-bikes, are unique.

Growth

Growth can be measured by

- the net number of bikes and scooters added in a period;
- change in revenue in a period; or
- the increase in number of rides, number of new users, length of rides, and number of locations.

Stable Returns to Shareholders

Returns can be measured using standard ratios such as return on investment, total dividends paid to shareholders, or increase in company value period over period.

For Assessment Opportunity #4 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to provide some performance measures to monitor Amped's performance.

Competent – The candidate provides some performance measures to monitor Amped's performance.

Competent with distinction – The candidate provides several performance measures to monitor Amped's performance.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate discusses the risk assessment and first-time audit considerations for the 2021 year-end audit.

The candidate demonstrates competence in Assurance.

CPA Map Competencies:

4.3.5 Assesses the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures (Core – Level B)

4.3.6 Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement (Core – Level B)

CPA Map Enabling Competencies:

2.2.1 Assists in identifying and monitoring risks within areas of work responsibility

5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

6.1.1 Identifies and articulates issues within areas of work responsibility

6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

7.1.1 Targets message content and tone to meet audience needs within areas of work responsibility

7.1.2 Communicates non-complex financial information logically, clearly, concisely

Risk Assessment

The following factors increase the risk of material misstatement at the financial statement level:

- This is the first time that Amped will have an audit performed. This increases the risk of material misstatement on the opening balances, as there has been no scrutiny of those figures.
- There is a management bonus based on a percentage of revenue. This increases the risk of material misstatement since management would be biased to choose accounting policies and/or record transactions in a way that increases revenue, perhaps by overriding controls.
- Amped is considering obtaining additional financing. This increases the risk of material misstatement since management may be biased to manipulate the financial results to make Amped's performance look better in order to obtain this additional financing. Management may also be motivated to overstate PP&E, which is Amped's main asset and could be pledged as security for the financing.
- Shareholders are not involved in the business (silent shareholders), so there is some risk of material misstatement since they may be over-relying on management.

In addition, there are some risks of material misstatement at the assertion level:

- Amped has had several new complex transactions in 2021, including a change in accounting estimate related to useful lives and depreciation of PP&E, a correction of error related to componentization of PP&E, derecognition of stolen scooters, and foreign currency purchases. This increases risk of material misstatement at the assertion level for PP&E, depreciation, retained earnings, accounts payable, and foreign exchange losses, as the accounting team may be unfamiliar with how to account for these more complex transactions.
- There have been control deficiencies noted in PP&E (see previously in this report). These control deficiencies fail to prevent or detect risks of material misstatement due to fraud or error in PP&E and accounts payable, such as paying for bikes and scooters that were not received or were improperly invoiced. There are actual instances of errors, as discussed.

Based on these factors, the risk of material misstatement at the financial statement level is high.

First-Time Audit Considerations

Opening balances

In addition to auditing the year-end balances, the auditors will need to perform work on the opening balances, because many of the income statement amounts depend on both opening and closing balances of the balance sheet accounts (such as PP&E). While some accounts would be easy to verify for opening balances (e.g., cash, where bank confirmations can be sent for the opening balance date), it may be difficult to audit other balances. For example, inventory is typically an account for which this would be difficult, due to the volume of transactions during the year and the lack of attendance at an inventory count at the beginning of the year. However, for Amped, inventory is likely not material, since it would only consist of office supplies and perhaps minor parts for bike and scooter maintenance. Another area that might be difficult to verify is PP&E, since it appears that the tracking of disposed assets is not accurate and the Excel spreadsheets for PP&E in each location are not reconciled to a physical count of bikes and scooters. Thus, auditors may have difficulty rolling back to the opening balance. It may also be difficult to verify opening accounts payable, given the weaknesses in the purchases system and the fact that supplier invoices are held in each location rather than at head office.

If the auditor is unable to obtain sufficient audit evidence for certain opening balances, this may lead to a modified audit opinion. This might take the form of a qualified opinion (if material but not pervasive) or a disclaimer of opinion (if material and pervasive).

Comparative figures

The auditors will have to discuss with Amped management whether they would like both the current year and the comparative year figures audited. Given that the audit is only in preparation for future financing, management may decide that an audit of comparative figures is not required, in which case the financial statements would note the comparative figures as “unaudited.” In addition, CAS 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements*, requires the auditor to include an “Other Matters” paragraph in the auditor’s report, stating that the comparative information was not audited. If Amped would like the comparative figures audited, additional audit work will be required, since the auditors would also have to audit the previous year’s figures. While there may not be much incremental work to audit the balance sheet (because the auditors have already had to audit the opening balances), extra work would be required to audit the income statement and statement of cash flows.

Understanding of the business/internal controls

The auditors will be required to gain an understanding of Amped as part of their audit, as well as an understanding of the design and implementation of controls relevant to the audit, particularly with respect to the financial statement preparation. If the auditors find internal controls that are functioning effectively, they may be able to reduce their substantive work in the audit. The auditors must document their understanding and, based on that understanding, identify risks of material misstatement due to fraud or error.

Identification and assessment of risks of material misstatement and response to those risks

The auditors will also have to perform other risk assessment procedures (e.g., preliminary analytical review) to identify and assess risks (as discussed above) and plan audit tests to respond to those risks. In addition, there are certain mandatory tests that auditors must perform to address the risk of management override of controls, such as journal entry testing and retrospective review of estimates.

Independence and client acceptance

The auditors will have to assess their independence. For example, because I have made operational and financial accounting recommendations, it would be inappropriate for me to perform the engagement. They will also have to perform client acceptance procedures, to ensure that they are able to perform the engagement.

For Assessment Opportunity #5 (Assurance), the candidate must be ranked in one of the following five categories:

Not addressed – The candidate does not address this assessment opportunity.

Nominal competence – The candidate does not meet the standards of reaching competence.

Reaching competence – The candidate attempts to discuss the audit risk or the first-year audit considerations.

Competent – The candidate discusses the audit risk and the first-year audit considerations.

Competent with distinction – The candidate provides a thorough discussion of the audit risk and the first-year audit considerations.

APPENDIX E

**RESULTS BY ASSESSMENT OPPORTUNITIES FOR DAY 2 AND DAY 3
(FOR ALL WRITERS)**

THE LEVEL 2 DEPTH TEST (DAY 2 and DAY 3)**Financial Reporting:**

		NA	NC	RC	C	CD	C+CD
Day 2 Common							
AO1	LOB investment	1%	11%	23%	61%	4%	65%
AO2	Franchise Revenue	2%	7%	21%	68%	2%	70%
AO3	Sale-leaseback	3%	11%	46%	38%	2%	40%
AO4	Non-monetary transaction	2%	6%	37%	54%	1%	55%
Day 3 – Q2 HSE							
AO6	Lawsuit provision and MD&A	2%	17%	48%	30%	3%	33%
Day 3 – Q3 Amped							
AO1	PP&E	5%	24%	38%	30%	3%	33%

Management Accounting:

		NA	NC	RC	C	CD	C+CD
Day 2 Common							
AO5	Break-even analysis	4%	8%	21%	62%	5%	67%
AO6	Operational Plan	7%	12%	26%	51%	4%	55%
Day 3 – Q1 FenceCo							
AO1	New licensing model-quant	1%	9%	24%	56%	10%	66%
AO2	New licensing model-qual	1%	18%	34%	43%	4%	47%
Day 3 – Q2 HSE							
AO1	Recalculate mediation agreement	2%	15%	38%	41%	4%	45%
Day 3 – Q3 Amped							
AO3	Resort town proposal	3%	9%	35%	45%	8%	53%

THE LEVEL 3 DEPTH TEST ROLES (DAY 2)

Audit and Assurance		Papers	NA	NC	RC	C	CD	C+CD
AO7	Risk	6125	1%	12%	20%	64%	3%	67%
AO8	Approach and materiality	6125	0%	11%	48%	39%	2%	41%
AO9	Procedures – acctg issues	6125	2%	35%	21%	39%	3%	42%
AO10	Procedures – payroll report	6125	2%	21%	24%	49%	4%	53%
AO11	Reporting options and procedures	6125	1%	36%	32%	28%	3%	31%
AO12	Controls self-checkout	6125	0%	14%	19%	62%	5%	67%
AO13	Franchise disclosure agreement	6125	4%	37%	21%	35%	3%	38%

Finance		Papers	NA	NC	RC	C	CD	C+CD
AO7	Financing proposals	429	1%	9%	24%	59%	7%	66%
AO8	New product line NPV	429	1%	3%	15%	62%	19%	81%
AO9	WACC	429	2%	6%	43%	40%	9%	49%
AO10	Equipment purchase FX hedge	429	3%	19%	31%	43%	4%	47%
AO11	Investments	429	4%	12%	45%	38%	1%	39%
AO12	Franchise financials	429	3%	20%	43%	31%	3%	34%
AO13	Logistics Proposal	429	10%	25%	35%	29%	1%	30%

THE LEVEL 3 DEPTH TEST ROLES (DAY 2)

Performance Management		Papers	NA	NC	RC	C	CD	C+CD
AO7	SWOT	1213	0%	3%	15%	75%	7%	82%
AO8	Vision and mission	1213	1%	8%	45%	44%	2%	46%
AO9	Fresh food delivery project	1213	0%	4%	36%	58%	2%	60%
AO10	Department analysis	1213	2%	7%	39%	50%	2%	52%
AO11	Managerial performance	1213	4%	16%	28%	50%	2%	52%
AO12	Proposed supplier contract	1213	6%	17%	45%	30%	2%	32%
AO13	Loyalty program	1213	5%	11%	50%	34%	0%	34%

Taxation		Papers	NA	NC	RC	C	CD	C+CD
AO7	CCA& other capital items	365	1%	15%	34%	32%	18%	50%
AO8	Taxable income-quant	365	1%	1%	29%	61%	8%	69%
AO9	Taxable income-qual	365	3%	9%	31%	46%	11%	57%
AO10	Taxes payable, RDTOH, CDA	365	2%	12%	32%	38%	16%	54%
AO11	Interest and penalties, compliance system	365	4%	21%	27%	45%	3%	48%
AO12	Shareholder/employee benefits	365	4%	7%	29%	47%	13%	60%
AO13	GST/HST return	365	7%	11%	21%	54%	7%	61%

THE LEVEL 4 BREADTH TEST (DAY 2 AND DAY 3, BY COMPETENCY AREA)

Financial Reporting:		NA	NC	RC	C	CD	RC+C+CD
Day 2 Common							
AO1	LOB investment	1%	11%	23%	61%	4%	88%
AO2	Franchise Revenue	2%	7%	21%	68%	2%	91%
AO3	Sale-leaseback	3%	11%	46%	38%	2%	86%
AO4	Non-monetary transaction	2%	6%	37%	54%	1%	92%
Day 3 – Q2 HSE							
AO6	Lawsuit provision and MD&A	2%	17%	48%	30%	3%	81%
Day 3 – Q3 Amped							
AO1	PP&E	5%	24%	38%	30%	3%	71%

Management Accounting:		NA	NC	RC	C	CD	RC+C+CD
Day 2 Common							
AO5	Break-even analysis	4%	8%	21%	62%	5%	88%
AO6	Operational Plan	7%	12%	26%	51%	4%	81%
Day 3 – Q1 FenceCo							
AO1	New licensing model-quant	1%	9%	24%	56%	10%	90%
AO2	New licensing model-qual	1%	18%	34%	43%	4%	81%
Day 3 – Q2 HSE							
AO1	Recalculate mediation agreement	2%	15%	38%	41%	4%	83%
Day 3 – Q3 Amped							
AO3	Resort town proposal	3%	9%	35%	45%	8%	88%

THE LEVEL 4 BREADTH TEST (DAY 2 AND DAY 3, BY COMPETENCY AREA)

Strategy and Governance		NA	NC	RC	C	CD	RC+C+CD
III-1 AO7	US expansion	1%	8%	28%	59%	4%	91%
III-2 AO5	RFP process	3%	11%	35%	47%	4%	86%
III-3 AO4	Performance measures	3%	23%	36%	33%	6%	75%

Audit and Assurance		NA	NC	RC	C	CD	RC+C+CD
III-2 AO3	Procedures - settlement	3%	6%	21%	62%	8%	91%
III-3 AO2	Controls - PP&E	1%	8%	27%	54%	10%	91%
III-3 AO5	Risk & first-time audit	1%	10%	40%	39%	9%	88%

Finance		NA	NC	RC	C	CD	RC+C+CD
III-1 AO3	Business valuation	0%	12%	24%	59%	5%	88%
III-1 AO5	Personal investment options (financial)	3%	15%	24%	44%	14%	82%
III-2 AO2	Short-term financing options	1%	16%	49%	30%	4%	83%

Taxation		NA	NC	RC	C	CD	RC+C+CD
III-1 AO4	Tax on sale of business	3%	33%	31%	23%	10%	64%
III-1 AO6	Personal investment options (tax)	5%	23%	42%	25%	5%	72%
III-2 AO4	Employee benefits	1%	9%	31%	50%	9%	90%

APPENDIX F

BOARD OF EXAMINERS' COMMENTS ON DAY 2 AND DAY 3 SIMULATIONS

BOARD OF EXAMINERS' COMMENTS ON DAY 2 SIMULATION**Paper/Simulation:** Day 2 (FFTY) – Role Case COMMON**Estimated time to complete:** 300 minutes**Simulation difficulty:** Easy to Average**Competency Map coverage:** Financial Reporting (4); and
Management Accounting (2).**Evaluators' comments by COMMON Assessment Opportunity (AO) for all roles****AO#1 (Investment in LOB) (Fin Rep)**

Candidates were asked to assess the accounting for the investment in LOB. Information on FFTY's investment and how it was previously recorded was provided in the excerpts from the management committee meeting in Appendix III (Common). To demonstrate competence, candidates were expected to discuss whether there was evidence of significant influence over LOB, recognize the accounting policy choice available under *ASPE 3051 – Investments*, and conclude on which option would best suit the needs of FFTY, based on the impact of choosing cost or equity.

Candidates performed well on this AO. The majority of candidates discussed the concept of significant influence in reasonable depth, typically including some case facts to support their analysis, most often FFTY's ownership percentage and its seat on LOB's board. Most candidates identified the accounting policy choices available to FFTY, and provided an accurate explanation of the impact of at least one of those choices. Candidates were more likely to discuss the equity option than the cost option in reasonable depth, explaining that the investment should be recorded at cost, while adding FFTY's share of the income of LOB and deducting the dividends received. Very few candidates identified the negotiated dividend percentage as a case fact to support their discussion of significant influence.

Strong candidates incorporated additional case facts into their significant influence discussion, such as the material intercompany transaction, and discussed the seat on the board in the broader context of the number of total board members. Strong candidates were also more likely to correctly discuss the impact of both the cost and equity options, and to link the choice of policy to FFTY's objective of maximizing net income, concluding that the equity option was the most appropriate as it would result in greater investment income in the current year.

Weak candidates used fewer case facts to support their analysis, often simply concluding that no significant influence was present because FFTY owned 18% of the shares. Weak candidates often confused the concept of significant influence with that of control, incorrectly concluding that consolidation was an acceptable policy choice. Other weak candidates struggled to understand the impact of the various options, incorrectly describing the entries to account for the initial investment, dividends, and subsequent income. Some weak candidates incorrectly suggested that the cost method was the only policy choice available to FFTY, or concluded that there would be a greater impact on FFTY's net income under the cost method due to the dividends, failing to identify the proportionate income inclusion under the equity method. Other weak candidates confused the two options, made unnecessary adjustments, such as intercompany entries for FFTY's purchase of bread from LOB, or simply concluded on one of the options without providing any justification for their recommended policy choice.

AO#2 (Revenue recognition) (Fin Rep)

Candidates were asked to assess the accounting for revenues from two new franchisees. Information on the two franchisees and their agreements was presented in Appendix IV (Common). To demonstrate competence, candidates were expected to use *Handbook* guidance in order to discuss the various franchise revenue streams and conclude appropriately. Very few candidates used *AcG-2 – Franchise fee revenue* to frame their analysis; instead, they applied the guidance found in *ASPE 3400 – Revenue*. Either guidance was acceptable, as it allowed candidates to appropriately discuss the performance, collectability, and measurement of the three revenue streams.

Of all the Common AOs, Candidates performed the strongest on this AO. The majority of candidates used *ASPE 3400* to discuss at least two of the three revenue streams in sufficient depth. Candidates typically focused their discussions on the performance aspect of the various streams, using case facts, such as the timing of the services performed for the initial fee, to support their discussion. Candidates typically discussed the initial fee and optional services fee, determining that the initial fees had been recorded correctly, and calculating an appropriate adjustment to make in order to defer a portion of the optional services fee. Candidates typically spent less time discussing the ongoing royalty fee, and often simply concluded that the revenues from this fee were appropriately recorded.

Strong candidates generally discussed all three revenue streams in depth, often using the three main concepts of *ASPE 3400*—collectability, measurement, and performance—to frame their discussions. Strong candidates typically used additional case facts to support their analysis, such as identifying the ongoing use of FFTY's brand name as the achievement of performance on the royalty fees, and provided an overall conclusion that linked their findings to FFTY's objective to maximize net income.

Weak candidates were less likely to discuss the revenue streams in depth, often forming an unsupported conclusion regarding the correct treatment of each stream. Other weak candidates focused their discussions on the collectability and measurement concepts of *ASPE 3400*, which led them to miss the key aspect of the analysis of whether performance had been achieved. For example, these candidates were more likely to conclude that the revenue should be recorded on the initial fees because the contract was non-refundable. Some weak candidates appeared confused by the difference between *ASPE 3400* and *IFRS 15*, and discussed the *IFRS 15* steps of identifying a contract, which did not provide any value in the context of the specific case facts presented in this simulation.

AO#3 (Sale and leaseback) (Fin Rep)

Candidates were asked to assess the accounting treatment for the sale and leaseback transaction. Information on the sale and leaseback of the land and building was provided in the excerpts from the management committee meeting in Appendix III (Common). To demonstrate competence, candidates were expected to discuss whether the lease should be classified as a capital or operating lease, and based on the type of lease arrangement, discuss the accounting adjustments relevant to the sale and leaseback transaction in reasonable depth.

Of all the Common AOs, candidates struggled the most on this AO. Information regarding the type of lease arrangement was relatively easy to identify and apply, and most candidates applied it appropriately, typically listing all three criteria under *ASPE 3065 – Leases*, and concluding appropriately. The majority of candidates were therefore able to discuss the type of lease arrangement, and determine whether it was a capital or operating lease, in sufficient depth. However, many candidates simply ended their discussion there, failing to recognize that further analysis was required in order to deal with the sale and leaseback aspect of the transaction. Those who took the discussion further generally struggled to demonstrate their understanding of lease accounting, often concluding that they did not have enough information to calculate the interest expense (even though several acceptable interest rates were presented in the case, or they could have provided an explanation of the required calculation). Many candidates did not discuss the treatment of the gain on the sale, despite the fact that it was a significant dollar amount. Very few candidates discussed whether the land and building should be separated when classifying the leased asset.

Strong candidates, after identifying the type of lease arrangement, discussed the subsequent accounting adjustments required. Their discussion typically focused on the reversal of the gain previously recognized, noting that it would need to be deferred and amortized over the term of the lease. Some strong candidates also discussed other aspects of lease accounting, such as the rent, interest expenses, and amortization of the lease. While these aspects of the lease were less significant than the gain, these discussions further demonstrated their understanding of lease accounting.

Weak candidates were more likely to conclude that the lease was an operating lease, despite the case facts clearly indicating that it was a capital lease. Some weak candidates simply copied and pasted the criteria from the *Handbook* without providing further analysis, while others stated that classifying the lease as either an operating or a capital lease was a policy choice, demonstrating a misapplication of paragraph 63 of the standard. Weak candidates who identified the need to discuss the gain and lease accounting often simply recalculated the gain but provided no further discussion of how to account for it. Many simply restated that the lease would need to be amortized over the life of the lease, but did not demonstrate how to apply this. Many candidates struggled with the concept of interest, and incorrectly concluded that it would need to be added to the lease obligation.

AO#4 (Non-monetary transaction) (Fin Rep)

Candidates were asked to assess the accounting treatment for the exchange with Design Webmasters Corp. Information on the transaction was provided in Appendix III (Common). Candidates were told that FFTY exchanged \$290,000 of prepared foods for an estimated \$310,000 of web design services, and that the transaction had been recorded at the value of the services received. To demonstrate competence, candidates were expected to use *ASPE 3831 – Non-monetary transactions*, to discuss whether the transaction had commercial substance and determine the appropriate value for recording the transaction.

Candidates performed relatively well on what is a more difficult accounting standard to interpret. The majority of candidates identified that *ASPE 3831* was the appropriate section of the *Handbook* with which to assess the transaction, and correctly concluded that the transaction should be recorded at the value of the goods given up. While candidates rarely described in detail how the configurations of cash flows would be impacted, most identified that the transaction would have an impact on FFTY's cash flows. Most candidates concluded that the transaction had commercial substance, and used at least one of the available case facts to support this conclusion. Most candidates determined an appropriate value with which to record the transaction.

Strong candidates used case facts to support their conclusions of commercial substance, typically by recognizing the impact the transaction would have on FFTY's cash flows. These candidates described how the configuration of the cash flows from FFTY's website would differ from those from selling freshly prepared foods, or noted how the timing of FFTY's cash flows would be impacted by the transaction. Strong candidates also recognized that the value of the goods given up would be more reliably measurable, since it is an internal measure, and identified the web design services as an estimate, thus concluding that the transaction should be recorded at \$290,000. These candidates also provided a journal entry to correct the initial entry, and recognized that neither the adjustment nor the transaction would have an impact on net income.

Overall, weak candidates appeared confused about how to apply the standard (i.e., there are four exceptions that should lead to using carrying value if one of them is met). Weak candidates often concluded that the transaction lacked commercial substance, but still used the fair values despite the guidance suggesting otherwise. Many weak candidates appeared confused about how to confirm the existence of commercial substance, and struggled with the application of case facts to the standard. For example, some candidates concluded that the transaction had commercial substance because the transaction was “goods for services,” but did not explicitly link this conclusion to criterion in the standard. Other weak candidates simply stated that the transaction had commercial substance without further supporting their position, or used the differing values of the goods given up and the services received to support their analysis, despite the fact that the values were not significantly different (approximately 7%). Weaker candidates were more likely to use the value of the goods given up as the transaction amount without using the *Handbook* to justify the use of this value, and often provided an incorrect journal entry, such as recording the difference in values as a gain. In addition, their conclusion about how to record the transaction was often unsupported.

AO#5 (Breakeven) (Mgmt Acct)

Candidates were asked to calculate the breakeven number of bottles to be sold for an organic wine proposal. Information on the organic wine proposal was provided in Appendix V (Common). While some case facts were found directly in the appendix, several adjustments or exclusions were required as part of the calculation, such as the step-costs of the warehouse expense or the exclusion of the survey and administrative costs. The percentage of sales of the two bottles of wine to be sold was a key case fact, as it allowed candidates to calculate the sales mix of the proposal and combine the price points into one contribution margin. To demonstrate competence, candidates were expected to provide a reasonable calculation of a breakeven number of bottles to be sold, incorporating various components into their calculation, such as the sales mix, variable costs, fixed costs, and a correct exclusion of the irrelevant costs of the proposal.

Candidates performed well on this AO. The majority of candidates demonstrated their conceptual understanding of how to perform a breakeven calculation while incorporating the sales weightings of the different bottles, and factored in the various costs into their analysis with limited conceptual errors. However, many candidates made other types of errors throughout their calculations, such as failing to exclude all the irrelevant costs, or correctly account for the step-costs of the warehouse.

Strong candidates had fewer technical errors in their calculations. They correctly excluded the survey and administrative costs from their analysis, and appropriately explained their rationale for doing so. They incorporated the step-costs of the warehouse and calculated the annual amortization on the new shelving that would be required. Strong candidates were more likely to combine the sales mix into one contribution margin, demonstrating their understanding of how to apply weighted averages into their breakeven analysis. They also included the extra contribution margin from the cheese sales.

Weak candidates often had both numerical and conceptual errors throughout their analysis. For example, these candidates often did not account for the additional contribution margin from the cheese sales, or used the cost of a full case instead of the cost per bottle when determining the selling and distribution costs. Others struggled to apply the sales weights to their analysis, often forming a conclusion that included two breakeven points. Weak candidates were more likely to use the full cost of the shelving units in their calculations, suggesting that these costs would be incurred each year, which was not realistic. While most candidates correctly excluded at least some of the irrelevant costs, weak candidates often did so with no explanation, making it difficult to assess whether the exclusion was on purpose or due to neglect.

AO#6 (Operational plan) (Mgmt Acct)

Candidates were asked to analyze operational data provided and make recommendations, to help FFTY improve operating profits. Information on the 2021 operational plan was listed in Appendix VI (Common) in a variety of charts related to revenues, gross margins, and spoilage. To demonstrate competence, candidates were expected to provide an analysis of the data presented, suggest improvements for any of the issues identified, and provide recommendations for improving FFTY's operating profit. Candidates could demonstrate their competence by providing a discussion of a combination of findings.

Candidates performed adequately on this AO. Candidates were more comfortable analyzing the data presented from a financial or operational perspective than discussing the reliability of the data or providing recommendations. Many candidates focused their discussion on the spoilage data presented, which, although relevant, was only one of the several key issues to be discussed. Other candidates focused on identifying as many issues as possible while failing to address the implications of each issue identified, or to provide recommendations for resolving those issues.

Strong candidates were more likely to perform their analysis using a structured approach, linking each analysis point to a supported and logical recommendation. These candidates were also more likely to discuss several of the key issues found in the data, as they often framed their discussions from the perspective of the three primary segments of FFTY's operations: perishable, non-perishable, and freshly prepared foods. These candidates typically provided more insightful discussions as they were more likely to integrate the data from multiple charts, such as explaining how the dip in sales of perishable foods in summer was a concern as this segment has the highest margins. Finally, these candidates were more likely to discuss the reliability of the data presented, most often noting deficiencies, such as the lack of additional sources of data, the sole use of internal data, or the poor controls surrounding the tracking of the spoilage data.

Weak candidates were more likely to focus on only one aspect of the data presented, most notably spoilage. These candidates often simply rephrased what was displayed on the charts. For example, while many weak candidates identified that the revenue from the freshly prepared foods was lower in summer months, they often ended their analysis there. As a result, these candidates did not provide any explanation for why the revenues might be lower, or why this was of particular concern to FFTY, which led to a lack of depth in their response. Other weak candidates often restated the same point multiples times, which did not enable them to achieve adequate breadth in their discussion. Some weak candidates did not provide recommendations for the trends they identified, or if they did, the recommendations provided were not logical or practical, such as recommending that FFTY sell expired food. In general, weak candidates were less likely to discuss the reliability of the data, missing out on the opportunity to further demonstrate their competence.

Paper/Simulation:	Day 2 (FFTY) – Role Case ASSURANCE
Estimated time to complete:	300 minutes
Simulation difficulty:	Average
Competency Map coverage:	Audit and Assurance (7 Assessment Opportunities)

Evaluators' comments by Assessment Opportunity (AO) for the ASSURANCE ROLE

AO#7 (Risk assessment)

Candidates were asked to prepare the audit plan for the 2020 year-end audit. As part of the audit plan, candidates were expected to perform a risk assessment. Information relevant to the risk assessment was provided throughout the case, both in the Common and Assurance sections. To demonstrate competence, candidates were expected to provide a reasonable risk assessment, discuss several factors affecting the risk of material misstatement at the financial statement level, and conclude on the overall financial statement risk or discuss ways the auditor can respond to the risks identified.

Candidates performed well on this AO. Most candidates provided a reasonable risk discussion that included several relevant risk factors, explained how each factor impacted the risk of material misstatement at the financial statement level, and concluded on the overall financial statement risk. The most commonly discussed risk factors were: the fact that Scott stated that FFTY wants to maximize profits when possible; the several new transactions during the year in which errors were found; some control weaknesses noted throughout FFTY; and the fact that the management committee meets regularly to review actual and budgeted statements. Most candidates considered factors that increased risk as well as ones that decreased risk.

Strong candidates provided more risk factors in their risk assessment and often provided better explanations for the impact of each factor on the risk of material misstatement. They were more likely to recognize that the franchising strategy would have a significant impact on the risk of material misstatement, either due to the new processes in place, or to the bias to attract new franchisees.

Weak candidates generally did not provide an adequate risk assessment, either because they identified an insufficient number of risk factors or simply listed risk factors without explaining how they would impact the overall financial statement risk. Some weak candidates struggled to provide overall financial statement risks, instead focusing their discussion on assertion level risks. Also, some weak candidates provided business risk factors instead of focusing on financial statement risk factors, and therefore had difficulty providing a useful analysis.

AO#8 (Approach and materiality)

Candidates were asked to prepare the audit plan for the 2020 year-end audit. As part of the audit plan, candidates were expected to discuss the audit approach and materiality. Information relevant to the audit approach and materiality discussions was provided throughout the case, both in the Common and Assurance sections. To demonstrate competence, candidates were expected to provide a reasonable discussion of both the audit approach and materiality. A reasonable audit approach discussion would consider some of the relevant case facts that would impact control risk, and come to a supported conclusion as to whether a combined or substantive approach would be required in the affected area. A reasonable materiality discussion would include an adequate discussion of the users and their needs, selection of an appropriate basis and percentage to be applied to the basis, and a calculation of materiality, considering the relevant adjustments to the basis that were needed.

Candidates performed adequately on this AO. Many different case facts could have been used in discussing the audit approach. For example, candidates could have discussed: the nature of the grocery store business and how there are high volume, low dollar transactions; the franchising strategy that FFTY has recently taken; the heavy reliance on IT in the business; or the specific internal control weaknesses identified, such as in the areas of payroll or self-checkouts. Unfortunately, rather than incorporate any of the specific case facts, many candidates generally provided an audit approach discussion that was quite generic. When candidates did discuss the audit approach with a specific case fact, it was generally related to one or more of the internal control weaknesses identified, but they struggled to discuss the impact that the internal control weaknesses would have on the audit approach, often concluding that a fully substantive approach should be taken for the entire audit, even when the payroll or self-checkout internal control weaknesses only affected a limited number of stores. However, most candidates provided a reasonable materiality analysis by discussing multiple users of the financial statements and choosing an appropriate basis that would address their needs, calculating a planning materiality using updated financial statement amounts, and applying an appropriate percentage, given their selected benchmark. Candidates generally also adjusted their benchmark before calculating materiality with the adjustments required due to the financial reporting errors noted.

Strong candidates' audit approach discussions were more specific to the case facts presented, and they often understood that an internal control weakness in one area does not prevent a combined approach from being taken in other areas. They were also more likely to consider the fact that FFTY operates in an environment of high volume, low dollar transactions, or that the franchising strategy has created new processes that may impact the audit approach. In addition, strong candidates' materiality discussions identified more of the relevant users of the financial statements. They discussed each user's needs in greater detail and often justified both the basis they chose, reflecting the users' needs, as well as why they chose a specific percentage within the acceptable range, by linking their choice to the sensitivity of the users. Some strong candidates also provided a discussion and calculation of performance materiality, which helped strengthen their materiality discussions.

Weak candidates provided audit approach and materiality discussions that were generic. For example, in their audit approach discussions, weak candidates often simply explained what substantive and combined approaches were, or that controls had to be tested, without discussing what factors the auditor should consider or applying the specific case facts that were given. For the materiality discussions, weak candidates often mentioned “shareholders” and “lenders” as users, without specifying who these users were, and often neglected to discuss potential franchisees as users. In addition, weak candidates often did not adjust their materiality basis for the errors found in the financial reporting issues. Weak candidates’ discussions also often contained technical errors, such as basing their choice of materiality percentage on the overall financial statement risk instead of basing it on the sensitivity of the users, or not choosing an appropriate percentage range for the basis they selected for materiality.

AO#9 (Procedures – accounting issues)

Candidates were asked to prepare the audit procedures for any accounting issues identified. Information on the accounting issues was provided in the Common section of the case. To demonstrate competence, candidates were expected to discuss a number of procedures that would address the specific risks related to the accounting issues identified.

Candidates performed adequately on this AO. Most candidates provided sufficient breadth, by providing one or two procedures for each of the accounting issues identified. Most candidates were also able to adequately explain their procedures, by discussing what audit evidence they would obtain and what they would do with the audit evidence. The procedures most often adequately explained, and that addressed the most significant risks, were related to the investment in LOB and the franchise fee revenues, as these areas are more straightforward to audit and contained many risks that could be tested.

Strong candidates clearly demonstrated that they understood the significant audit risks of each transaction. For example, for the investment in LOB, instead of simply verifying the purchase price of the investment, strong candidates focused their audit procedures on whether there was significant influence, by verifying FFTY’s seat on the board or the 18% of outstanding common shares purchased. Strong candidates also provided precise and well-described procedures, clearly noting what external evidence would be obtained and what the auditor should do with that evidence.

Weak candidates tended to only address the typical risks for the accounts that were impacted by the accounting issue identified. For example, instead of auditing the existing non-monetary transaction between FFTY and DWC, many weak candidates proposed reviewing whether there were other errors in the accounts impacted by the financial reporting issues raised, such as suggesting that Crawford & Powell look for other non-monetary transactions during the year, or agreeing the fair value of web design services and freshly prepared foods to supporting documentation. Weak candidates also often provided vague procedures, such as suggesting that the present value of the lease payments be “recalculated,” without suggesting what specific audit evidence needed to be obtained and what information needed to be verified to do so, which made it difficult to determine exactly what they were proposing, and what risk they were trying to address.

AO#10 (Procedures – summary wage report)

Candidates were asked to review one of FFTY's store's summary wage reports, and recommend audit procedures that should be performed on any significant changes during the year and on any anomalies identified. Information on the summary wage report and additional information related to payroll was provided in Appendix VII (Assurance). To demonstrate competence, candidates were expected to discuss some of the anomalies or significant changes in the report and provide audit procedures for some of these areas.

Candidates performed adequately on this AO. Most candidates identified some of the anomalies or significant changes, adequately explained why they were identified as such, and provided an appropriate audit procedure. Candidates most frequently discussed the anomaly found in the average weekly hours per employee in April and December, and in the average hourly pay per employee in August.

Strong candidates identified most of the anomalies and significant changes and attempted procedures for each one they identified. Their procedures were precise and well described, demonstrating that they understood what external evidence would be available in the context of payroll and what the auditor should do with that evidence. Strong candidates were more likely to discuss and provide procedures for the change in the number of employees and the net pay as a percentage of gross pay.

Weak candidates often did not address the anomalies or significant changes in the report, and only provided procedures for how to audit payroll. When they did identify anomalies and significant changes, they simply stated that there may be a potential issue without explaining why they thought that was the case, or what they were comparing the amount to. Weak candidates' procedures were also often vague or suggested that they did not understand the payroll process. For example, some weak candidates suggested using timesheets to verify the hourly pay rate, not understanding that it would be very unlikely to find an hourly rate on that document.

AO#11 (Reporting options and procedures)

Candidates were asked to discuss the various reporting options that could provide independent verification of the annual statement of gross sales to be provided to SMT, and to discuss the procedures that would need to be performed for the recommended report. Information on the lease agreement terms, and details of the requirements related to the annual statement of gross sales, was provided in Appendix VII (Assurance). To demonstrate competence, candidates were expected to discuss some of the valid reporting options available, and some of the procedures that would be performed.

Candidates struggled on this AO. Most candidates attempted to discuss two reporting options, but often at least one of the options was not valid for the situation presented. Some of the commonly suggested reports that were not considered valid included an auditor's report on compliance with an agreement, an audit of financial statements prepared in accordance with special purpose frameworks, and compilation engagements. When candidates did recognize the appropriate reports that could be used, their discussions were vague, often simply stating that a report had a high or low cost with a high or low assurance level, without being more specific about how the report is applicable to the situation, or what SMT's needs might be. These important considerations were not discussed by most candidates. While most candidates also attempted to provide several procedures to test the annual statement of gross sales, they struggled with providing relevant procedures. Many procedures provided were generic, such as suggesting that sales be agreed to supporting documentation, which was not sufficiently specific and indicated that the candidate did not consider the nature of the business.

Strong candidates identified only the reporting options that were valid in this situation, often identifying three valid options, and provided more depth in their discussion of each of the options. For example, strong candidates considered what work had already been done for the financial statement audit, and the potential for leveraging the work already performed. The procedures they provided were also more specific and relevant, often demonstrating an understanding that the completeness of sales was a bigger risk than the existence of sales.

Weak candidates struggled to provide valid reporting options, often only suggesting options that would not apply to the situation, such as suggesting a *CAS 800 Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* report or a *CSRS 4200 Compilation Engagements* report. Some weak candidates demonstrated technical weakness in their discussion, for example, by suggesting that a CAS 805 report could be performed as a direct or an attestation engagement. They also often suggested audit procedures that were not relevant, such as providing procedures on cost of sales or the lease expense. Given that the request was to provide verification on the annual statement of gross sales, these procedures did not provide any value.

AO#12 (Internal Controls)

Candidates were asked to assess the internal controls related to the self-checkouts at three stores for weaknesses, and recommend improvements. A process description was provided in Appendix VII (Assurance). To demonstrate competence, candidates were expected to identify several of the internal control weaknesses, explain the implication of each weakness, and provide a reasonable recommendation for addressing each weakness.

Candidates performed well on this AO. Most candidates identified many of the weaknesses and discussed them in sufficient depth. The most commonly identified weaknesses were that: the attendant is too busy and overrides the weight check without checking; an exception report of overrides and corrections is available but is not reviewed; receipt checks are not performed if the attendant is not immediately available; and there is a lack of segregation of duties over the cash reconciliation process.

Strong candidates better explained the implications of each weakness identified. For example, instead of simply stating that the implication of the overriding of the weight check is that theft would occur, they would provide more detail as to how that could happen (e.g., someone may purposely enter a code for something that is less expensive and this would not be detected, and FFTY would not charge the correct amount to the customer). They also provided sufficiently specific recommendations; for example, for the weakness related to the review of exception reports, instead of simply stating that the report should be reviewed, they specified exactly what types of things should be reviewed (e.g., errors occurring on the same inventory item). Strong candidates also often recognized the bigger issue—that the attendants were too busy to enforce some of the controls already in place.

Weak candidates often did not explain the implications of the internal control weaknesses identified, or did so in very vague terms. In addition, the recommendations they provided were often not sufficiently specific or practical. For example, weak candidates often suggested that there should be an attendant for each of the four self-checkouts, or that a manager should perform every override, which would not be practical. Weak candidates also often simply reiterated the existing control as a recommendation, such as recommending that receipt checks or that inventory counts be performed, without any recognition that there is already an existing policy that requires this.

Weak candidates also typically spent more time discussing processes that were not problematic, and as a result provided a lot of discussions with limited value to the user. For example, they suggested that having a sticker on an item rather than a UPC bar code is not appropriate and that all products should have UPC bar codes; however, given the other controls in place, having a sticker on an item is not problematic or different from having a UPC bar code.

AO#13 (Disclosure document)

Candidates were asked to perform the appropriate audit procedures on the disclosure document for potential franchisees. Excerpts from the disclosure document were provided in Appendix VII (Assurance). To demonstrate competence, candidates were expected to document and perform the work required with respect to the information presented in the disclosure document by identifying some of the clear inconsistencies in the document, based on FFTY's financial statements or the candidate's understanding of FFTY, discuss what additional information may be needed to perform the procedures, and/or discuss what Crawford & Powell's responsibilities are related to this document.

Candidates struggled with this AO. There was a wide variety of approaches and most candidates did not seem to understand their role related to the disclosure document. As a result, some candidates suggested procedures to audit each of the statements in the disclosure document, when this was not necessary as Crawford & Powell would only be required to ensure that there are no material inconsistencies with the audited financial statements or the auditor's knowledge of FFTY. Other candidates simply copied and pasted from the *Handbook*, but did not apply that guidance to the situation. As the required asked the candidate to perform the audit procedures on the disclosure document, simply quoting sections from the *Handbook* did not provide much value.

Strong candidates demonstrated good integration skills, recognizing that they needed to use the facts given earlier in the case to compare to the statements in the disclosure document. They also not only addressed the clear inconsistencies in the document, but often took a step back to, for example: explain what Crawford & Powell's responsibilities were in relation to the document; note that the financial reporting errors found would have to be incorporated into the figures in the document; or note that the statement—that Crawford & Powell has audited the information in the disclosure document—cannot remain, as it is misleading.

Weak candidates often simply provided procedures for auditing the statements in the disclosure report, not understanding that an auditor's responsibilities related to the disclosure document are different, compared to the financial statements. In addition, the procedures they provided were often vague and did not specify either the audit evidence to obtain, or what was to be done with the audit evidence provided. Some weak candidates suggested procedures that they could have actually performed as part of their response, based on the information provided; for example, they would suggest that the auditor needs to recalculate the debt-to-asset ratio, which they could have done themselves, as all the information required to calculate this ratio was provided in the case.

Paper/Simulation: Day 2 (FFTY) – Role Case FINANCE

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Finance (7 Assessment Opportunities)

Evaluators' comments by Assessment Opportunity (AO) for the FINANCE ROLE

AO#7 (Financing proposals)

Candidates were asked to compare two financing alternatives being considered by FFTY in order to repay the MG Bank loan early and eliminate the existing personal guarantees. Specifically, candidates were asked to compare the two financing alternatives, discuss their impact on FFTY's annual cash flows, and recommend which option to pursue. The terms of the proposed financing alternatives, including repayment terms, were provided in Appendix VII (Finance). To demonstrate competence, candidates were expected to evaluate the two financing alternatives by comparing the terms of the proposals or by discussing the impact of the terms on FFTY's operations, and to make a recommendation. FFTY's financial information could be integrated into the discussion of whether FFTY could afford to service the debt (using FFTY's annual cash flows), and the balance sheet information could be utilized to calculate FFTY's current debt-to-asset ratio.

Candidates performed well on this AO. Most candidates compared the two financing options, discussing the impact of the options on FFTY's annual cash flows, as well as other terms of the financing proposals. The discussion often addressed the different interest rates, as well as terms specific to the Kings Bank option, such as the covenants (i.e., the long-term debt-to-asset ratio), and loan security requirements. However, not all candidates correctly calculated FFTY's long-term debt-to-asset ratio, often including all liabilities rather than long-term debt only. In terms of the Jason Puneet loan, candidates often discussed Jason's expertise with franchise operations, the board seat requirements, and the impact of the detachable warrants, but not all candidates correctly calculated Jason's implied ownership interest upon exercise of the warrants. Most candidates provided a supported recommendation for which financing proposal FFTY should accept.

Strong candidates demonstrated additional depth in their analyses by linking the terms to their impact on FFTY. For example, they recognized that, if FFTY were to breach the Kings Bank covenants and the bank called the loan, FFTY would need to raise funds to repay the loan. Strong candidates provided accurate calculations of FFTY's long-term debt-to-asset ratio and Jason's implied ownership upon exercise of the warrants. Some strong candidates also compared FFTY's annual cash flows to each loan's debt service requirements, to support their discussion of whether FFTY could afford to service each option.

Weak candidates identified differences between the financing options but did not discuss the impact of these differences on FFTY. For example, they recognized that the Kings Bank loan is secured by land, buildings, and equipment whereas the Jason Puneet loan does not have security requirements, but did not explain why this could be important to FFTY. Weak candidates also often discussed only one or two differences before concluding, which did not demonstrate sufficient competence. Weak candidates also often provided an analysis that was skewed towards one of the financing proposals; as both options had advantages and disadvantages worthy of discussion, this was not a balanced discussion.

AO#8 (New product Line NPV)

Candidates were asked to prepare a quantitative analysis of a proposed project to offer home delivery of freshly prepared meals, and to recommend whether FFTY should proceed with the pilot project. Details of the project, including upfront costs and annual revenue and cost information, was provided in Appendix VII (Finance). To demonstrate competence, candidates were expected to provide a net present value calculation, incorporating appropriate upfront and end-of-life costs, annual cash flows, and a reasonable discount rate.

Candidates performed very well on this AO. Most candidates applied the net present value technique, using a discount rate of 8% (as provided in the case), and included appropriate items in the analysis. This included upfront costs such as the vehicle purchase and inventory investment, and end-of-life cash flows such as the salvage value. Most candidates incorporated appropriate annual cash flows, including food sales, delivery charges, cost of food, fixed costs, marketing costs, and taxes. Most candidates also provided a conclusion that was supported by their quantitative analysis.

In addition to the above, strong candidates incorporated correct tax shields on the upfront equipment costs and the salvage value, and considered the release of working capital (from the upfront inventory investment) at the end of the project life.

Weak candidates sometimes incorrectly applied the net present value method, for example, by applying an annuity or perpetuity to each year's cash flows. Some weak candidates used an incorrect or unsupported discount rate, such as the cost of debt, to evaluate the project. Some weak candidates also included costs in the wrong years, for example, including the salvage value in the first year.

AO#9 (WACC)

Candidates were asked to estimate FFTY's weighted average cost of capital (WACC). In Appendix VII (Finance), candidates were provided with information on public companies that could be considered comparable to FFTY, including a description, the number of stores, average store size, and beta for each company. Candidates were also provided with additional rates in Appendix VII (Finance), and the fair value of FFTY's equity in the Finance role requirements. To demonstrate competence, candidates were expected to calculate FFTY's WACC, incorporating reasonable inputs such as the risk-free rate, cost of debt, and market risk premium. Candidates were expected to select a reasonable beta based on an assessment of the public companies provided in the case.

Candidates performed adequately on this AO. Most candidates calculated FFTY's WACC using the appropriate formula, taking into consideration FFTY's proportion of equity, using either the fair value of equity provided in the case or the book value of FFTY's equity. Most candidates incorporated reasonable inputs into the WACC calculation, such as the risk-free rate, market risk premium, and cost of debt (typically based on FFTY's cost of debt or the interest rates in the financing proposals). Most candidates attempted a discussion of at least one of the comparable companies, selecting an appropriate beta based on their assessment of comparable companies. This assessment typically incorporated a discussion of at least one of the activities undertaken by the company, number of stores, or average store size.

Strong candidates thoroughly discussed the comparable companies, and often discussed all of the companies presented rather than just those that were considered most comparable; they discussed these companies with reference to multiple relevant factors, such as store size, number of stores, and key activities. Although specific rates were not provided in the case, strong candidates often considered additional factors in their WACC calculation, and supported their inclusion, for example, of a size premium or company-specific risk premium.

Weak candidates sometimes calculated WACC using the wrong formula, for example, by calculating the cost of equity only. Some weak candidates also did not discuss the comparable companies, selecting the beta based on an average of all the companies, or based on two of the companies without explaining why these companies were the most comparable to FFTY.

AO#10 (Equipment purchase FX hedge)

Candidates were asked to discuss three proposed alternatives for hedging equipment that FFTY purchased from a U.S. supplier, determine the final cost of the equipment under each alternative, and provide a supported recommendation for which hedging option to use. Information on FFTY's existing U.S. dollar cash flows, and three options with respect to the equipment purchase, was provided in Appendix VII (Finance). To demonstrate competence, candidates were expected to discuss most of the hedging alternatives, include an assessment of the benefits and drawbacks of each option, calculate the final cost of each option (where available), or discuss why the natural hedge option was not available to FFTY.

Candidates performed adequately on this AO. Most candidates discussed all three options for hedging FFTY's equipment purchase. Most candidates calculated the final cost of the supplier discount and forward hedge, and attempted a discussion of the benefits and drawbacks of these two options. In their discussion, most candidates focused on the benefit of having a fixed rate/payment. Most candidates also attempted a discussion of the natural hedge, either attempting to explain a natural hedge or explaining that a natural hedge would not apply to FFTY as they do not have U.S. dollar cash inflows through their operations.

Strong candidates demonstrated greater depth in their assessment of the supplier discount and forward hedge by discussing additional factors beyond the benefits of the fixed rate/payment. In addition to the fixed rate/payment, they often included a discussion of at least one of: whether FFTY had the cash available to pay the supplier earlier; a calculation of the implied financing cost if FFTY were to pay the supplier earlier; or the disadvantages of a forward contract, such as lost opportunity for gains or counterparty risk (recognizing that the bank as a counterparty does not carry significant risk).

Weak candidates sometimes provided only a brief analysis, typically focusing on a quantitative analysis of the final cost of the supplier discount and forward hedge without any, or very little, discussion of the qualitative factors that could impact FFTY. Weak candidates often demonstrated technical weaknesses in their analyses, for example, by confusing the forward contract with options (typically by stating that FFTY could decide not to exercise on the forward contract), or not understanding the mechanics of a natural hedge (i.e., not recognizing that U.S. dollar cash inflows are needed in order to create a natural hedge).

AO#11 (Investments)

Candidates were asked to discuss FFTY's investment objectives, review the current investments, and recommend changes, if any, to the investment mix. Candidates were also told that FFTY has excess funds available for the next 12 to 15 months, and that Scott and Antonia have different views on how to invest these funds. Information on Scott's and Antonia's preferences, and the investment options available to FFTY, was provided in Appendix VII (Finance). To demonstrate competence, candidates were expected to discuss FFTY's investment objectives, such as its investment time horizon, desire to preserve capital, and capital growth requirements, integrate those investment objectives into their assessment of the investment options presented, and provide a recommendation for FFTY's investment mix. Candidates could integrate FFTY's interest in purchasing equipment or investing in a new product line or, in particular, FFTY's investment time horizon into their discussions.

Candidates performed adequately on this AO. Most candidates discussed each of the investment options in terms of the risk and reward balance, and considered the investment objectives in some way. Some candidates also attempted to calculate the annual income from each investment option, although they often did not incorporate these calculations in their assessment of the option's suitability for FFTY, given its investment objectives. Candidates typically identified the investment objectives upfront, but often did not explicitly discuss FFTY's investment objectives in depth, i.e., by going beyond references to Scott's and Antonia's objectives to explain why specific objectives were important to FFTY. Candidates typically spent more time discussing the investment options, and provided a conclusion on FFTY's appropriate investment mix based on the investment objectives identified.

Strong candidates demonstrated depth in their discussion of the investment objectives by explaining why they would be important to FFTY, for example, linking the time horizon objective to FFTY's planned investments in equipment and the new product line. Strong candidates also demonstrated depth in their discussion of each of the investment options, by describing, for each option, whether it met each investment objective.

Weak candidates provided a more generic assessment of risks and rewards of the investment options without consideration of FFTY's specific needs. Some weak candidates identified the objectives but did not use them throughout their analysis, or did so at a superficial level (e.g., only discussing the annual return for each investment option). Weak candidates sometimes provided recommendations that were not practical, ignoring the other objectives for the sake of return (e.g., suggesting that FFTY invest in ETFs although they identified capital preservation as an objective).

AO#12 (Franchisee financial state)

Candidates were asked to review the financial statements of Franchisee #1, that is behind on its franchise fee payments, evaluate its financial health, and recommend ways that FFTY could avoid similar situations in the future. Candidates were provided with internally prepared financial statements for Franchisee #1, as well as franchisee benchmarks, in Appendix VII (Finance). To demonstrate competence, candidates were expected to calculate and discuss various financial ratios for the franchisee, based on the benchmark ratios provided in the case, and provide valid recommendations that could assist future franchisees in avoiding the same issues being experienced.

Candidates performed adequately on this AO. Using the benchmark ratios provided, most candidates attempted to calculate the equivalent ratios for FFTY; however, some candidates missed the fact that the financial information provided was for three months only, and therefore did not calculate the ratios correctly. Most candidates attempted to discuss the ratios relative to the benchmarks, sometimes explaining why the franchisee's performance could be different than the benchmark, or the impact of a higher or lower ratio on the franchisee. Most candidates provided some recommendations for ways that FFTY could assist the franchisees; most recommendations centered around the expertise of the franchisees, reducing the high level of debt carried by the franchisees, or reducing or modifying the structure of the franchise fees.

Strong candidates demonstrated greater depth in their discussion of the ratios by consistently commenting on whether they were above or below benchmarks, and then tying that specific performance back to case facts, for example, recognizing that times interest earned is lower than the benchmark due to the franchisee's high level of debt. Strong candidates also provided realistic recommendations for FFTY, such as reducing the franchise fee or providing franchisees with loans.

Weak candidates did not attempt to calculate or discuss all of the ratios, or only provided a superficial discussion, for example, recognizing that the times interest earned ratio is below the benchmark with no explanation of why this could be the case, or suggesting that FFTY investigate the rationale. Weak candidates often did not provide recommendations, or their recommendations were not linked to the results of the ratio analysis, for example, suggesting that FFTY needed to perform credit checks on franchisees without explaining why this would be helpful. Some weak candidates also provided recommendations from the wrong perspective, for example, suggesting ways a franchisee could improve its ratios even though they were asked to provide recommendations to FFTY.

AO#13 (Logistics proposal)

Candidates were asked to assess the impact of a proposal from Logistics Inc., a warehousing and distribution service provider, on working capital and net warehouse costs, discuss some relevant qualitative factors, and provide a supported recommendation for whether FFTY should accept the proposal. Details of the existing warehouse costs, terms of the proposal, including payment requirements and the expected impact on FFTY's inventory, were provided in Appendix VII (Finance). To demonstrate competence, candidates were expected to evaluate the proposal by assessing the working capital impact (i.e., calculating current and revised days in

inventory and related inventory savings and financing costs) or the impact on warehousing costs, discuss some qualitative factors, and make a recommendation for whether FFTY should accept the proposal.

This AO was challenging for candidates. Most candidates calculated the saved warehouse costs and compared them to the cost of the Logistics proposal. However, they failed to consider the impact of the timing of cash flows; Logistics would need to be paid on the first day of the month compared to the end of the month for existing cash flows. Fewer candidates attempted to address the impact on working capital. When they did, many candidates incorrectly either divided the inventory balance by twelve months, or divided the inventory reduction by twelve months, as a way of calculating the days in inventory. Most candidates attempted a qualitative analysis of the proposal, but many candidates repeated case facts without explaining their impact on FFTY. Most provided a conclusion on whether FFTY should accept the proposal that was consistent with their analysis. Candidates could have also integrated information from the Common section (i.e., their understanding of the business) into their qualitative analysis.

Strong candidates provided an accurate analysis of the working capital impact of the proposal by calculating the current days in inventory, revising the inventory balance, and calculating the revised days in inventory. Strong candidates also sometimes considered finance costs, typically the warehouse costs due to the timing of the cash flows. Strong candidates also demonstrated greater depth in their qualitative analysis by discussing the impact of the various qualitative factors on FFTY. For example, they tied reduced stock-outs and fresher products (i.e., reduced spoilage) to higher customer satisfaction.

Weak candidates often focused on the quantitative cost comparison only without considering the impact on working capital or discussing any of the qualitative factors. Weak candidates who attempted the working capital often misinterpreted case facts, calculating the reduction in inventory incorrectly. Some weak candidates provided a qualitative discussion that only repeated case facts without explaining why these factors would impact FFTY's decision.

Paper/Simulation:	Day 2 (FFTY) – Role Case PERFORMANCE MANAGEMENT
Estimated time to complete:	300 minutes
Simulation difficulty:	Average
Competency Map coverage	Performance Management (7 Assessment Opportunities)

Evaluators' comments by Assessment Opportunity (AO) for the PERFORMANCE MANAGEMENT ROLE

AO#7 (SWOT analysis)

Candidates were asked to prepare a situational (SWOT) analysis for FFTY. Candidates were specifically asked to only address a few of the most relevant considerations of the SWOT. Most of the relevant information for this analysis was presented in the first two pages of Appendix VII (Performance Management). Additional elements could be found in Background Information, Appendix I (Common), and in Appendix VI (Common, the 2021 operational plan). To demonstrate competence, candidates were expected to prepare a SWOT analysis that included some correctly classified and well supported items, and to demonstrate an understanding of the difference between elements of FFTY's external environment and its internal environment.

Candidates performed very well on this AO. Candidates generally limited their SWOT analysis to only a few elements, as requested, and addressed each one in sufficient depth. Most candidates incorporated several valid elements from both FFTY's external and internal environment, and most understood the difference between elements that affect the internal versus the external environment. They also adequately articulated why each consideration mattered to FFTY.

Strong candidates accurately classified and explained all the elements they identified, covering all four components of a SWOT analysis. Strong candidates typically identified and analyzed numerous valid elements of FFTY's environment. Their analysis of the external environment generally went beyond stating the opportunities that were specifically part of the requests for AOs #9, #12, and #13, to include more general trends in the industry. Their discussion often focused on the high level of competition in the industry and on the presence of large competitors, who could benefit from volume discounts that could be transferred to their clients.

Weak candidates often listed strengths, weaknesses, opportunities, and threats without supporting why the elements listed were of importance to FFTY. Weak candidates also mixed external elements with internal elements, often misclassifying them. For example, many weak candidates assessed the foreign currency risk or the presence of seven large competitors as being weaknesses of the company, or labelled several of FFTY's weaknesses as being "threats." Weak candidates also limited the opportunity section of their analysis to restating the themes to be addressed in AOs #9 (delivery project), #10 (long-term supplier contract), and #13 (customer loyalty program).

AO#8 (Mission and vision)

Candidates were asked to review FFTY's mission and vision statements, which Antonia thinks are outdated. Candidates were asked to recommend appropriate changes, keeping in mind the recent strategic shift toward franchising. They were also asked to provide a list of core values, which FFTY has never had. The current mission and vision statements were provided in Appendix VII (Performance Management). To demonstrate competence, candidates were expected to perform this analysis while integrating the relevant information mentioned throughout the case, such as the attributes of a successful franchisor, also presented in Appendix VII (Performance Management). As neither of the original statements addressed the franchising activity, candidates were expected to incorporate franchising into their recommended changes.

Candidates generally performed adequately on this AO. Most candidates attempted to restate the mission and vision statements while addressing the weaknesses they perceived in the current statements. However, candidates did not always demonstrate that they understood the difference between a mission and a vision statement, and that the purpose of these statements was to orient FFTY's future strategic direction rather than reflect FFTY's current or past activities. Many candidates simply added the word "franchising" somewhere in one of the statements, without necessarily realizing that the statements needed to be coherent and consistent with FFTY's strategic direction. Most candidates identified additional weaknesses with the current statements beyond the lack of franchising, such as unrealistic growth targets or lack of focus on FFTY's specific market niche of locally produced, whole foods. Candidates performed better at identifying and listing FFTY's core values; however, few candidates provided support for the elements they listed.

Strong candidates addressed both the mission and vision statements, explained the weaknesses in each of them, and provided a revised version of both statements. They incorporated franchising, either by mentioning it as a growth strategy (vision), or by mentioning franchisors as additional partners (mission). Some strong candidates integrated the franchisees' specific preferences and needs that were mentioned in the case into their revisions. Strong candidates also provided a list of core values that was specific to FFTY's situation, consistent with its strategic direction, and linked it to the case facts, such as the type of products being sold or the needs expressed by franchisees.

Weak candidates either restated both statements and provided a list of core values with little or no supporting analysis, or simply added the word "franchising" to one or both statements: for example, "to be the largest Canadian-owned retailer **and franchisor** of fresh, whole foods." Others simply added to both statements operational details linked to projects that FFTY is currently contemplating (such as deliveries to seniors or millennials, the organic wine boutique project, or the loyalty program), without considering the broader strategic direction that FFTY should be taking. Many weak candidates proposed revised mission and vision statements without referring to the supporting case facts. Weak candidates generally provided a list of core values that was generic and had little connection to FFTY's strategic direction. For example, the values made reference to "satisfied customers," "happy employees," or other objectives that could apply to any business, rather than focusing on elements specific to FFTY's industry and strategy.

AO#9 (Cash flow – fresh food delivery)

Candidates were asked to compare two potential markets: seniors and millennials, in terms of the cash flows generated by each segment, and to qualitatively analyze each, to help determine which would be the preferred market for FFTY if it went forward with the delivery project. Information needed for performing a quantitative and qualitative analysis was presented in Appendix VII (Performance Management). Candidates could also incorporate general information about the company and the industry presented in the Common section of the case. To demonstrate competence, candidates were expected to recommend which market would be preferable to target with this project, based on reasonable quantitative and qualitative analyses.

Candidates generally performed well on this AO. Most candidates performed a reasonable calculation of the cash flows related to each potential market. However, even though the calculations were quite straightforward, some candidates incorrectly treated the delivery fees charged by FFTY as a cash outflow instead of a cash inflow, or they failed to realize that the depreciation expense allocated to the project generated no cash outflow and needed to be excluded from the calculation, or that the app's development costs were upfront costs that represented a cash outflow only in the first year. Some candidates presented only one scenario for each market, when the case provided projections for two potential scenarios in terms of volume (high and low), to allow candidates to assess the risk associated with the projections. Most candidates provided a reasonable qualitative analysis of the two markets considered. They also integrated the case facts presented in order to help support their recommendation.

Strong candidates made a near-perfect calculation of the cash flows generated by the project for each market, for both scenarios presented. They also presented an analysis that addressed the many variables presented in the case that could differentiate the two markets from a qualitative standpoint, such as price sensitivity, the budget allocated to food, the level of competition, the location of the residences, and loyalty to the brand. They concluded with a recommendation that was supported by both their quantitative and qualitative analyses.

Weak candidates made many of the errors listed above while preparing their cash flow projections. Their qualitative analysis generally consisted of a list of case facts presented in a pros-and-cons format, with little or no analysis of how these facts could help FFTY choose which market to prioritize. Some weak candidates qualitatively analyzed the project on a global basis rather than performing a comparative qualitative analysis of the two markets, which resulted in an analysis that was less useful for the client, who was looking to choose one or the other.

AO#10 (Departmental analysis)

Candidates were asked to analyze FFTY's departmental performance evaluation system in three ways: identify the type of responsibility centre for each of FFTY's four departments; suggest various key performance indicators (KPIs) for each department; and analyze the current bonus structure of the managers of two of these departments. A table containing a description of the responsibilities of each department, and a detailed description of the bonus calculation of the two managers in question were provided in Appendix VII (Performance Management).

Candidates could enhance their analysis by integrating general information on the company and its industry, found in the Common section. To demonstrate competence, candidates were expected to make a reasonable assessment of the type of responsibility centre of each of the four departments, develop KPIs consistent with the nature of these centres, and assess the current bonus structures for the two managers, stressing the controllable nature of the elements included as well as the congruence with corporate goals.

The majority of candidates performed reasonably well on this AO. Most correctly identified the type of responsibility centre for most departments, and suggested valid ways to evaluate the performance for some of them. Most candidates appeared more comfortable discussing the corporate stores and product purchasing departments than the franchising and marketing departments. Most candidates classified the corporate stores and product purchasing departments as the correct responsibility centre, suggested valid KPIs based on elements controlled by the departments, and discussed Dennis's bonus structure adequately. For the franchising and marketing departments, the classification of the responsibility centre was often incorrect, the KPIs suggested were often generic or vague, or displayed a lack of understanding of what the departments were responsible for. Candidates generally struggled most with the last component of the required, and provided a weaker critique of the current bonus structures of the two managers.

Strong candidates correctly identified all the types of responsibility centres, provided useful KPIs for all of them that were consistent with the type of centre identified, and supported their analysis with case facts. Their analysis considered the specifics of the grocery store industry, and their recommendations were practical. Strong candidates also identified the main deficiencies of the current bonus structures: the manager of the franchising department's bonus calculation excluded all the expenses under her control, which could reduce the incentive for her to exercise control over them; and the corporate store department's manager bonus was based on a calculation of the aggregate profits of the corporate stores, and many expenses listed, such as marketing costs, overhead allocations, and property taxes, were out of his control. Their responses were generally well structured and each of the three requests was clearly addressed.

Weak candidates either made errors in identifying the type of responsibility centres, or demonstrated that they did not know what the basic responsibility centres were. The KPIs recommended for the various departments were often disconnected from the type of responsibility centre identified in their response, or were overly generic. Some weak candidates listed objectives for the departments rather than supplying performance indicators that would allow FFTY to measure whether those objectives were met. Weak candidates also seemed to misunderstand the concept of franchising, and were under the impression that the franchised stores' revenues and expenses were under FFTY's control. Their responses were generally less structured, and the bonus discussion was often entangled with the KPI discussion for the franchising and the corporate stores departments, making it difficult to determine which request was being addressed.

AO#11 (Managerial performance)

Candidates were asked to determine the causes of the low operating income of two specific corporate-owned stores that are underperforming, and to provide recommendations for improving their performance going forward. Appendix VII (Performance Management) contained a table showing various KPIs used to evaluate the stores' performance, the value of this indicator for the 2020 fiscal year, and the target established by FFTY for each indicator. A description of various events that took place in those two stores was presented following the table. To demonstrate competence, candidates were expected to use these events to explain the poor performance of the two stores in relation to the various KPIs presented in the table, and to provide useful recommendations for improving the situation in the future.

Candidate performance on this AO was mixed, with some doing exceptionally well while others struggled. However, most candidates identified a few root causes of the stores' poor performances on a KPI-by-KPI basis, but failed to realize that the poor performance was pervasively caused by decisions made by the manager of the first store, and by an event outside the manager's control at the second store.

Strong candidates provided structured responses, analyzing the underperforming KPIs one by one for each store, and made appropriate links to the case facts presented. For example, the manager of the first store had decided to reduce the prices of commonly sold items in order to follow the actions of a nearby competitor, and to reduce the employees' hours in order to save on benefits. Strong candidates linked these actions to the affect they had on the store's KPIs, such as sales growth rate, gross margin percentage, salaries-to-sales ratio, employee turnover, and customer complaints. They also provided useful recommendations for mitigating these issues going forward. The second store had closed for six weeks due to a sewer backup, and employees had been asked to work overtime to help with the cleanup. Strong candidates identified the impact of this event on KPIs such as sales growth rate, average hourly labour rate, salaries-to-sales ratio, and net operating margin. They also concluded that the manager could not be held responsible for this poor performance, as it was generally out of his control, and formulated useful recommendations for addressing such unforeseen events in the future.

Weak candidates' responses were less structured. They generally identified the root causes of the poor performance but made little or no use of the case facts presented, such as the management decisions made in the first store, and the sewer backup having occurred in the second store. Instead, they speculated on the potential causes that could explain why gross margins, sales growth, or employee turnover did not meet expectations. Rather than attempting to link this knowledge to the case facts describing events that had taken place during the year, weak candidates relied on their theoretical knowledge of the drivers for these ratios. Other weak candidates displayed technical weaknesses in their understanding of how increases in the selling price influence the gross margin ratio, the sales growth ratio, or the salaries-to-sales ratio. Some presented an analysis that lacked breadth, only addressing one or two KPIs, and without noticing the pervasive issues mentioned above.

AO#12 (Proposed supplier contract)

Candidates were asked to perform a quantitative and qualitative analysis of an offer to secure a long-term supply contract with Riverside, one of its existing suppliers of dairy products. Candidates were told that the six-year contract would significantly increase the portion of dairy products purchased from this supplier, and reduce the portion purchased from FFTY's remaining dairy product suppliers. Information needed to perform their analysis was found in Appendix VII (Performance Management), in a table containing the breakdown of FFTY's current dairy product purchases for each supplier, along with a brief description of the related conditions, and relevant clauses from the proposed contract. To demonstrate competence, candidates were expected to provide a reasonable quantitative comparison of the cost of the dairy products for a six-year period under both scenarios (status quo and proposed contract), and a qualitative assessment of the contract, to support a recommendation for whether FFTY should go forward with the contract.

Most candidates struggled with this AO, especially with the quantitative analysis. They attempted a comparison of the dairy costs of the two options, but many misunderstood the case facts and assumed that the entirety of the purchases would be from Riverside. Candidates were expected to realize that the savings made from the lower price increases promised by Riverside could be potentially offset by the large price increases coming from FFTY's existing suppliers for the remaining products. Ignoring the impact on the prices charged by the existing suppliers made the calculation less useful for the client. However, most candidates provided a useful qualitative analysis of the contract, raising valid points such as the reduction in variety of products for the customers, the convenient delivery conditions, the relatively long ordering period, the penalty associated with orders below the minimal annual amount, the pressure that the short payment terms would put on FFTY's cash flows, and the general trend in the industry to enter into long-term supplier contracts.

Strong candidates performed a useful quantitative comparison of the two scenarios, incorporating the two components of the orders going forward: the component purchased through Riverside at stable contractual prices, and the portion purchased from the existing suppliers at significantly higher prices. Their calculation was presented in a structured way, clearly showing the comparison being done, and the two components of the purchases being distinctly considered. Strong candidates also presented a clear qualitative analysis of the contract, identifying the pros and cons of entering the contract, and clearly explaining how and why these elements mattered to FFTY.

Weak candidates presented a very poor quantitative analysis, often starting an analysis but not completing it. Many did not seem to plan their calculation, and its purpose, before starting. Some weak candidates merely compared the minimal volume to be purchased through Riverside (\$10 million) to the total amount currently spent for dairy products (\$12 million), not realizing that the remaining volume had to be purchased from existing suppliers. Weak candidates included a fewer number of adjustments, or did not include explanations for their adjustments. The qualitative analysis of the weak candidates generally consisted of a list of case facts presented in a pros-and-cons format, with little or no explanation.

AO#13 (Loyalty program)

Candidates were asked to quantitatively and qualitatively assess a proposed customer loyalty program for FFTY's corporate stores. A description of the program, the projected impact on sales, and other assumptions were presented in Appendix VII (Performance Management). To demonstrate competence, candidates were expected to calculate the incremental impact of the program on FFTY's operating income, based on the projections and underlying assumptions presented, provide a qualitative analysis of the program, and make a recommendation.

Candidate performance on this AO was mixed, with some doing very well while the majority struggled. Most candidates provided a calculation of the impact of the program on FFTY's operating income, took into account the reduction of sales generated by the points being redeemed, and incorporated the assumed portion of points being redeemed into the calculation. However, many candidates made technical errors in the process, such as ignoring the cost of the additional sales resulting from the growth in sales volume generated by the program, and calculating the points being awarded based on the existing sales instead of on the increased sales. Most candidates provided a brief qualitative analysis of the program, but it lacked breadth as it only consisted of a few elements.

Strong candidates provided an almost-perfect calculation of the incremental impact of the program on FFTY's operating income, correctly incorporating all the relevant assumptions and projections: the growth in sales volume generated by the program; the value of the points; the rate of redemption of the points; FFTY's gross-margin ratio; and the additional administrative costs generated. Strong candidates also provided a reasonable qualitative analysis of the program, stressing the potential use of customers' personal information as part of a targeted marketing strategy, the general trend in the industry to introduce such programs, the uncertainty linked with certain assumptions, the potential issues linked with the presence of the program in corporate stores only, and the additional administrative burden.

Weak candidates attempted a calculation that contained many technical errors, such as ignoring the cost of additional sales, ignoring the lost sales caused by the points being used (or considering them as inflows instead of outflows), or ignoring the assumed redemption rate. Their qualitative analysis was generally very short, often consisting of repeating elements of the quantitative analysis in a narrative form. As this was the last AO, some weak candidates, having poorly managed their time, rushed through this required, providing a shorter response.

Paper/Simulation: Day 2 (FFTY) – Role Case TAXATION

Estimated time to complete: 300 minutes

Simulation difficulty: Easy to Average

Competency Map coverage: Taxation (7 Assessment Opportunities)

Evaluators' comments by Assessment Opportunity (AO) for the TAXATION ROLE

AO#7 (CCA and other capital items)

Candidates were asked to provide a supported calculation of taxable income and taxes payable for 2020, based on the revised net earnings. Thomas wants to know the ending undepreciated capital cost balances so he can prepare the entries later. Candidates were told not to prepare the financial reporting entries for current and future taxes payable. A capital asset continuity table was provided in Note 3 of the financial statements in Appendix II, some additional information on the sale-leaseback was provided in the management committee meeting excerpts in Appendix III, and information on opening UCC balances and other capital transactions was provided in Appendix VII (Taxation). To demonstrate competence, candidates were expected to calculate CCA for the classes provided, including several of the current year additions or disposals.

Candidates performed adequately on this AO. Most candidates calculated CCA using a typical "Schedule 8" format, starting with opening balances for all the classes, adding the additions for the various classes, attempting the dispositions in Class 1 and Class 10, and applying an appropriate rate. They usually had correct calculations in Class 8 and often in Class 10 (terminal loss) and Class 12. They often struggled with the Class 1 disposition, removing the net book value instead of the lesser of cost and proceeds. Calculations on Class 13 often included smaller errors, such as missing the accelerated investment incentive or using the wrong lease term. Most candidates calculated the correct taxable capital gain; however, they often wasted time trying to allocate proceeds between land and building even though both clearly exceeded cost, making the allocation irrelevant.

Strong candidates correctly calculated CCA, again using a typical Schedule 8 format, and included the correct additions or dispositions for all classes. They also usually calculated the taxable capital gain correctly.

Weak candidates attempted to calculate CCA but struggled with the specific concepts being tested in each class. They frequently made errors, such as removing the net book value instead of the lesser of cost and proceeds in Class 1, using the half-year rule instead of the accelerated investment incentive in Class 8, failing to recognize a terminal loss in Class 10, claiming more than 100% of the balance as CCA in Class 12, and using inappropriate straight-line CCA periods (such as 20 years, 9 years, or 11 years) for Class 13. Poor responses also rarely calculated the taxable capital gain, and those that did usually calculated it incorrectly (often simply taking 50% of the accounting gain).

AO#8 (Taxable income – quantitative)

Candidates were asked for a supported calculation of taxable income for 2020, based on the revised net earnings, and this AO focused on the quantitative aspects of this request. Information about the current year's activities was provided throughout the case, and particularly in the income statement in Appendix II. Additional information about the general and administrative expenses was provided in Appendix VII (Taxation), and candidates were also expected to integrate the results of their financial reporting analyses into their calculations. To demonstrate competence, candidates were expected to calculate taxable income, factoring in most of the required adjustments.

Candidates performed very well on this AO. Most candidates provided clear and thorough calculations of both net income for tax purposes and taxable income, including most of the required adjustments.

Strong candidates demonstrated strong technical skills and calculated net income for tax purposes and taxable income, including virtually all of the required adjustments.

Weak candidates also calculated taxable income, including several of the required adjustments. However, weak candidates sometimes stumbled on some of the fundamental items, such as remembering to add back depreciation and deduct CCA, or to add back income tax expense.

AO#9 (Taxable income – qualitative)

Candidates were asked for a supported calculation of taxable income for 2020, based on the revised net earnings, and this AO focused on the support for the calculations that candidates performed. Similar to AO#8, information about the current year's activities was provided throughout the case, and particularly in the income statement in Appendix II. Additional information about the general and administrative expenses was provided in Appendix VII (Taxation), and candidates were also expected to integrate the results of their financial reporting analyses into their calculations. To demonstrate competence, candidates were expected to explain the adjustments they made in reconciling from net income to net income for tax purposes and taxable income, including at least some of the more difficult concepts, such as the impact of the accounting issues, the capital items that had been expensed, or the 75% limit on donations.

Candidates performed reasonably well on this AO. Most candidates provided notes supporting most, if not all, of their adjustments, either directly in their spreadsheet or in a bulleted section of their written response. Most candidates provided brief explanations, which for many adjustments was sufficient. Most candidates did not explain the tax impact of very many of the accounting issues identified; however, they often attempted at least one of them (usually the deduction for dividends received).

Strong candidates provided notes supporting each of their adjustments. Their responses often provided more depth in their explanations and focused their efforts on the more complex adjustments, such as the tax implications of the accounting issues they discussed in the common section of their response.

Weak candidates either did not attempt to explain their adjustments, or their explanations were insufficient. Some only used two or three words to explain their adjustments (e.g., “insurance not deductible”), which was only sufficient for simple adjustments that needed no more explanation. Others simply restated the math (e.g., “add back depreciation”), which did not sufficiently illustrate that they understood why they were making the adjustment.

AO#10 (Taxes payable, RDTOH, CDA)

Candidates were asked for a supported calculation of taxes payable for 2020, for an explanation of what the RDTOH and capital dividend accounts are, and for a calculation of FFTY's balances at January 1, 2021. Candidates were told on the first page of the case that FFTY is a Canadian-controlled private corporation (CCPC). Information specifically for these calculations was provided in Appendix VII (Taxation), and candidates also needed to integrate the results of the work they performed in AO#7 through AO#9 to complete these calculations. To demonstrate competence, candidates were expected to provide a calculation of corporate income tax that reflected the different taxation of business income and investment income, and to provide depth in their response through either a more detailed calculation that reflected the various components of income tax, or a calculation and/or discussion of RDTOH and CDA.

Candidates performed reasonably well on this AO. Most candidates calculated taxes payable in detail, showing the basic rate, abatement, additional refundable tax (ART), and general rate reduction (GRR). Most candidates had many valid components in their tax calculation, such as correctly recognizing the ART on investment income, and adjusting the base for calculating the GRR to back out aggregate investment income and/or income claimed under the small business deduction. However, most candidates did not realize that the small business deduction was ground down to zero due to FFTY's taxable capital. Most candidates understood some of the basic components of RDTOH and CDA and attempted to explain these accounts, although discussions of the CDA were usually stronger than discussions of the RDTOH.

Strong candidates calculated taxes payable in detail. They again usually had many valid components in their tax calculation, and realized that the small business deduction was ground down to zero due to FFTY's taxable capital. They also usually understood some of the basic components of RDTOH and CDA, and explained these accounts clearly.

Weak candidates attempted to calculate taxes payable without considering any of the key elements of the income taxes calculation. They frequently did little more than apply a single tax rate to all of the income, often not explaining how they chose that rate. Some weak candidates stated that they “assumed” a tax rate because they were not provided with one, and others applied an “effective” tax rate based on the financial statements. Weak candidates often did not attempt the RDTOH and CDA calculations, and those who did frequently made significant errors (such as excluding historical losses in the CDA, or adding in items that did not belong in RDTOH, such as historical dividends or the entirety of the business income for the year). They frequently misunderstood the very nature of RDTOH, seemingly confusing it with GRIP and LRIP balances.

AO#11 (Interest and penalties, compliance system)

Candidates were asked to explain why FFTY was assessed interest and penalties on income taxes for 2019, to calculate the corporation income tax instalments that should be paid for 2021, and to provide guidance on how to ensure that future tax payments are made on time. In Appendix VII (Taxation), they were provided with information on when FFTY filed its return and made tax payments for the 2019 year, and they were able to build on their knowledge of the business, as well as on the work performed in AO#10, to address parts of this request. To demonstrate competence, candidates were expected to address at least two of the three areas (interest/penalties, instalments, and a system for ensuring future compliance) in some depth.

Many candidates struggled on this AO. Most candidates attempted to calculate instalments using one or two, but rarely all three, methods, often misaligning the years (using an incorrect earlier or later year when calculating the instalment methods), or stumbling on the second part of the second prior year instalment method. They often stated that instalments were due quarterly even though FFTY does not qualify for quarterly instalments. They also identified some of the potential reasons for interest and penalties being assessed, but struggled to clearly link the case facts to the rules in order to explain precisely which deadlines had been missed and by how much. Most candidates did not attempt to provide a system for meeting future deadlines.

Strong candidates attempted to calculate instalments using all three methods (often providing only a qualitative discussion of the current-year method, which was a reasonable approach), and factored in the results of their AO#10 calculations when determining the 2021 instalment base. They recognized that instalments were due monthly because FFTY does not qualify for quarterly instalments. Strong candidates also identified some of the potential reasons for interest and penalties being assessed, clearly identifying when the deadline was, and when the compliance activity (payment, filing) was completed. Strong candidates also usually attempted to provide a system for meeting future deadlines, but still struggled to come up with valid suggestions.

Weak candidates attempted to discuss penalties/interest or attempted to calculate one of the three instalment methods, but rarely attempted both discussions. They frequently struggled to come up with the correct deadlines for anything, often concluding that corporate tax returns were due on April 30, for example, or that payments were all due before the end of the year. Those who attempted to calculate instalments often struggled to calculate these correctly, usually picking up the incorrect year or using hypothetical examples rather than case facts.

AO#12 (Shareholder/employee benefits)

Candidates were asked to comment on the tax implications of loans made to Ross (Antonia's spouse) and Scott. Candidates were also asked to comment on the tax implications of certain benefits being suggested by some employees, from both the employees' and FFTY's perspective. Information about these loans and benefits was provided in Appendix VII (Taxation). To demonstrate competence, candidates were expected to discuss several of the loans or benefits, with at least one or two in some depth.

Candidates performed adequately on this AO. Most candidates discussed several of the employee benefits, usually providing some depth on at least one of them by going beyond a “taxable/ not taxable” or “deductible/ not deductible” statement to consider the specific case facts provided, from the perspective of both FFTY and the employee. They usually attempted to discuss the shareholder loans but failed to provide correct technical knowledge, and struggled to apply it to the specific case facts presented.

Strong candidates discussed all of the employee benefits, usually providing some depth on several of them by explaining whether each benefit was taxable to the employee, and whether each benefit was deductible to FFTY, considering the specific case facts provided. Strong candidates usually attempted a discussion of the shareholder loans, providing some valid discussion, particularly on the loan to Scott; strong candidates identified the rules around loans to shareholder-employees for specified purposes, such as the purchase of a home.

Weak candidates discussed only a few of the employee benefits, often simply stating whether something was deductible by FFTY, or taxable to the employees, without considering any of the specific case facts provided or explaining why the benefit was, or was not, taxable/deductible. Poor responses, if they attempted the shareholder loans, usually provided lengthy but technically incorrect discussions, often suggesting that the loan to Ross would only incur imputed interest, even though it clearly did not fall anywhere near any of the exceptions for income inclusion.

AO#13 (GST/HST return)

Candidates were asked to estimate the GST/HST balance payable for January, and to explain how it was calculated. They were also asked to explain any GST/HST implications for FFTY for each of the suggested employee benefits. Information on the employee benefits, as well as information about the transactions that took place in January, was provided in Appendix VII (Taxation). To demonstrate competence, candidates were expected to calculate the net tax for the month, including some of the more specific adjustments in the calculation, and/or discuss the GST/HST impacts of the employee benefits.

Candidates performed well on this AO, which tested a topic that recently received more prominence in the Competency Map. Most candidates calculated the GST/HST charged on FFTY's revenues, and the ITC available on its costs for the month, using the information provided. They usually correctly backed out zero-rated sales and purchases, although they sometimes had difficulty with the furniture and fixtures purchases, either excluding them altogether because they are capital or adjusting them to remove the portion still unpaid. They also usually factored in a few of the other items, such as commercial rent, meals and entertainment, and club dues. Most candidates attempted to explain the GST/HST implications of the employee benefits, but often only identified the correct treatment for the TFSA and disability plan.

Strong candidates calculated the GST/HST charged on FFTY's revenues and the ITC available on its costs for the month, using the information provided. Strong candidates not only backed out zero-rated sales and purchases correctly but also treated the furniture and fixtures purchases correctly. They also usually factored in a few of the other items, such as commercial rent, meals and entertainment, and club dues. Strong candidates explained the GST/HST implications of the employee benefits, usually identifying the correct treatment for the employee discounts, TFSA, and disability plan.

Weak candidates attempted to calculate net tax for the month, making many mistakes in their calculations. They typically did not understand the nature of zero-rated items, and often calculated 13% tax on these sales, or did not back them out of the total sales for the period. They also sometimes calculated ITCs on zero-rated purchases; commonly, this error was supported with a statement that expenses related to zero-rated sales are eligible for ITCs, which is true, but failed to recognize that no ITC is available when 0% GST/HST was paid in the first place. Weak candidates also frequently used cost of goods sold instead of purchases, and either did not claim the furniture and fixture purchases at all or backed out the amount remaining in accounts payable. Weak candidates rarely addressed the employee benefits, and those who did frequently made errors, such as suggesting that an ITC could be claimed for disability insurance contributions.

APPENDIX F (continued)
BOARD OF EXAMINERS' COMMENTS ON DAY 3 SIMULATIONS

Paper/Simulation:	Day 3, Case 1 (FenceCo)
Estimated time to complete:	90 minutes
Simulation difficulty:	Average
Competency Map coverage:	Management Accounting (2); Finance (2); Taxation (2); and Strategy and Governance (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (New revenue model - quantitative) (Mgmt Acct)

Candidates were asked to quantitatively analyze whether the Moons should add another revenue model to FenceCo. Candidates were provided with information specific to the additional revenue model in Appendix II, but information relevant for their calculation was also included in Appendix I. To demonstrate competence, candidates were expected to prepare an analysis of the incremental income that the new revenue model would provide over the next two years.

Candidates performed well on this AO. Most candidates performed a two-year analysis of the incremental income that the new revenue model would provide. Most candidates gathered the data given per post, such as the gross profit per post in Appendix II, and related it to the number of feet of fence in Appendix I and the projected demand in Appendix II, and integrated the information in order to calculate the added margin of the new revenue model correctly. Most candidates also calculated and integrated the licensing revenue into their analysis. They also correctly calculated the variable costs per foot, and correctly included the fixed costs in their analysis.

Strong candidates provided a complete calculation, and accurately calculated the cannibalized margin from the lost sales, which many candidates failed to consider. These candidates used the information provided in Appendix I to calculate the gross margin per foot that FenceCo would lose to cannibalization, and applied it to the correct footage of fence.

Weak candidates typically did not know how to approach this analysis, often using the fixed costs given to calculate a break-even figure. This analysis did not provide any useful information to the Moons in order to decide whether they should add this other revenue model. Other weak candidates confused the two units of measurement (per post or per foot), which yielded incorrect results. They also had other errors or omissions in their calculation, such as not including fixed or variable costs. Many weak candidates calculated the cannibalization of sales based on 1% of FenceCo's current sales rather than on 1% of the new revenue model's sales. Others used the revenue per foot provided, instead of calculating the gross margin per foot.

AO#2 (New revenue model - qualitative) (Mgmt Acct)

Candidates were asked to qualitatively analyze whether the Moons should add another revenue model to FenceCo, and to recommend a course of action. To demonstrate competence, candidates were expected to discuss some pros and cons of the new revenue model, and provide a recommendation. Candidates were expected to draw from the general information about FenceCo in order to analyze the new revenue model from a qualitative standpoint.

Candidates struggled more than expected on this AO. Although most candidates addressed some factors in their analysis, many of their considerations were quantitative, not qualitative, and were simply a repetition in words of their AO#1 analysis. For example, many candidates stated that cannibalization would reduce revenue, or that licensing revenue would increase the overall profit from this new revenue model, when these factors were already accounted for in their quantitative analysis. About one-half of the candidates were still able to provide sufficient discussion around the qualitative factors. The most frequently addressed factors included the fact that the Moons are looking to grow FenceCo in its existing markets and significantly increase profits, which the new revenue model clearly did. Another factor that was often discussed was that the new revenue required no capital investment, which also met the Moons' strategic objectives. Many candidates also did a good job of discussing the risk that the contractors could tarnish FenceCo's reputation with poor quality work.

Strong candidates generally provided more breadth in their analysis, discussing both pros and cons. They also discussed valid points other than the Moons' strategic objectives, for example, that the contractors might copy FenceCo's technology and use it for themselves. These discussions went beyond the quantitative or qualitative case facts listed in Appendix II and provided additional value to the Moons. Many strong candidates also did a good job of questioning the inputs of the calculation, specifically discussing that a 1% cannibalization rate seemed low.

Weak candidates typically looked to their quantitative analysis to support their qualitative discussion. For example, they often noted as a pro that this revenue model would be very profitable, without relating this point back to the Moons' strategic objectives. In addition, weak candidates often noted that 1% of sales would be lost by using this new model, rather than discussing the uncertainty around this percentage being higher in the future, which was a more relevant discussion point. Some weak candidates also brought in irrelevant points, such as whether the contractors would be considered employees. These discussions were not relevant to the overall analysis.

AO#3 (Business valuation of ABC) (Fin)

Candidates were asked to value ABC Feeder Inc. (ABC), based on normalized net income and using the industry standard multiplier of five. Candidates were provided with ABC's balance sheet and income statement, with notes that provided relevant information for making normalizing adjustments. To demonstrate competence, candidates were expected to calculate a normalized net income, which included sufficient adjustments, using the information provided in Appendix III, and multiplying this amount by the industry standard multiplier of five in order to calculate a capitalized earnings valuation of the business.

Candidates performed well on this AO. Most of the information needed to calculate the normalizing adjustments was clearly laid out in Appendix III. Some candidates struggled to locate the director fees adjustment, as these fees were in Appendix IV. Candidates were the most comfortable calculating the adjustments related to the severance, recruiting fee, and rent. A majority of candidates multiplied the normalized net income that they calculated by the appropriate multiplier. However, most candidates missed adjusting the income tax expense to reflect the adjustments they had made to net income.

Strong candidates correctly incorporated most, if not all, of the normalizing adjustments in their revised net income calculation, using the information located in Appendix III. These candidates identified the director fees located in Appendix IV, and correctly applied the change in gross margin percentage points related to the suppliers' price increase and the change in shipping costs. Many strong candidates also included the tax impact in their calculation. Their calculations provided the Moons with a good idea of ABC's value for an eventual sale. A very small percentage of strong candidates also noted that there were other ways to value ABC, such as a net asset valuation, and mentioned that this could give a different value in an eventual sale, which was good advice for the Moons.

Weak candidates struggled to incorporate the change in gross margin following the suppliers' price increase and the change in shipping costs. For example, instead of using the sales figures in their calculation, many weak candidates erroneously used the cost of sales or net income. Many weak candidates did not attempt any adjustments related to the gross margin. Some weak candidates had a hard time determining in which direction to make their adjustments, subtracting when they should have been adding, or vice versa. Many weak candidates noted that an adjustment was required for the director fees, but that they could not locate the amount of the adjustment, which demonstrated a lack of ability to integrate case facts. Others did not multiply the rent of \$4,000 per month by 12 to get an annualized adjustment. Most weak candidates did not consider the impact of income taxes on the calculation.

AO#4 (Taxes payable on sale of ABC) (Tax)

Candidates were asked to calculate the taxes payable on the sale of the ABC shares, using their recommended selling price and assuming that the shares are qualified small business corporation (QSBC) shares. Details regarding adjustments to the adjusted cost base (ACB) of the shares and the lifetime capital gains exemption (LCGE) were located in Appendix IV. To demonstrate competence, candidates were expected to exhibit some understanding of the concepts of ACB and LCGE, and to calculate the taxes payable on the sale of the shares.

Candidates performed poorly on this AO. Most candidates started their calculation with the selling price from their previous valuation of ABC. From there, candidates often deducted the \$40,000 original ACB to get to a capital gain, failing to recognize that Elizabeth and Adam had a different ACB for the shares they each held. Many candidates calculated a combined capital gain instead of splitting the proceeds between Elizabeth and Adam, thereby failing to recognize that each of the two had an LCGE available. When candidates recognized that Elizabeth and Adam were separate taxpayers, many adjusted Elizabeth's LCGE for the \$234,000 that she had previously used, and recognized that Adam had his full lifetime capital gains exemption left; some candidates also adjusted Elizabeth's LCGE for the sale to Adam in 2016. Most candidates demonstrated an understanding that capital gains are taxed at 50%. Candidates struggled with what rate to apply for taxes, often using corporate tax rates or the rate applicable to ABC from Appendix III, rather than personal tax rates. Many candidates struggled with Elizabeth's share sale to Adam, providing a calculation that often omitted these case facts altogether, both in the ACB deducted from the sales price to get to the capital gain, and in Elizabeth's adjustment in her LCGE.

Strong candidates recognized that, because Elizabeth sold her shares to Adam, there would be a difference in Elizabeth's and Adam's ACB. These candidates generally provided a separate calculation for Elizabeth and Adam, first allocating the sales price between them, and then deducting the selling costs and the relevant ACB per person to get to a capital gain. Because they realized that a calculation of the taxes payable had to be done for each individual, most of the strong candidates correctly applied Adam's full LCGE. Strong candidates recognized that there was at least one adjustment to Elizabeth's LCGE (either from the sale of some of her shares to Adam or from the sale of her shares on another investment), and appropriately applied the amount against her capital gain. Strong candidates consistently applied either the full LCGE against the gain, or half of the LCGE against the taxable gain. Strong candidates also saw that these shares were being sold personally, and applied a personal tax rate, most often 33%, against the taxable capital gain to get personal taxes payable.

Weak candidates often omitted the information from Appendix IV entirely from their calculation. Many weak candidates took the ABC valuation they had calculated and applied the \$40,000 ACB noted on the first page of the case against the selling price to get the capital gain. They then applied 50% against this gain to get to the taxable capital gain, without a further calculation of the taxes payable. Many weak candidates struggled with how to apply the LCGE, and applied the full LCGE against the taxable capital gain, or applied 50% of the LCGE against the capital gain, or applied it directly against taxes payable, or did not use it at all. Many weak candidates applied a corporate tax rate against the sale, most often using the 22% tax rate that could be calculated from Appendix III.

AO#5 (Personal investment options) (Fin)

Candidates were asked to provide advice to the Moons on some investment options for the sale proceeds of ABC. They were also asked for a recommendation, and an explanation of their choice. Various investment options were presented in Appendix IV, as well as the clients' objectives for the next few years, and their investment objectives with regards to risk and return. To demonstrate competence, candidates were expected to discuss the risk and expected return of some of the investment options while considering the Moons' investment objectives, and provide a recommendation.

Candidates performed well on this AO. Most candidates discussed the risk related to the stock market, GICs, and the rental property, supporting their discussion with relevant information, such as the fact that the GIC principal is guaranteed and secured by the government, or that there is volatility in the stock prices. When discussing the return, candidates did a good job of discussing that the GIC return was low, that the bond return was moderate or slightly higher than the GIC, and that the return from the rental property can come from capital appreciation or through stable rental income. Most candidates discussed the Moons' objectives of moderate risk and average return in their conclusion, often concluding that the bond would best meet these objectives. Fewer candidates addressed the Moons' objective of having more free time.

Strong candidates had a more in-depth analysis of each of the investment options and better explanations of their assessment of the risk, such as noting that the bond risk was moderate as interest is guaranteed but the principal amount can vary depending on the bond discount or premium. Most strong candidates also discussed each investment in terms of the Moons' objectives, specifically noting whether each investment met the two clear objectives of moderate risk and average return and more free time to spend on their hobbies. Most strong candidates provided a good discussion of the rental option, specifically incorporating case facts, such as the vacancy rate and the volatile repair costs, to strengthen their discussion of the risk and expected return. Many strong candidates noted that the rental would not meet the Moons' objective of having more free time. Strong candidates also suggested more creative ways to invest, such as diversifying the portfolio in stocks, bonds, and GICs as ways to meet the Moons' investment objectives.

Weak candidates often provided a cursory analysis of the investment options, usually stating that the risk was high or low without explaining why. For the bonds and GICs, many weak candidates just noted the case facts provided, for example, mentioning what the return would be (4% or 2.2%) without explaining if this was a high or low return. Many weak candidates ignored the Moons' objectives altogether and focused on the fact that they want to retire, therefore recommending low-risk investments. These candidates often recommended the GIC as a result. Many weak candidates grouped GICs and bonds together, and stocks and cryptocurrency together, limiting the depth of their analysis. Weak candidates also noted that the rental was a safe return as property always appreciates, ignoring the case facts about the vacancy rate and variable maintenance costs. Many weak candidates also struggled to understand that an RRSP was not an investment in and of itself. For example, they often recommended investing in RRSPs up to the RRSP limit available, and investing the rest in GICs/bonds/stocks.

AO#6 (Tax on personal investment options) (Tax)

Candidates were asked to provide a discussion of the tax implications of each investment option. The different investment options were noted in Appendix IV. In Appendix IV, candidates were also asked if the Moons should put their entire proceeds from the sale of ABC in their RRSPs, and to calculate the Moons' 2021 RRSP deduction limits. To demonstrate competence, candidates were expected to address several of the taxation issues presented, such as the tax implications of the investment options provided, the possible benefits of using an RRSP, and the calculation of the RRSP deduction limit for 2021.

Candidates performed poorly on this AO. Most candidates explained that interest income would be taxable and included in their income. For the rest of the investments, many candidates defaulted to telling the Moons that the income earned on the investments would be included in their tax return, without further explanation. For example, many candidates noted that, when the stocks/cryptocurrency are sold, there would be a capital gain, but did not note how capital gains are taxed (included in income at 50%), which was important information to give the Moons in order for them to assess the difference between the taxation of the different investment options. Many candidates also noted that rental income would be included in the Moons' property income but did not discuss the fact that rental expenses could be deductible. Many candidates ignored dividend income earned altogether. Candidates also struggled to provide any depth in their analysis of RRSPs, often noting that, if the Moons overcontribute, there would be penalties, but neglecting to discuss the bigger picture of the tax-deferral benefits of putting the proceeds in an RRSP. Candidates also struggled with the RRSP calculation, either including all income from Appendix IV (dividends, interest, director fees, and employment income), or just using the 2020/2021 RRSP dollar limit as the net addition to each of Adam's and Elizabeth's RRSP deduction limit, demonstrating a lack of understanding of earned income altogether.

Strong candidates recognized the need to be specific in their explanation of the tax treatment of the different investment options. For example, these candidates noted that there would be a gross-up and/or credit for any dividend income. For capital gains, they noted that these are only included in income at 50%. For the rental income, many strong candidates noted that allowable expenses could be deducted from gross rental income, but also that CCA could be claimed, or that CCA cannot create or increase a loss. Strong candidates also had a reasonable calculation of the RRSP deduction limit, with only minor errors, such as not including director fees or including the interest income. These candidates often noted the benefit of putting some of the proceeds into an RRSP, given the high income in the year of the sale and the possibility of withdrawing the income during retirement at a lower tax bracket.

Weak candidates did not provide enough information to the Moons on the tax implications of the investments, with many of them simply stating that investment income would be included in their tax returns. Many weak candidates confused the personal taxation of investment income with the corporate taxation of investment income, noting that each option would be taxed at the highest rate. Weak candidates also struggled with the RRSP calculation, for example, by including dividends in their calculation of the deduction limit, or using the 2020 RRSP deduction limit as the 2021 deduction limit, without any adjustments. Some weak candidates omitted the RRSP calculation entirely from their response.

AO#7 (U.S. expansion) (Strat & Gov)

Candidates were asked whether the expansion into the U.S. market fit well with FenceCo's strategic objectives. FenceCo's strategic objectives were provided in Appendix I, and details of the U.S. expansion were provided in Appendix V. To demonstrate competence, candidates were expected to discuss whether some of FenceCo's strategic objectives were met with the expansion to the U.S. market, given the case facts noted, and provide a recommendation.

Candidates performed well on this AO. Most candidates recognized that the timeline of the expansion did not align with the objective to sell the company in two to three years. They also noted that this expansion would require significant capital investment, which did not meet the goal of growing without capital investment. Finally, candidates did a good job of discussing the fact that the U.S. is outside of existing markets, which was against the objective to grow in existing markets only. Based on this, it was clear that the expansion did not meet the objectives, and most candidates recommended not proceeding.

Strong candidates provided an in-depth analysis, discussing some of the other objectives that were met, such as the fact that the U.S. expansion was planned to have a strong return on investment, which would meet the goal of significantly increasing profits. They also noted that the expansion would target six to eight cities, which met the objective of fast growth. While these candidates identified that some of the objectives were met, they provided a balanced discussion, and still recommended that the Moons not proceed with the expansion, as it was clear that the expansion did not align overall with their stated objectives.

Weak candidates missed the point of this AO and defaulted to management advice. For example, many of them explained that it will be harder for the Moons to manage an operation in the U.S., given the geographical distance. Others were concerned that foreign exchange will make accounting more difficult. These discussions did not address whether the expansion met FenceCo's strategic objectives.

APPENDIX F (continued)
BOARD OF EXAMINERS' COMMENTS ON DAY 3 SIMULATIONS

Paper/Simulation:	Day 3, Case 2 (HSE)
Estimated time to complete:	80 minutes
Simulation difficulty:	Average
Competency Map coverage:	Management Accounting (1); Financial Reporting (1); Finance (1); Assurance (1); Taxation (1); and Strategy and Governance (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (Claimable costs) (Mgt Acct)

Candidates were asked to explain any required adjustments, and revise the preliminary calculation, of the costs to be reimbursed as part of a remediation agreement, which was prepared by a junior employee. Excerpts of the mediation agreement were provided in Appendix I. The preliminary calculation of costs, and several notes found in Appendix II, were provided to allow candidates to assess which of the reimbursable costs were relevant to the mediation agreement discussion. To demonstrate competence, candidates were expected to prepare a revised calculation of the costs to be reimbursed that included several adjustments, and to explain why the adjustments were required, based on the details found in the mediation agreement.

Candidates performed adequately on this AO. Most candidates made several adjustments to the initial calculation of the costs to be reimbursed, and provided explanations that drew on the contents of the mediation agreement. Candidates generally demonstrated an understanding of the limitations imposed by the mediation agreement, and applied them to their calculation. The most common adjustments included the additional benefits, the capital asset limit, the leased space, and the estimated lawsuit payout. However, many candidates calculated the leased space adjustment incorrectly, either forgetting to adjust for the 300 square feet already available, or for the fact that only 1,200 square feet were needed. In addition, candidates often considered the lawsuit estimated payout in their calculation, but their explanation to support their adjustment was often incomplete. For example, they often mentioned the payment deadline of March 31, 2022, but did not always explain that, with the lawsuit court date of February 2022 being so close to the deadline, there could be an issue with it being paid within the payment deadline.

Strong candidates accurately calculated the revised claimable amount by including most of the required cost adjustments, and the adjustments that required more integration between the description of the costs in the preliminary calculation and the limitations for the mediation agreement, such as the adjustment for the manager's salary and the adjustment related to the hiring and training costs. Strong candidates also clearly explained why these adjustments were necessary in order to be compliant with the mediation agreement, for instance, recognizing that the leased space should be limited to only the portion needed, or addressing the timing concern around the court date for the lawsuit.

Weak candidates provided an incomplete revised calculation of the claimable costs. They often suggested only a few adjustments, and usually focused on the more obvious adjustments, such as the additional benefits or the capital asset maximum limit. Many weak candidates adjusted for the leased space, but their calculation was often incorrect, either forgetting to adjust for the 300 square feet already available, or for the fact that only 1,200 square feet were needed. In addition, weak candidates did not fully explain the limitations imposed by the mediation agreement, often stating that the adjustment they were making was being done "as per the agreement," without further explanation.

AO#2 (Short-term financing options) (Fin)

Candidates were asked to analyze some short-term financing options and make a recommendation. Information about the three different options offered to HSE (factoring, a loan, and crowdfunding) was provided in Appendix III. To demonstrate competence, candidates were expected to provide a reasonable quantitative and qualitative analysis of the options presented, and make a recommendation.

Candidates performed poorly on this AO. Although most candidates discussed some of the relevant qualitative considerations, using the case facts provided, many did not attempt to quantify the options presented. Of those candidates who did provide a quantitative analysis, only a few calculated an effective rate of return for the factoring and LMI options, which were the two options for which calculations could be made. Most candidates who attempted a quantitative analysis failed to consider the time value of money, which impacted the usefulness of their analysis as it did not allow for a comparison of the options. Candidates performed better in the qualitative portion of their discussion. The most frequently discussed qualitative factors were: the flexibility of having factoring available for future cash flow needs; how factoring might affect HSE's reputation; the extensive application process for LMI's loan and the absence of collateral needed; and concerns around the sufficiency of funds for the BusinessFunds option in a crowdfunding context. However, candidates seemed confused about the BusinessFunds crowdfunding, as their discussions were often directed toward donations rather than funds being borrowed at a rate of return that HSE would post as part of its financing requirements.

Strong candidates provided a calculation of the financing cost of each option and compared the options from a quantitative perspective. Many strong candidates provided an effective interest rate calculation for the factoring and LMI options. Strong candidates also provided a thorough qualitative discussion of each option, providing good coverage of differentiating factors, and a recommendation that was consistent with their analysis. Strong candidates were better able to identify factors that related to the timing of the cash flows, such as the fact that the LMI option provided financing for a longer period than needed.

Weak candidates provided a list of case facts for each option without discussing them or explaining how they would affect HSE. For example, they stated that LMI had an extensive application process without explaining why this could be an issue. Weak candidates also lacked breadth in their analysis, only noting the most obvious qualitative factors, such as LMI's extensive application process, or whether the BusinessFund option would provide sufficient funding. Many weak candidates did not attempt any calculation, and simply restated the amount of funds that HSE would be getting under each option and whether it was enough, for example, mentioning that Option 1 was providing \$750,000, which was more than the \$600,000 needed, or that Option 2 was providing exactly the amount needed.

AO#3 (Audit procedures) (Assu)

Candidates were asked to provide a list of procedures that the external auditor is likely to perform on all the costs that are part of HSE's claim. Information on the costs claimed was presented in Appendix II, and candidates were provided with limitations to the claim in the excerpts from the mediation agreement provided in Appendix I. To demonstrate competence, candidates were expected to provide some examples of procedures that the external auditor would perform on the specific costs presented in Appendix II.

Candidates performed well on this AO. They provided an array of audit procedures that covered the costs to be reimbursed according to the mediation agreement. Candidates also provided audit procedures on the limitations as per the agreement, but struggled more with the audit of those limitations than with the audit of the specific costs. For example, candidates provided clear and valid procedures to audit the cost of the ten computers and software for the HR staff, but had a difficult time providing a valid procedure to audit that the \$20,000 limit on capital assets was respected, focusing only on the computers and not on all capital assets included in the list of costs. Candidates focused primarily on providing procedures for the salaries of the HR staff, the computers and software capital expenses, and the leased space, and often provided procedures on the cut-off of the expenses, with the March 31 deadline for payment of the costs.

Strong candidates provided several valid audit procedures that covered a variety of the costs presented. They provided procedures that often covered both the costs listed, and the limitations included in the mediation agreement, which added breadth to their response. For example, these candidates provided a procedure to audit the cost of the leased space, and then also provided a procedure to audit the proration of the cost of the leased space, based on what was allowed in the mediation agreement in comparison to the space that was leased. Their procedures were complete, and not only explained what should be audited, but also how it should be audited, for example, suggesting a review of the contract of the employees hired, to identify the benefits they are entitled to, and to compare those benefits to the benefits outlined in the claim.

Weak candidates provided only a few audit procedures that were mainly focused on the audit of the costs, and did not cover the audit of the limitations of the agreement. Weak candidates suggested procedures that were often incomplete or vague. For example, for the rented space, many weak candidates suggested reviewing the lease agreement but did not explain what they would look for in the agreement, such as the date, monthly amount, or square footage. Some weak candidates provided a list of supporting documents to prepare for the auditor, such as a copy of the mediation agreement or a copy of the employees' contracts, without providing procedures as asked. Other weak candidates provided generic audit procedures that were not tailored to HSE's situation, for example, suggesting that supporting documentation (such as invoices and contracts) be obtained, to verify the nature of the cost and whether it is directly related to PP not performing its contractual obligation, without giving specific details on the limitation they were reviewing, or the nature of the cost they were auditing.

AO#4 (Taxable benefits) (Tax)

Candidates were asked to determine the tax consequences, for both the employees and HSE, of additional benefits that HSE wants to offer its employees. Details of the potential additional benefits that HSE is considering were provided in Appendix IV. To demonstrate competence, candidates were expected to explain the correct tax treatment for some of the benefits, from both the employees' and HSE's perspective.

Candidates performed adequately on this AO. Most candidates explained the correct tax treatment for a number of benefits. Although most candidates addressed the tax treatment from both the employees' and employer's side, they were more likely to provide an explanation for the tax treatment for the employees' side. Their discussion of the employer's side sometimes lacked depth due to a lack of explanations. For example, many candidates stated that the bonus would be deductible, or that the membership fees would not be deductible, without further explanation.

Strong candidates covered most of the benefits presented from both the employees' and HSE's perspective. They often provided detailed information on the bonus, such as the timing of the deduction for HSE, or the need to calculate source remittances on the bonus paid. They were also more likely to address the RRSP or TFSA contributions, to explain the mechanics of each, and point out the main differences between them, such as the timing of the taxation.

Weak candidates typically addressed some of the benefits proposed, but struggled to determine the correct tax treatment. For example, they often concluded that the club membership would be deductible to HSE, or that the parking pass would not be taxable to the employees. When weak candidates concluded on the correct treatment, their explanations to support their conclusions were often incorrect; for example, many weak candidates said that the counselling costs would be deductible because it would be offered to all employees, or that parking was not a taxable benefit if its value was under \$500. Some weak candidates also failed to support their conclusion on the tax treatment, for instance, stating that membership dues are a taxable benefit to the employee, or not deductible to HSE, without providing any explanation as to why. Some weak candidates only discussed the tax consequences for the employees, and disregarded the required of discussing the tax consequences for HSE.

AO#5 (RFP process) (Strat & Gov)

Candidates were asked for their input on how to improve the process that was used to select PP. Details of the process were provided in an email from the board chair in Appendix V. To demonstrate competence, candidates were expected to explain a sufficient number of the weaknesses in the process, and recommend ways to improve them.

Candidates performed adequately on this AO. Most candidates identified and explained the weaknesses in the RFP process, and proposed improvements. Candidates most often discussed the weaknesses relating to the drafting of the RFP, the board's lack of discussion before voting on the RFP, the decision criteria, the lack of due diligence on new vendors before signing the contract, and the review of the service contract before approval.

Strong candidates clearly understood the different steps of the RFP process, such as the drafting of the RFP, the review of it, the submission process, the review of the submissions, etc., which allowed them to better describe the implications of the weaknesses, and to provide a recommendation that was better suited to the weakness identified. For example, to address the lack of review of the RFP drafts, strong candidates not only suggested that someone else review the RFP, but that management be involved in drafting the RFP to ensure that it better fits HSE's needs. Strong candidates also covered a wider variety of weaknesses in their analysis of the process.

Weak candidates seemed confused about the different steps in the RFP process and the sequence of events, for example, thinking that the board did not have sufficient time to approve PP as a supplier, when the case facts suggested that they did not have sufficient time to review the RFP. Other weak candidates thought that the board had made the decision to go with PP before other proposals came in, which was not the case. These candidates focused on the selection of PP as a vendor instead of looking at the process in its entirety to see where improvements could be made.

AO#6 (Lawsuit provision and MD&A) (Fin Rep)

Candidates were asked to review the draft Management Discussion and Analysis (MD&A) section related to PP, and the accounting treatment of the lawsuit, and to discuss any concerns. The draft year-end MD&A section was provided in Appendix VI and information about the lawsuit was provided in Appendix II. To demonstrate competence, candidates were expected to discuss the accounting treatment for the lawsuit and the misleading statements in the MD&A section, using case facts to support their conclusions.

Candidates performed poorly on this AO. Most candidates provided an analysis of the accounting treatment of the lawsuit, using the relevant *Handbook* guidance and case facts to support their analysis. However, candidates struggled with the analysis of the MD&A. Many candidates did not address the MD&A required at all, and some candidates seemed to think that the statement was only there to provide information on the accounting treatment of the lawsuit, more specifically that no amount had been accrued for the lawsuit. Those candidates who did address the MD&A often commented on one of the statements made, for example, the statement about the lawsuit being “without merit,” but did not discuss any other misleading statements in the MD&A.

Strong candidates provided a complete discussion of the accounting treatment of the lawsuit, using the appropriate case facts to support their analysis, such as the estimate provided by the lawyer, and used the relevant guidance from IAS 37 to conclude that a provision should be accounted for. Strong candidates correctly recommended recording the best estimate of \$800,000 as a provision, as per IAS 37. They also discussed the misleading statements in the MD&A section, and supported their discussion with case facts. For example, candidates pointed out that, while the MD&A states that all costs incurred by HSE (\$1,231,500) will be reimbursed by PP, some of the costs incurred were not eligible to be reimbursed, as per the mediation agreement. Some strong candidates also proposed better wording to be used in the MD&A, which added to the depth of their response. For example, some suggested wording that provided a clearer picture of the situation, to avoid misleading the readers, thereby demonstrating their understanding of the purpose of the MD&A.

Weak candidates did not provide a sufficient analysis of the criteria for the accounting treatment of the lawsuit, often stating for each criterion that it was “met” without providing any additional explanation. Weak candidates often misapplied the IAS 37 guidance, and incorrectly concluded that the lawsuit was a contingent liability. Many weak candidates did not discuss the MD&A section at all, or misunderstood the context and thought they needed to provide business advice to HSE. For example, these candidates identified that the statement, “There has also been no impact on employee morale” was incorrect, but suggested conducting a survey to assess the employees’ appreciation of HSE rather than noting that the MD&A was misleading and needed to be corrected.

APPENDIX F (continued)
BOARD OF EXAMINERS' COMMENTS ON DAY 3 SIMULATIONS

Paper/Simulation:	Day 3, Case 3 (Amped)
Estimated time to complete:	70 minutes
Simulation difficulty:	Average to Hard
Competency Map coverage:	Financial Reporting (1); Assurance (2); Management Accounting (1); and Strategy and Governance (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (PP&E accounting issues (IFRS) (Fin Rep))

Candidates were asked to discuss the financial reporting considerations on PP&E after the CFO voiced his concern that PP&E had been incorrectly accounted for. He mentioned that scooters have required a lot of maintenance, and some have gone missing. To discuss the accounting treatment for the bikes and scooters, candidates needed to integrate information that was found throughout the simulation: information on the useful life of the scooters and the components of the bikes was in Appendix I; information related to the depreciation expense for scooters and bikes was in Appendix II; and information on the useful life of each component of the bikes was in Appendix III. To demonstrate competence, candidates were expected to identify the relevant PP&E accounting issues, i.e., the useful life of scooters, the componentization of the bikes, and the derecognition of the damaged or lost scooters, analyze the IFRS accounting criteria with relevant case facts for each issue, and recommend the appropriate accounting treatment.

Most candidates struggled with this AO. The AO had a multitude of PP&E issues to contend with, and most candidates had difficulty correctly identifying the right accounting issues. Those who provided a PP&E discussion most often addressed the damaged scooters. While they identified that there were issues with the scooters being damaged, they did not always address the need to derecognize the scooters that were at the bottom of the lake, failing to recognize that those scooters were not just damaged but also irretrievable. When they did identify the correct issues, they did not always properly account for the issues they described; as a result of mixing the issues of useful life and damaged scooters together, they often failed to use the relevant case facts correctly to support their analysis. In addition, many candidates addressed the damage to the scooters from an impairment perspective, noting the indicators of impairment rather than seeing the need to derecognize the asset. These candidates lacked some technical knowledge, as they applied the *Handbook* standard to an individual asset rather than to a cash-generating unit. As there was insufficient information provided in the simulation to have this discussion, they were unable to provide a complete discussion and conclude as to impairment of the cash-generating unit. Many candidates did not address the useful lives of scooters; those who did only concluded on the need to change the useful life of the asset and did not provide any further discussion, which

could have included the change in accounting estimate related to the change in useful life of the scooters, and the need to apply the change prospectively. In addition, very few candidates discussed the error related to the failure to componentize the bikes and depreciate the main components (the frame, battery, and drivetrain) over different useful lives.

Strong candidates better understood and integrated the case facts found throughout the simulation, and correctly identified most of the PP&E issues, i.e., the useful life of scooters, componentization of the bikes, and derecognition of the damaged or lost scooters. They demonstrated their understanding by discussing the issues in more depth, using the correct case facts to support their position. For example, strong candidates went beyond simply stating that the bikes needed to be componentized and named the components (i.e., three-year useful life of the battery, six-year useful life of the bike frames, and drivetrains that need replacing every 5,000 km), to explain what the accounting treatment should be. Strong candidates incorporated information from other parts of the simulation, such as the fact that several scooters had their GPS devices destroyed, and disappeared, to support derecognition. In their discussion of the useful life of the scooters, some strong candidates explained that this would be considered a change in accounting estimate, which should be adjusted prospectively, thereby providing more depth by explaining the impact that a change in useful life would have.

Weak candidates often discussed irrelevant accounting issues, such as whether the bikes and scooters fit the definition of PP&E, or whether they were inventory or PP&E. A few weak candidates also addressed potential foreign exchange accounting issues, having noted that there was a U.S. supplier; however, there was no accounting issue related to foreign exchange, as there were no case facts to indicate that the accounting treatment was incorrect. Those weak candidates who did identify one of the relevant accounting issues typically lacked depth in their analysis; they often concluded on an accounting treatment without using relevant *Handbook* criteria or case facts to support their recommendation, for example, mentioning that the bikes needed to be componentized but not using the case facts provided to explain what the components would be and what period to depreciate them over. These candidates had difficulty integrating the information contained in the different appendices, where they could have found the information needed to better explain how the componentization should be done.

AO#2 (PP&E control weaknesses) (Assu)

Candidates were asked to suggest ways to improve the controls in Amped's PP&E processes. A description of the current PP&E processes was provided in Appendix II. Candidates could also draw on the information provided in Appendix I, which, for example, described some of the recent events related to the scooters being thrown in the lake, etc. To demonstrate competence, candidates were expected to identify some of the PP&E control weaknesses, explain their implications, and provide recommendations for addressing the control weaknesses identified.

Candidates performed well on this AO. Most candidates addressed several control weaknesses, recognized their implication on Amped, and discussed the improvements that Amped could implement. Candidates often applied a weakness, implication, recommendation approach, which was an effective way to address this AO. The most commonly addressed weaknesses included the lack of reconciliation or inspection when receiving the bikes and scooters at the Vancouver warehouse, payments based on the accounts payable amount without checking that the invoiced units and amounts are accurate, the use of Excel rather than the PP&E tracking module, and the lack of centralization in the PP&E ordering process.

Strong candidates discussed more control weaknesses and showed a greater understanding of the issues, providing complete discussions that included a clear identification of the weakness and implication, and a recommendation. The implications of the control weaknesses tended to be better explained, and recommendations tended to be more precise, for example, suggesting that Amped verify the order received against the purchase order on reception of the units rather than simply saying "check the order."

Weak candidates often recommended controls without explaining what the weakness was, or the implication of that weakness. They also sometimes provided controls that were not practical or did not reasonably address the weakness identified. For example, for the issue related to the head office leaving the choice of supplier to the location office, which resulted in foreign exchange losses being incurred by the Toronto office purchasing from the U.S., some candidates suggested practicing hedge accounting. Although this solved one of the issues identified, the foreign exchange loss, it did not protect Amped from the location office ordering units that do not meet the technical specifications suggested. It was also not a practical solution, as Amped is not likely to have easy access to the specialized resources needed in order to practice hedge accounting. A much simpler solution would have been to mandate the location offices to purchase their units from a list of pre-approved suppliers. Other weak candidates struggled to understand the case facts, and therefore did not provide the appropriate implication for the weakness identified. For example, some identified the lack of reconciliation when receiving the units at the Vancouver warehouse as a weakness, but the implication they provided for this was really the implication of the Vancouver warehouse incorrectly shipping out the units to the other locations. These candidates confused the case facts about shipping the units from the supplier to the Vancouver warehouse with the shipping of the units from the Vancouver warehouse to the other locations.

AO#3 (Resort town proposal) (Mgmt Acct)

Candidates were asked whether Amped should move more bikes to resort locations or keep them in the current urban locations, given the results of the pilot project that was conducted. Information about the resort town operations was provided in Appendix III, and information from the user reviews in Appendix IV could also be integrated into the analysis. To demonstrate competence, candidates were expected to calculate the total profitability of the Fernie pilot project, and compare it to the profitability of the same bikes in the Victoria urban area.

Candidates generally performed well on this AO. Most candidates correctly calculated the revenue related to the Fernie location, and often attempted to adjust some of the expense items, the most common of which were the maintenance worker and the replacement parts costs. Most candidates also recognized that the pilot project in Fernie was over a six-month period whereas the Victoria figures were provided on an annual basis, and adjusted their analysis to allow for a comparison of the two locations, either on an annual or semi-annual basis.

Strong candidates demonstrated a greater depth of understanding of the case facts. They accurately assessed the relevance of the expense items to the analysis, such as the incremental savings related to the maintenance worker, replacement parts, and redistribution costs, and appropriately incorporated these amounts into their analysis using a timeframe that was consistent. Strong candidates also appropriately excluded the head office costs. Many strong candidates provided appropriate qualitative factors to consider, incorporating relevant case facts, such as the demand for the bikes, which was presented in the user reviews.

Weak candidates provided an incomplete profitability analysis by attempting only a few, or no, expense adjustments, or their expense adjustments were incorrect. For example, many weak candidates only considered the cost of the maintenance worker for the Fernie location, not understanding that the salary was a fixed cost for the Victoria location that would not be included in that location's contribution margin, and therefore needed to be adjusted for in their Victoria calculation as well. Some weak candidates also failed to adjust the replacement parts or redistribution costs to the correct annual or semi-annual period, providing an analysis with some figures on an annual basis, and others on a semi-annual basis.

AO#4 (Performance measures) (Strat & Gov)

Candidates were asked to design some performance measures that would allow the shareholders to monitor whether Amped's operational results align with its strategic objectives. The strategic objectives were listed in Appendix I, but candidates had to draw on information throughout the case to determine the relevant performance measures. To demonstrate competence, candidates were expected to provide some valid performance measures that were tied to a variety of Amped's stated strategic objectives.

Candidates struggled on this AO. Although each strategic objective included multiple individual components, providing many opportunities for candidates to design performance measures, this AO required candidates to think creatively in order to identify performance measures that were suitably linked to the strategic objectives. The most common strategic objectives addressed by candidates were: to grow and provide stable returns to shareholders; to provide an efficient and safe network of electric transportation across Canada; and to reduce waste and energy usage. Some candidates lost sight of their role and provided business or operational advice rather than performance measures, for example, providing ways to reduce the energy usage rather than providing a measure to track Amped's performance on energy usage, or suggesting that Amped hold competitions for innovations rather than providing a way to measure innovation.

Some candidates simply listed measures and the objective they were measuring, without further explaining why the measures were appropriate, how to measure them, or what benchmarks could be used to assess performance. This additional information would be useful for Amped to be able to implement the suggested measure.

Strong candidates provided several performance measures and directly linked each of them to an individual component of Amped's strategic objectives, providing good coverage of the strategic objectives listed. Strong candidates suggested measures that were specific, useful, practical, and tended to provide a good explanation of the measure or a target to measure against, for some of the performance measures they identified. For example, to measure the safe network of electric transportation, some candidates suggested tracking the number of accidents, and comparing it to a target that would have been previously set.

Weak candidates did not address as many performance measures, or provided measures without tying them to the strategic objectives. Some weak candidates provided measures that were not useful or practical for Amped's operations. For example, some suggested a measure related to the management of inventory in order to maintain efficient and effective supply-chain management, failing to understand that Amped's business was a scooter and e-bike sharing service rather than a resale business, and would therefore not have inventory. Other weak candidates lost sight of the strategic objectives, and provided measures based on other aspects, such as the battery life, which was said to be a key success factor, or customer satisfaction, based on user reviews provided. Candidates who provided these types of measures failed to link them to the strategic objectives that Amped was trying to measure. In addition, some weak candidates were confused as to their role, and provided advice on how to meet the strategic objectives from a business operations framework. The required specifically asked for measures to monitor the performance; therefore, providing ways to improve the performance was not part of the required, and was not a relevant discussion.

AO#5 (Audit risk and first-time audit considerations) (Assu)

Candidates were asked to explain some of the factors that impact audit risk, and any first-time audit considerations that an auditor would address. To address audit risk, candidates could use information found throughout the case, whereas the discussion of first-time audit considerations was more general in nature and required candidates to draw on their assurance knowledge. To demonstrate competence, candidates were expected to provide a discussion of some audit risks specific to Amped, as well as some first-time audit considerations.

Candidates performed adequately on this AO. Most candidates addressed the relevant audit risk factors specific to Amped, and discussed some first-time audit considerations. However, candidates more often discussed the audit risks than the first-time audit considerations. The most common audit risks that candidates addressed were the risks related to the opening balances, the management bonus, the control deficiencies related to PP&E, and the errors in the PP&E accounting. The most commonly addressed first-time audit considerations included the work related to the opening balances, understanding of the business and controls, and independence and client acceptance.

Strong candidates discussed several factors, often recognizing audit risks that were specific to Amped's situation, such as the risks related to the new management bonus plan, the future financing need, or the control weaknesses that were detected. Strong candidates incorporated relevant case facts in their analysis, and explained why these factors impacted audit risk. These candidates also discussed first-time audit considerations, commenting on more than one consideration, and provided depth in their discussion of those considerations, for example, explaining the consequences of the auditors not being able to review the opening balances instead of simply stating that the audit of the opening balances could be an issue.

Weak candidates provided generic audit risks that were often not tied to specific case facts, for example, stating that, if there were control weaknesses, it would increase the audit risk, without referring to the actual control weaknesses presented in the case, which the candidate had likely discussed earlier in their response. Some weak candidates simply defined inherent, control, and detection risks from a technical perspective without further discussion of how these applied in this case. When addressing the first-time audit considerations, many weak candidates copied considerations straight from the *Handbook* without providing any additional analysis. Other weak candidates provided an insufficient breadth of factors in audit risks or first-time audit considerations, often focusing on the audit risks and ignoring the first-time audit considerations.

APPENDIX G

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

1. PRESENT VALUE OF TAX SHIELD FOR AMORTIZABLE ASSETS

Present value of total tax shield from CCA for a new asset acquired after November 20, 2018

$$= \frac{CdT}{(d+k)} \left(\frac{1+1.5k}{1+k} \right)$$

Notation for above formula:

C = net initial investment

T = corporate tax rate

k = discount rate or time value of money

d = maximum rate of capital cost allowance

2. SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

	2020	2021
Maximum depreciable cost — Class 10.1	\$30,000 + sales tax	\$30,000 + sales tax
Maximum depreciable cost — Class 54	\$55,000 + sales tax	\$55,000 + sales tax
Maximum monthly deductible lease cost	\$800 + sales tax	\$800 + sales tax
Maximum monthly deductible interest cost	\$300	\$300
Operating cost benefit — employee	28¢ per km of personal use	27¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	59¢ per km	59¢ per km
— balance	53¢ per km	53¢ per km

3. INDIVIDUAL FEDERAL INCOME TAX RATES

For 2020

<u>If taxable income is between</u>	<u>Tax on base amount</u>	<u>Tax on excess</u>
\$0 and \$48,535	\$0	15%
\$48,536 and \$97,069	\$7,280	20.5%
\$97,070 and \$150,473	\$17,230	26%
\$150,474 and \$214,368	\$31,115	29%
\$214,369 and any amount	\$49,644	33%

For 2021

<u>If taxable income is between</u>	<u>Tax on base amount</u>	<u>Tax on excess</u>
\$0 and \$49,020	\$0	15%
\$49,021 and \$98,040	\$7,353	20.5%
\$98,041 and \$151,978	\$17,402	26%
\$151,979 and \$216,511	\$31,426	29%
\$216,512 and any amount	\$50,141	33%

4. SELECTED INDEXED AMOUNTS FOR PURPOSES OF COMPUTING INCOME TAX

Personal tax credits are a maximum of 15% of the following amounts:

	2020	2021
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is greater than or equal to the amount at which the 33% tax bracket begins	\$12,298	\$12,421
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is less than or equal to the amount at which the 29% tax bracket begins	13,229	13,808
Age amount if 65 or over in the year	7,637	7,713
Net income threshold for age amount	38,508	38,893
Canada employment amount	1,245	1,257
Disability amount	8,576	8,662
Canada caregiver amount for children under age 18	2,273	2,295
Canada caregiver amount for other infirm dependants age 18 or older (maximum amount)	7,276	7,348
Net income threshold for Canada caregiver amount	17,085	17,256
Adoption expense credit limit	16,563	16,729

Other indexed amounts are as follows:

	2020	2021
Medical expense tax credit — 3% of net income ceiling	\$2,397	\$2,421
Annual TFSA dollar limit	6,000	6,000
RRSP dollar limit	27,230	27,830
Lifetime capital gains exemption on qualified small business corporation shares	883,384	892,218

5. PRESCRIBED INTEREST RATES (base rates)

<u>Year</u>	<u>Jan. 1 – Mar. 31</u>	<u>Apr. 1 – June 30</u>	<u>July 1 – Sep. 30</u>	<u>Oct. 1 – Dec. 31</u>
2021	1	1		
2020	2	2	1	1
2019	2	2	2	2

This is the rate used for taxable benefits for employees and shareholders, low-interest loans, and other related-party transactions. The rate is 4 percentage points higher for late or deficient income tax payments and unremitted withholdings. The rate is 2 percentage points higher for tax refunds to taxpayers, with the exception of corporations, for which the base rate is used.

6. MAXIMUM CAPITAL COST ALLOWANCE RATES FOR SELECTED CLASSES

Class 1.....	4%	for all buildings except those below
Class 1.....	6%	for buildings acquired for first use after March 18, 2007 and $\geq 90\%$ of the square footage is used for non-residential activities
Class 1.....	10%	for buildings acquired for first use after March 18, 2007 and $\geq 90\%$ of the square footage is used for manufacturing and processing activities
Class 8.....	20%	
Class 10.....	30%	
Class 10.1.....	30%	
Class 12.....	100%	
Class 13.....	n/a	Straight line over original lease period plus one renewal period (minimum 5 years and maximum 40 years)
Class 14.....	n/a	Straight line over length of life of property
Class 14.1.....	5%	For property acquired after December 31, 2016
Class 17.....	8%	
Class 29.....	50%	Straight-line
Class 43.....	30%	
Class 44.....	25%	
Class 45.....	45%	
Class 50.....	55%	
Class 53.....	50%	
Class 54.....	30%	

The CPA certification program prepares future CPAs to meet the challenges that await them. For more information on the qualification process, the common final examination (CFE), and the specific education requirements for your jurisdiction, contact your provincial/regional CPA body.

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