CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

CFE CANDIDATE NUMBER:

Common Final Examination
May 29, 2024 – Day 2
(Booklet #1 – Case)

Total examination time: 5 hours.
Further details on the examination can be found on the next page.

GENERAL INSTRUCTIONS BEFORE THE EXAMINATION

1. Fill in your candidate number on the booklets. The examination booklets (or paper response, as instructed) must be submitted before leaving the examination writing centre. They must NOT BE REMOVED from the writing centre. If these items are not received, the response may not be accepted.
2. Follow the instructions provided. Instructions must not be removed from the writing centre.
3. Sign the Policy Statement and Agreement Regarding Examination Confidentiality below.

<u>Policy Statement and Agreement Regarding Examination Confidentiality</u>

I understand that all examination materials are the property of CPA Canada and are under the exclusive custody and control of CPA Canada. CPA Canada has the exclusive authority over examination materials to determine the content, use, retention, disposition and disclosure of this material. Candidates will not have access to their examination response, the examination marking keys or any other marking materials. The examination questions and marking guides will only be publicly available when published by CPA Canada.

I hereby agree that I will not:

- Obtain or use answers or information from, or give answers or information to, another candidate or person during the sitting of the examination;
- Refer to unauthorized material or use unauthorized equipment during the examination including but not limited to generative artificial intelligence and similar technologies (for example, ChatGPT, Grammarly, Chatbots, etc.); or
- Remove or attempt to remove any CPA Canada Examination materials, notes or any other items from the examination writing centre.

I further agree to report to the Regional/Provincial/Territorial Body any situations where there is a material risk of compromising the integrity of the examination.

I affirm that I have had the opportunity to read the *CPA Examination Regulations* and the *Policy on Academic Integrity and the Use of Artificial Intelligence* and I agree to all of their terms and conditions.

In addition, I understand that failure to comply with this Policy Statement and Agreement will result in the invalidation of my results, and may result in my disqualification from future examinations, expulsion from the profession and possible legal action.

______________________________ CANDIDATE NAME (Please print)

______________________________ SIGNATURE

Examination Details

The examination consists of:
Booklet #1 – Case (this booklet)
Booklet #2 – Rough notes

Candidates are allowed **five (5) hours** to respond.

The case should be answered using the examination software provided, which includes a word processor and spreadsheet for inputting your response. The main body of your response should be in the word processor file. Only supporting calculations should appear in the spreadsheet file, in **Sheet 1**. All financial tables in the case with ten lines or more have been preloaded into the spreadsheets that follow Sheet 1. Those spreadsheets are in read-only mode. You must copy and paste the financial information into your Sheet 1, where you can then do all your calculations. You are responsible for clearly explaining all your calculations.

Answers or part answers will not be evaluated if they are recorded on anything other than the examination software or, in the event of computer failure, the CPA Canada writing paper provide.

Rough-note paper is available in a separate booklet. Rough notes, and any other notations made in the examination booklets, will not be evaluated.

The CPA Canada Handbooks, the *Income Tax Act* and the *Excise Tax Act* are available in the examination software throughout the entire examination. These materials provides the standards in effect and tax laws substantively enacted as at December 31, 2023.

A tax shield formula and other relevant tax information are available at the end of this booklet.

Candidates are instructed to consider and respond to the examination questions as presented even though the circumstances described in the examination questions may not be reflective of the current environment.

Common Final Examination, 2024

Chartered Professional Accountants of Canada
277 Wellington Street West
Toronto, Ontario M5V 3H2

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.

INDEX

(CONTINUED ON PAGE 3)

BACKGROUND
COMMON INFORMATION FOR ALL ROLES

Fancy Luxury Jewellery Inc. (Fancy) sells and repairs both internally and externally designed and manufactured fine jewellery. Fancy's jewellery is unique, and often procured directly from the manufacturer. Fancy is a long-running family business, owned and managed by two brothers, Kenji and Daiki Okuda, Canadian residents who each own 50% of the shares.

Today, May 13, 2024, the company has 13 upscale retail stores throughout Canada. Fancy's head office and distribution centre (DC) are both in Toronto, and all the properties it occupies are leased. Fancy follows IFRS. Fancy has remained stable and profitable over the years by closing underperforming stores and opening new stores in growing areas. However, sales and profits have seen little growth recently, and both brothers believe Fancy can do better.

In early 2023, a new VP Marketing, Nyasia Yamin, was hired, bringing fresh ideas and extensive experience in the jewellery industry. Recently, Nyasia was appointed as a director on the Board of Directors, along with Fancy's CFO, Steven Lundstrom, who joined the company in early 2024, four months after the previous CFO left. The other two directors are Kenji, who is the CEO, and Daiki, who is the VP Operations.

Fancy has significant cash on hand, which has not been spent because the brothers have not yet decided on the new investments to pursue.

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

(CONTINUED ON PAGE 4)

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

ASSURANCE REQUIREMENTS

You, CPA, work as an audit senior at Quinton Lester Wright LLP (QLW), Fancy's external auditor. QLW has again been engaged to conduct the annual audit of the 2023 year-end financial statements and provide additional services. Kenji and Daiki have always obtained an audit in case of future lending needs, but as they do not have a current lender, they have agreed with QLW to have the audit completed in June.

George, the engagement manager, has asked you to discuss the financial reporting treatment of the warranty program, management terminations, and the cash and cash equivalents. He also wants you to assist Daiki with some tasks related to the introduction of a giftware line, privacy and data security, and the potential closure of a store. George also mentioned that Steven is looking at a new investment, and would like some advice from QLW on how to treat the investment for financial reporting purposes. George has asked you to ignore any independence and conflict of interest considerations at this stage, as he will discuss them with the audit partner before any deliverables are provided to the client.

George asks you to revise the draft preliminary audit plan that was completed in September 2023. He also wants you to recommend audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents.

In previous years, QLW has applied substantive procedures to test certain Fancy expense accounts. George would like you to discuss the benefits of applying data analytics procedures within the audit, and explain, for this year, which of these expense accounts QLW should consider performing data analytics procedures over.

George recently met with Daiki to discuss the inventory processes and systems used at Fancy. George asks you to discuss any control weaknesses identified, along with recommendations for improvement.

QLW has hired an expert to determine the valuation of Fancy's raw materials inventory as at December 31, 2023. George asks you to explain why using the work of an expert is appropriate, and provide additional procedures that QLW must perform in order to rely on the expert's report.

(CONTINUED ON PAGE 5)

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

ASSURANCE REQUIREMENTS (continued)

Daiki wants to source diamonds from a new supplier, but is concerned that they may not follow the "mine-to-market process," which guarantees that the diamonds are from a conflict-free area and are ethically sourced. George asks you to draft a memo to Daiki, explaining what procedures would be performed by an independent third party performing an engagement in accordance with CSAE 3531, *Direct Engagements to Report on Compliance*, to provide reasonable assurance that the supplier follows the mine-to-market process.

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

(CONTINUED ON PAGE 6)

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

FINANCE REQUIREMENTS

You, CPA, work as a financial analyst for Integra Consulting LLP, a consulting company, and report to Clara Zhang. Clara has asked you to discuss the financial reporting treatment of the warranty program, management terminations, and the cash and cash equivalents. She also wants you to assist Daiki with some tasks related to the introduction of a giftware line, privacy and data security, and the potential closure of a store.

Nyasia is working on a potential deal with a new spokesperson. Daiki asks you to assess whether the deal meets Fancy's return requirements, and calculate the maximum upfront amount that Fancy can pay while meeting its hurdle rate. He also asks you to discuss any qualitative considerations and provide a recommendation.

The owner of the building in which Fancy's DC is located has informed Fancy that they have received offers from other jewellers to acquire the building. The owner wants to sell the building for $3.1 million. Daiki asks you to recommend a price that Fancy could offer based on a quantitative analysis of the building's value.

Daiki wants Fancy to obtain financing to acquire the DC building. He wants you to analyze the available financing options and provide a recommendation.

Your Neighbourhood Jewellery Inc. (YNJ) is a distressed jewellery retail store located in an area where Fancy is looking to open a new store. Daiki wants to acquire YNJ and has asked you to determine an appropriate offer price, using an asset-based approach, for all outstanding shares of YNJ.

Fancy plans to buy 180 ounces of gold in 24 months. Steven would like you to discuss two hedging alternatives to secure the price of the gold, and provide a recommendation.

Steven believes Fancy is not using working capital efficiently as it keeps too much gold on hand. Fancy currently orders 500 ounces of gold at a time; Steven has identified an option to order 250 ounces of gold at a time. He asks you to assess the quantitative and qualitative considerations of these options, and provide a recommendation.

Fancy wants to invest any excess cash on hand. Daiki has asked you to determine Fancy's total investible funds, after considering Fancy's minimum cash requirements and the impact of the proposed projects, and discuss the investment options presented.

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

(CONTINUED ON PAGE 7)

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

PERFORMANCE MANAGEMENT REQUIREMENTS

You, CPA, work as a financial analyst for Fancy, and report to Daiki Okuda, VP Operations. Daiki has asked you to discuss the financial reporting treatment of the warranty program, management terminations, and the cash and cash equivalents. He also wants you to assist with some tasks related to the introduction of a giftware line, privacy and data security, and the potential closure of a store.

Fancy is considering offering a product line featuring lab-grown diamonds instead of mined diamonds. Daiki would like you to develop a price for the product line under two proposed pricing strategies. He asks you to provide a quantitative and qualitative analysis to determine which pricing strategy should be used.

He would also like you to analyze whether Fancy should offer lab-grown diamonds.

Fancy is also considering selling its products in a virtual store of its own. Daiki would like you to determine, from a quantitative standpoint only, whether it would be a good idea to sell some products online or whether it would be better to maintain the status quo.

The manager of the Toronto store is concerned that, since its reopening as a flagship store, the operating revenues and expenses allocated to the store are not in accordance with Fancy's policy. Daiki has asked you to review the store's financial results, and provide the necessary adjustments to comply with the policy. He also wants you to comment on the company's current allocation policy.

Daiki would like you to propose metrics for assessing sales employee performance, specifically in the areas in which they receive training, and prioritizing leading indicators. He also wants you to identify any potential drawbacks of relying on the metrics proposed.

Fancy is interested in using a diamond-tracking technology. Daiki asks you to comment on the benefits, and potential issues, related to the use of this technology.

Finally, Fancy's existing strategy is to maintain Fancy as a reputable brand, to sell exclusive, high-quality products at a wide range of price points, and to provide excellent customer service during and after each sale.

(CONTINUED ON PAGE 8)

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

PERFORMANCE MANAGEMENT REQUIREMENTS (continued)

Daiki is wondering how the decisions and initiatives mentioned above fit into this strategy, whether you believe that changes to this strategy are needed, and asks you to propose potential changes to the strategy going forward.

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

(CONTINUED ON PAGE 9)

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

TAXATION REQUIREMENTS

You, CPA, work as a tax specialist for Quinton Lester Wright LLP, in its tax consulting division. You report to the partner, Heena Prasad, who has asked you to discuss the financial reporting treatment of the warranty program, management terminations, and the cash and cash equivalents. She also wants you to assist Daiki with some tasks related to the introduction of a giftware line, privacy and data security, and the potential closure of a store.

Steven sent Heena an email, following up on a meeting you had last week to discuss his residency status for income tax purposes after his move to Canada last year. Steven knows he is late in filing his return, but Heena has asked you to focus only on determining his residency status for 2023.

Steven also has questions about a Notice of Reassessment for Fancy, some principles of the Canadian tax system, and Fancy's federal income tax instalment requirements.

Heena asks you to determine Fancy's federal income taxes payable for the year ended December 31, 2023, including an explanation of the adjustments you make, as well as the income tax treatment of the financial reporting issues.

Daiki has asked for assistance in preparing his 2023 personal income tax return. Daiki had a busy March and April, and has only just provided Heena with his tax documents. Heena asks you to calculate Daiki's federal income tax balance owing for the 2023 tax year, including any interest and penalties that may apply.

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

(CONTINUED ON PAGE 10)

APPENDIX I – COMMON
ADDITIONAL INFORMATION

Fancy targets high-income customers. For custom-designed jewellery made in-house, gemstones and metals are sourced from a limited number of suppliers. Gemstones (such as diamonds or rubies) vary significantly in price, based on size (carat weight), colour, clarity, and cut. Market prices of gemstones can vary by as much as 20% in any year.

The company is organized by regions, each with a regional manager who reports directly to Daiki. Regional and head office costs are allocated equally to each store. In-store salespeople are paid a fixed wage plus 6% commission on sales.

The jewellery industry has experienced increased competition from department stores, mass merchandisers, and e-commerce platforms, especially in the high-end giftware segment. It is common in the industry to provide a warranty for minor repairs or replacements for up to five years.

Furthermore, extended lifetime warranties in the industry are typically available for customers to purchase for 7% of the sale price, and warranty benefits are typically only claimed up to 15 years after the date of purchase.

(CONTINUED ON PAGE 11)

APPENDIX II – COMMON
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS

Fancy Luxury Jewellery Inc.
Statement of Financial Position
As at December 31
(in thousands of Canadian dollars)

	2023 Draft	2022 Audited
Assets		
Current assets:		
Cash and cash equivalents	$ 5,190	$ 3,120
Inventories	21,750	22,560
Prepaid expenses	1,080	1,120
Total current assets	28,020	26,800
Property, plant, and equipment – net	17,887	17,291
Right-of-use assets – net	26,435	29,795
Total assets	$ 72,342	$ 73,886
Liabilities		
Current liabilities:		
Trade payables	$ 11,955	$ 13,054
Accrued liabilities	2,020	2,510
Restructuring provision	1,098	0
Current portion – lease obligations	5,150	4,833
Total current liabilities	20,223	20,397
Lease obligations	18,940	24,239
Deferred tax liability	1,014	758
Total liabilities	40,177	45,394
Shareholders' equity		
Common shares	8,000	8,000
Retained earnings (Note 1)	24,165	20,492
Total shareholders' equity	32,165	28,492
Total liabilities and shareholders' equity	$ 72,342	$ 73,886

(CONTINUED ON PAGE 12)

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

Fancy Luxury Jewellery Inc.
Statement of Profit and Comprehensive Income
For the years ended December 31
(in thousands of Canadian dollars)

	2023 Draft	2022 Audited
Revenues	$ 88,550	$ 97,720
Cost of sales	48,075	57,180
Gross profit	40,475	40,540
Expenses:		
Selling, general, and administration	21,391	24,560
Depreciation (Note 2)	9,552	9,281
Restructuring costs	1,349	0
Total expenses	32,292	33,841
Operating income	8,183	6,699
Investment income	124	67
Interest – lease obligations	(2,018)	(2,344)
Loss on disposal of property, plant, and equipment	(1,120)	0
Income before taxes	5,169	4,422
Income taxes	1,396	1,142
Profit and comprehensive income	$ 3,773	$ 3,280

Notes (*in thousands of Canadian dollars*):

1. Fancy declared and paid dividends of $100 in 2023 (2022 – $0).
2. Includes depreciation of $3,360 (2022 – $3,460) for right-of-use assets.

(CONTINUED ON PAGE 13)

APPENDIX III – COMMON
SUMMARY OF DISCUSSIONS WITH STEVEN LUNDSTROM, CFO

Steven has not had time to resolve some 2023 financial reporting issues outstanding from the period when there was no CFO.

Warranty Program

In 2023, Fancy sold diamond jewellery totalling $8,660,000 under a new lifetime warranty program. The full $8,660,000 was recorded in revenue in 2023, and Steven is unsure if the initial revenue recognition considers the warranty appropriately.

Fancy started this warranty program in October 2023, whereby a lifetime product guarantee is included in every sale of diamond jewellery. In addition to covering any initial defects, the warranty states that Fancy will repair or replace any diamond that has been chipped, broken, or lost from its original setting during normal wear. The new warranty covers, at no cost to the customer, the replacement of the diamond and any labour and materials required to complete the repair.

Management Terminations

In November 2023, Fancy announced that it would eliminate all the assistant managers in its stores and reallocate their responsibilities between the store managers and regional managers. During December, Fancy notified employees whether they would be transferred to other positions within the company, or terminated and paid severance.

The following estimated costs were recorded as a restructuring provision liability as at December 31, 2023:

Cost	Amount
Severance pay for terminated employees	$ 560,000
Employee support services for retraining terminated employees	150,000
Moving costs for transferred employees	213,000
IT changes for accommodating the reallocation of responsibilities	175,000
Total	$ 1,098,000

These amounts were included in restructuring costs in 2023 and paid in February 2024. There were additional restructuring costs that were incurred and paid in 2023.

(CONTINUED ON PAGE 14)

APPENDIX III – COMMON (CONTINUED)
SUMMARY OF DISCUSSIONS WITH STEVEN LUNDSTROM, CFO

Cash and Cash Equivalents

During the year, Fancy made several new investments. Steven needs assistance in assessing whether the following accounts and investments can be classified as cash and cash equivalents on the financial statements. These accounts and investments are central to Fancy's cash management policies. Included in cash and cash equivalents as at December 31, 2023, are:

Description	Amount	Notes
Cash (bank overdraft)	$ (125,000)	The cash in the chequing account often fluctuated during the year between a positive and negative balance.
Guaranteed investment certificate	1,300,000	5.2%, issued September 10, 2023, and maturing March 10, 2024.
90-day term deposit	820,000	4.06%, maturing February 16, 2024.
Restricted cash	1,570,000	In November, a new diamond supplier required, in its contract, that Fancy hold cash in a demand deposit bank account as security for amounts payable to the supplier. Fancy has access to the cash but must always maintain a certain balance.
Money market funds	1,625,000	The funds are invested in high-credit-rated corporate and government bonds, with maturity dates of one to two years. The units are redeemable on demand; historically, annual returns have ranged between 2% and 7%.
Total	$5,190,000	

(CONTINUED ON PAGE 15)

APPENDIX IV – COMMON
MEMO FROM DAIKI OKUDA, VP OPERATIONS

To: CPA
From: Daiki Okuda, VP Operations

Giftware Line

One of our purchasing employees, Taylor, suggested we start selling high-end and unique giftware items, such as crystal vases, pens, and silverware. Only four stores have available capacity to add giftware items. Taylor prepared the following quantitative analysis, which is for the first year at the four stores in total. I would like you to critique and revise, as necessary. Please also provide a qualitative analysis and a recommendation on whether to go forward.

Revenue from giftware sales	$ 3,560,000	
Additional revenue from sale of products already in store	600,000	
Variable – Cost of sales	(2,704,000)	65% × revenue
Variable – Distribution and warehousing costs	(416,000)	10% × revenue
Contribution margin	$ 1,040,000	

Additional considerations:

- Each store would require $300,000 in leasehold improvements for new displays, which should last five years.
- Taylor could initially perform sourcing and purchasing for these products, which would represent 25% of his time. Taylor is currently paid $75,000 annually in salary and benefits.
- Taylor estimates that there would be $230,000 in annual travel costs, to source products and meet with suppliers.
- We would need to outsource distribution and warehousing of giftware, which would cost 10% of revenues, compared to our current cost of 4.3% of revenues.
- Total annual marketing costs for these new products are estimated to be $425,000, of which $75,000 would be a reallocation of our current marketing expenditures.

(CONTINUED ON PAGE 16)

APPENDIX IV – COMMON (CONTINUED)
MEMO FROM DAIKI OKUDA, VP OPERATIONS

Customer Data Collection

We implemented a new customer relationship management system in September 2023.

I would like you to analyze our privacy and data security practices, and describe what changes are necessary.

For every sale, we collect the following data in the system:
- Customer details: First and last name, address, phone number, email address, and birthdate.
- Sale details (for each customer sale): Store location, date, product sold, salesperson, specific ID code for diamond jewellery, amount paid, and description of the gemstone(s).

Information on each transaction is collected from the customer by the salesperson and entered in the point-of-sale computer, which has internet access. This information remains on the local hard drive for 60 days and is then deleted by the store manager. The information is uploaded nightly to the central database on the servers at head office.

Daily, the central database is backed up to the cloud on infrastructure owned by Fancy. Consistent with our past practices, the details of each customer's transaction are also printed and retained for seven years in a locked filing cabinet, with the store manager having the only key, at the store where the transaction occurred.

Any salesperson can create a new customer file and review, modify, or delete existing information. All directors and IT staff have access to the entire central database.

(CONTINUED ON PAGE 17)

APPENDIX IV – COMMON (CONTINUED)
MEMO FROM DAIKI OKUDA, VP OPERATIONS

Victoria Store

We periodically review operational results for each store. Attached are the 2023 results for the Victoria store (Victoria), which opened in 1998. Since 2021, sales have been declining annually. I would like you to perform a quantitative and qualitative analysis to determine whether we should close the store.

Victoria – Financial Results for 2023

Revenues	
Jewellery – externally purchased	$ 1,601,000
Jewellery – internally custom-designed	2,340,000
Repair services	1,678,000
Total revenues	5,619,000
Cost of goods sold	3,087,900
Gross profit	2,531,100
Selling and marketing	
In-store employee wages and benefits (excluding commissions)	324,500
Sales commissions	337,140
Distribution and warehousing costs	289,000
Local and regional marketing costs	214,000
Total selling and marketing	1,164,640
Depreciation and amortization	350,000
General and administration	
Maintenance, utilities, insurance, and property taxes	132,921
Store manager wages and benefits	81,463
IT support costs	115,000
Head office general and administration costs	210,800
Total general and administration	540,184
Total expenses	2,054,824
Operating income	$ 476,276

(CONTINUED ON PAGE 18)

APPENDIX IV – COMMON (CONTINUED)
MEMO FROM DAIKI OKUDA, VP OPERATIONS

Victoria – Additional Information

Distribution and warehousing costs are directly related to volume of product sales. 75% of the local and regional marketing costs are directly related to advertising for Victoria. The remaining 25% are costs allocated from head office.

IT support costs are allocated to the store based on actual time spent by IT personnel, and include extra overtime costs of $23,000 that had to be paid to IT employees for specific work at Victoria.

If Victoria is closed, all store employees would be laid off and paid severance equal to 20% of their total annual wages and benefits. The store manager would be moved to Toronto, and Fancy would cover $10,000 of their moving costs.

Annual lease payments are $420,000, and the lease expires in 2027. The store could easily and quickly be subleased to another business for $520,000 annually until the lease expires.

If Victoria is closed, 45% of all its revenues would go to our Vancouver store, which is four hours away. The remaining revenues would be lost to local competitors.

(CONTINUED ON PAGE 19)

(THIS PAGE INTENTIONALLY LEFT BLANK)

(CONTINUED ON PAGE 20)

ASSURANCE ROLE
ADDITIONAL INFORMATION

(CONTINUED ON PAGE 21)

APPENDIX V – ASSURANCE
ADDITIONAL INFORMATION

New Investment

Fancy is considering investing in a bond issued by Karat Co. (Karat), a company operating in the gold industry. Karat plans to issue a bond at a face value of $950,000 on June 1, 2024. Fancy has the choice between two bonds, both of which mature in three years and pay interest semi-annually. Steven has asked for your advice on the appropriate financial reporting treatment for each alternative, including the financial statement impact. Fancy plans to hold the bond until maturity.

<u>Alternative 1 – Bond with fixed interest rate</u>

Fancy will invest in a bond for $950,000 and receive fixed interest, at an annual rate of 12%.

<u>Alternative 2 – Bond with interest income tied to the market price of gold</u>

Fancy will invest in a bond for $950,000 and receive interest determined by a formula that uses the prevailing spot price of gold at the date of each interest payment.

Draft Preliminary Audit Plan – Completed in September

In conducting the preliminary audit planning, the auditor did not identify any risks of material misstatement at the overall financial statement level. Assertion-level risks of material misstatement will be assessed separately for each material account balance.

The following points were considered and documented in the audit file:
- Fancy has been an audit client of QLW's for 10 years.
- Fancy is a privately-owned company.
- Fancy is a long-running family business and is well established.

Planning materiality was determined to be $425,000, based on 5% of Fancy's projected year-end operating income, and performance materiality was set at $318,750.

The audit team will take a combined approach in conducting the audit, placing reliance on controls over inventory, revenue, trade payables, and property, plant, and equipment.

(CONTINUED ON PAGE 22)

APPENDIX V – ASSURANCE (CONTINUED)
ADDITIONAL INFORMATION

Procedures over Expenses – Prior Year

In previous years, QLW applied substantive procedures to test certain expenses at Fancy. The following outlines the approach taken for individual expense accounts in the prior-year audit.

- Employee wages:
  - The audit team selected all employees who have a salary in the top 20% of the company, and selected a statistical sample of six for the remaining salaried employees. For each employee sampled, procedures were performed to validate that the payroll expenses were accurate.
  - Additionally, a statistical sample of hourly employee payments was selected by the audit team, to verify that the hours worked and wages paid were accurate.
- Employee benefits:
  - The audit team performed a substantive analytical procedure, creating an expectation based on the benefits offered by Fancy to employees. The analytic resulted in a significant difference higher than expected, so the audit team selected a sample of 10 items to review.
- Sales commissions:
  - The audit team performed a substantive analytical procedure, creating an expectation based on sales revenue. The sales commissions per the financial statements were within a reasonable range of the expectation created.
- Travel expenses (meals, accommodations, transportation):
  - The audit team selected a statistical sample of 17 expense reports for employees who travelled throughout the year. In four instances, the employee was reimbursed for an amount higher than the supporting receipts.

Fancy has several IT applications that track data, including an electronic time entry system, and a human resources management system that includes employee wages and benefits information, sales records, and expense report details.

(CONTINUED ON PAGE 23)

APPENDIX V – ASSURANCE (CONTINUED)
ADDITIONAL INFORMATION

Inventory Processes and Systems

Inventory purchasing and receiving

Raw materials used for making custom jewellery, as well as ready-to-wear items, are purchased by buyers at head office, who are responsible for managing supplier relationships. Buyers have the discretion to make their own purchasing decisions, and do not require input or approval from the inventory manager prior to submitting an order.

The purchasing process starts when a Fancy buyer contacts a supplier and provides a "wish list" that the buyer has developed. The wish list is submitted to suppliers with a Fancy order number, assigned sequentially. When suppliers receive a wish list, they prepare an invoice for all items on the wish list and send the invoice to Fancy the next business day. Invoices are provided to the accounts payable clerk, who immediately processes the invoice and prints, signs, and mails a cheque for the full amount.

All raw materials and ready-to-wear items are shipped by suppliers to Fancy's distribution centre (DC). Raw materials can take anywhere from two to four months to arrive, whereas ready-to-wear items arrive in one to two months. When inventory arrives, a warehouse clerk puts away the inventory at the DC. At the end of the week, received items are entered into the DC inventory system by a warehouse clerk, based on the packing slips included in the shipments received during that week.

When a store requires ready-to-wear items or raw materials to create jewellery, the store manager emails the buyer associated with the relevant supplier. The buyer then calls a warehouse clerk at the DC, requesting a shipment of inventory to a particular store. Shipments have mistakenly been sent to the buyer directly or to the wrong store.

Inventory systems

Fancy has three separate inventory systems: one for the DC, and one for each of raw materials and ready-to-wear items held at stores. No inventory system manages internally-designed custom jewellery, as it is produced on demand. Buyers do not have access to any of the inventory systems, and stores cannot see inventory information outside of their specific store.

(CONTINUED ON PAGE 24)

APPENDIX V – ASSURANCE (CONTINUED)
ADDITIONAL INFORMATION

Valuation of Raw Materials

QLW attended Fancy's year-end inventory count on December 31, 2023. This year, QLW contracted a new expert to assist in valuing Fancy's raw materials inventory as at December 31, 2023. The final report was provided on March 22, 2024. Excerpts from the report are as follows.

Scope of work

- Inquired with Fancy's management on the method for determining the fair value of raw materials.
- For metals (gold, silver, platinum, etc.), physically inspected the quality of the metals on hand and determined the appropriate fair value of the metals, based on market research and prices of the commodities.
- For gemstones (diamonds, rubies, etc.), physically observed the clarity, cut, colour, and other features of the gemstones, compared to the points noted on the authenticity papers, and determined the appropriate fair value of the gemstones, based on market research.
- All documentation supporting the expert's valuation, including calculations and assumptions, are included in the report.

Qualifications of the valuator

Mr. William Livingston has over 20 years of experience as a valuator. He is a Qualified Asset Appraiser, which is an accredited qualification and requires passing a national exam, along with ongoing professional development. He also holds a certification from Gemological Science International (GSI), which is the most respected diamond grading agency. The majority of Mr. Livingston's clients are in the fine jewellery industry.

Results

Mr. Livingston concluded on the following fair values:

Raw materials – gemstones	$4,428,000
Raw materials – metals	1,722,000
Total value	$6,150,000

Disclaimer

The valuator does not have any stake, directly or indirectly, in Fancy.

(CONTINUED ON PAGE 25)

APPENDIX V – ASSURANCE (CONTINUED)
ADDITIONAL INFORMATION

Mine-to-Market Process

A new supplier, Symmetry Diamond Co. (Symmetry), recently entered the market and approached Daiki about supplying diamonds to Fancy. Symmetry mines and processes diamonds, for sale to jewellery brands and wholesalers. Fancy only sources diamonds from suppliers that follow the mine-to-market process. The mine-to-market process tracks diamonds to guarantee they are from a conflict-free area and are ethically sourced.

The process outlines five criteria that must be met:

1. Participants must appoint an official coordinator to oversee the mining practices of the organization. The official coordinator must hold a certification from the Institute of Mining of the country where the mine is located.
2. Participants must ensure that all of their diamond mines are licensed, and that all individuals mining the diamonds are licensed.
3. A digital certificate must be created for each diamond mined, which includes information on the mine site, date of extraction, weight of the diamond, and name of the miner.
4. Miners must be provided with fair pay and safe working conditions. This includes the official coordinator completing a monthly health and safety inspection and maintaining an up-to-date health and safety bulletin board, with information provided by the relevant Institute of Mining.
5. When exporting diamonds from their country of origin, the official coordinator must provide a declaration indicating that the diamonds are from a conflict-free area.

(CONTINUED ON PAGE 26)

FINANCE ROLE
ADDITIONAL INFORMATION

(CONTINUED ON PAGE 27)

APPENDIX V – FINANCE
ADDITIONAL INFORMATION

Fancy uses a hurdle rate of 10% when assessing working capital and making capital budgeting decisions. Fancy's tax rate is 27%.

Proposed Spokesperson Deal

Fancy is working on a sponsorship deal with Justine Casey, a well-known Canadian actress, whereby Justine will be the face of Fancy on its promotional materials for five years, commencing January 1, 2025. Justine is popular with Fancy's target market; her recent engagement and wedding were heavily publicized. Photos and videos of her wedding still trend on social media. Justine starred in the 2022 movie of the year but has not been in any award-winning movies since. Her husband, Sam, is an up-and-coming actor who is rumoured to have had issues with the law. Sam proposed to Justine with an engagement ring from Fancy. The couple resides in Vancouver but have expressed interest, on social media, in moving to Italy. Justine wants an upfront payment of $5 million plus annual payments of $2 million.

Revenues without the deal are expected to increase by 2.5% annually over the next five years, with the gross margin ratio remaining at current levels.

Market research shows that these types of deals result in additional revenue growth of 2% annually. With this increase, Fancy can negotiate more favourable prices with suppliers, resulting in a one percentage point improvement to its gross margin ratio.

If Fancy reaches a deal with Justine, Fancy will publish ads in the top bridal magazines at an annual cost of $300,000. Fancy will also purchase ads on social media platforms. Fancy expects to purchase 600,000 social media impressions in the first year, increasing by 10% each year. The average click rate is 5% of impressions. The average cost is $0.25 per impression and $1.00 per click. Costs per impressions and clicks are expected to remain at current levels for the next five years.

If this marketing strategy does not generate at least 35,000 annual clicks, Justine will pay Fancy a claw-back for any shortfall at a rate of $10 per click. If there are more than 35,000 annual clicks, Fancy will pay Justine a bonus at the same rate.

All cash flows, except for the upfront payment, occur evenly throughout the year.

(CONTINUED ON PAGE 28)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Distribution Centre (DC) Building Acquisition

If the owner wishes to sell the building or receives offers for it, they must inform Fancy, who has the right to make an offer to acquire it. The owner can choose to accept Fancy's offer or a third-party offer. Fancy does not have the right to make a counter-offer.

Fancy's lease payments are $350,000 annually. The owner of the building incurred the following operating costs in 2023 related to the building:

Property taxes	$50,000
Energy	$40,000
Insurance	$30,000
Mortgage interest	$15,000

Energy prices are expected to increase by 50% in 2024, and remain at that level.

The building is located on 450,000 square feet of land, with building floor space of 60,000 square feet. Fancy owns all equipment in the building and is the sole occupant. The building is 36 years old and has never been renovated. The average life span of similar buildings is 25 years. The cost to renovate a building is $100,000 for each year that the age of a building exceeds this average life span.

Sharon, a real estate valuations expert, informed Fancy that similar, but fully renovated, buildings sell for 12 times annual leasing operating income. Sharon has provided information on two recent sales, which should both be considered in your analysis:

	Comparable Building A	**Comparable Building B**
Square footage of land	55,000	375,000
Square footage of building	30,000	45,000
Building age	18 years	23 years
Fair market values		
Land	$ 130,000	$1,650,000
Building	1,100,000	1,630,000
Equipment	100,000	90,000
Total	**$1,330,000**	**$3,370,000**

The optimal land-to-building ratio is approximately 2:1 for similar buildings. Excess land can be subdivided and sold to developers for $5 per square foot.

(CONTINUED ON PAGE 29)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

DC Building Acquisition Financing

Olufsen Bank is willing to extend a commercial mortgage for up to 60% of the purchase price at an interest rate of prime plus 2%, which resets quarterly. This commercial mortgage requires blended monthly payments, at the end of each month, amortized over a 10-year term. Prime is currently 6.5%, and the DC would be pledged as collateral.

OuiFund Ltd. has offered a 10-year unsecured debenture for up to 100% of the purchase price, provided the maximum total debt-to-equity covenant is met. The debenture carries an 11% interest rate, with annual interest-only payments until maturity, at which point the outstanding principal must be repaid. The debenture has a maximum total debt-to-equity covenant of 1.4, which is assessed annually. The debenture is open and can be repaid at any time, in part or in full, without penalty.

The current yield on long-term government bonds is 6%.

Financial Information for YNJ Acquisition

<u>Accounts receivable</u>

Aging	Amount	% Collectable (Note 1)
< 30 days	$ 1,600,000	95%
30 to 60 days	$ 725,000	70%
61 to 90 days	$ 260,000	70%
> 90 days	$ 80,000	40%

Note 1: Assessed based on discussions with YNJ’s management.

(CONTINUED ON PAGE 30)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Financial Information for YNJ Acquisition (continued)

Inventory

YNJ is currently liquidating their finished goods. At the acquisition date, YNJ expects to have the following raw materials on hand:

Item	Units on Hand	Average Price
Gold	130 ounces	US$2,200 per ounce
Diamonds	450 carats	CA$1,780 per carat
Other gemstones	2,330 carats	CA$250 per carat

Daiki mentioned that 40% of the other gemstones are damaged and will not meet Fancy's quality standards. They will be liquidated at 20% of their market value.

The exchange rate today is CAD 1.30 = USD 1.00.

Lease

YNJ recently entered into a 10-year lease. Lease payments are $300,000 per annum, paid at the beginning of the year, with annual increases of 2%. Similar nearby locations are being leased to other parties for $350,000, with an annual increase of 4%. At the acquisition date, there will be nine years left on the lease.

Non-capital losses

YNJ has $10 million in non-capital loss carryforwards. Your firm's tax group confirmed that $5 million of tax losses could be used in each of the two years after purchasing YNJ.

Other assets and liabilities

There are no other current assets, and fixed assets have a fair value of $0. YNJ has current liabilities of $2.6 million and long-term liabilities of $3.0 million.

(CONTINUED ON PAGE 31)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Gold Purchase Hedge

Fancy has identified two hedging alternatives for securing the price of gold in 24 months.

Gold-backed zero-coupon bonds

Purity Co. (Purity), a U.S.-based private exploration and development company, is looking to raise US$50 million through a debt issuance, which will be used to open a gold mine in Africa. If successful, this would be Purity's first operational mine.

The bonds have a term of 24 months with no coupon payments, and are not transferrable, redeemable, or retractable. If Fancy purchases bonds with a total face value of US$350,000, it will receive 180 ounces of gold at maturity if the gold mine is operational. Otherwise, Purity will repay Fancy the face value plus a 20% return at maturity.

Gold futures contracts

Fancy could purchase 180 futures contracts, which mature in 24 months. These contracts trade at US$50 per contract, with a delivery price of US$2,100 per ounce of gold.

The spot price of gold is US$2,200 per ounce. Economic forecasts show the following expected gold price in 24 months:

Price per Ounce	Probability
US$2,100	20%
US$2,350	30%
US$2,600	50%

The exchange rate today is CAD 1.30 = USD 1.00.

(CONTINUED ON PAGE 32)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Gold Inventory

Fancy keeps gold on hand to meet its production requirements. In 2023, Fancy's average daily gold inventory was 600 ounces, and Fancy placed eight orders (of 500 ounces each) for gold. By reducing its order size to 250 ounces, Steven believes that Fancy's average daily gold inventory will decrease to 400 ounces. However, Fancy would need to double the number of orders placed.

Fancy currently sources its gold from a mine in Nevada, which is 3,750 km from Fancy's DC. It typically takes one week for shipments to arrive at Fancy's DC. The gold ships by ground transport, at an average cost of $5 per km, including insurance.

The Nevada mine does not accept gold orders of less than 500 ounces. Steven has identified an option to order 250 ounces of gold at a time from an overseas mine that has just begun operations, and has recently accepted many new customers. The gold will be transported by truck to the airport and air freighted to Fancy. The total transportation cost is $15,000 per order plus insurance of $20,000 per order. Steven heard a rumour that insurance costs are expected to increase substantially due to incidents of theft on the road between the mine and the airport, as well as increased claims for high-value packages lost by the air transport company. It typically takes one week for shipments to arrive, but delays can occur due to weather conditions.

It costs Fancy $18 to store an ounce of gold each month. This includes monthly insurance and warehousing costs.

(CONTINUED ON PAGE 33)

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Excess Cash

Daiki and Kenji will each invest cash of $1.5 million in Fancy.

Fancy's optimal working capital ratio is 1.75 and the board requires the company to hold a minimum cash balance of $400,000 to meet short-term financing needs. Working capital includes all current assets, net of trade payables and accrued liabilities. Investments are excluded from working capital.

Daiki and Kenji drive electric vehicles (EV) and want Fancy to invest in this industry. Fancy is considering two investment options:

		Returns			
Security	**Stock Exchange**	**5-Year Average**	**Worst Year**	**Best Year**	**Beta**
EV Co.	Canadian	20%	-25%	60%	1.75
EV exchange-traded fund (ETF)	U.S.	10%	-15%	20%	0.95

EV Co. has been in operation for three years and gained popularity due to its unique vehicle design and superior battery range. However, EV Co.'s vehicles are known to have quality issues and the company has a substantial number of manufacturing plants in politically unstable countries.

The EV ETF has investments in 10 different EV companies, including manufacturers, battery suppliers, and lithium mining companies.

(CONTINUED ON PAGE 34)

PERFORMANCE MANAGEMENT ROLE ADDITIONAL INFORMATION

(CONTINUED ON PAGE 35)

APPENDIX V – PERFORMANCE MANAGEMENT ADDITIONAL INFORMATION

Company and Industry Information

Annual revenue growth in Canada's jewellery industry is expected to be negative 0.6%. Some companies have responded to lower volumes by targeting customers seeking high-end products, which have better margins, with a focus on quality and brand reputation, while others have employed a low-price approach to drive up sales volumes. Some companies have created multiple brands to attract customers at varying price points.

Fancy currently has no e-commerce capability as, historically, it was assumed that customers seeking high-end products preferred trying on the jewellery in person before buying. Sales are highly seasonal, with the fourth quarter (holiday shopping) representing 40% of all sales. 55% of Fancy's jewellery sales are in-house designs, primarily for custom bridal orders. Online jewellery stores have recently seen a large increase in their popularity. These stores have the advantage of lower overhead, and can therefore offer equivalent jewellery at lower prices and still maintain their profitability.

Fancy, like others in the industry, sends customer satisfaction surveys in after-sales emails. These surveys are typically completed by 20% of customers. Online reviews are monitored by management but not associated with individual salespersons. A mystery shopper regularly visits each location and collects information about the store and employees.

The environmental and social impact of mined diamonds is a growing concern for consumers, including the possibility of contributing to armed conflict by purchasing mined diamonds. Diamonds that come with certificates of origin and are from conflict-free zones therefore fetch higher prices. There is also a concern about the environmental impact of mined diamonds. Some companies have responded by introducing lab-grown diamonds, reducing the potential for negative environmental or social consequences.

DeWines Diamonds (DeWines) controls over 35% of rough diamonds, and their supply can influence global prices. The DeWines supply has no impact on global diamond prices when they release 33 million carats; however, every subsequent million carats in either direction influences prices by +/- 10%.

(CONTINUED ON PAGE 36)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Grading and Pricing of Diamonds

Diamonds graded by reputable third parties fetch higher prices. For example, the Gemological Science International (GSI) laboratory is considered the best diamond grader in the industry, and diamonds graded by GSI typically fetch the highest price, followed by Gemological Institute of America (GIA)-graded diamonds, at about 95% of the GSI price. GSI does not currently grade lab-grown diamonds, but it may do so in the future.

The price of diamonds is influenced by four characteristics: cut, colour, clarity, and carat . A benchmark price, published annually, assumes that all diamonds are cut equally, and is based on 1-carat weights. Colour grades range from D to Z, while clarity grades range from 1 to 7. The current benchmark price for a GSI graded 1 carat, D colour diamond, with a clarity score of 1 (D1), is $22,888.

The following grades have corresponding discounts from the D1 benchmark price:

Colour/Clarity Grade	Discount
D1	0%
E2	42%
F2	55%
G3	61%

(CONTINUED ON PAGE 37)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Lab-grown Diamonds

Background

The diamond industry has recently seen a surge in lab-grown diamonds. These diamonds are created in a lab to replicate the natural processes that create diamonds. The resulting diamonds are chemically, physically, and optically the same as mined diamonds.

Consumers currently attribute less value to lab-grown diamonds than to mined diamonds. Despite this, demand for lab-grown diamonds continues to grow. Customers are attracted to the idea of getting a bigger diamond for the same amount of money, and appreciate the lower environmental and social footprint of lab-grown diamonds. Jewellery businesses appreciate the stable costs of lab-grown diamonds as compared to mined diamonds.

In response to growing demand for lab-grown diamonds, suppliers of mined diamonds have increased their supply, to deflate prices and stave off competition. For example, DeWines is projecting to release 36 million carats of mined diamonds in the coming year.

Fancy's Lab-grown Line

Given Fancy's reputation, Fancy has selected high quality lab-grown diamonds to be featured in its engagement rings. These E2 diamonds are graded by GIA.

Pricing

Fancy is considering using one of two pricing strategies for its lab-grown line of rings.

The first method is a cost-based approach. Most jewellery businesses use this approach, and mark up their costs by 30% for all their diamonds. The cost of a lab-grown 1 carat, E2 diamond is currently $6,500.

Fancy is also considering a demand-based strategy, in which it would price its lab-grown rings at 60% of the price of a similar ring featuring a mined diamond of comparable quality.

For most rings, the cost of the diamond represents the most significant cost. The other costs amount to, on average, $1,300, and are the same for both lab-grown and mined diamond rings.

(CONTINUED ON PAGE 38)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Virtual Store

Fancy is considering developing its online presence with the creation of a virtual store for engagement rings, where customers can virtually “try on” and “customize” their rings with specific selections from a menu. If successful, Fancy plans to expand the virtual store’s offering to other items, without changing its existing physical locations.

Market research has indicated that Fancy will be able to sell 2,700 rings per year in this virtual store, including 500 that would be from customers who would have otherwise purchased the rings in a Fancystore.

Fancy plans to sell these rings for $3,150, which is 15% less than the in-store price. Production costs for the rings are the same, wherever the ring is sold. The diamond in these rings has a weight of 0.3 carat.

Additional considerations:

- A third party has already built the structure of the virtual store into Fancy’s website, for an amount of $400,000.
- Custom software would scan a customer’s hand using an uploaded video and provide a ring design, based on the customer’s specifications. This software can design an unlimited number of rings, and would cost Fancy $35,000 for a one-year subscription.
- The diamonds used in the rings sold online would cost $1,200. The other costs of producing the rings are equivalent to the average ring sold in stores.
- To create rings at the sales volume forecasted for the virtual store, six jewellers, at a salary of $90,000 each, would be required. Since there will be a decrease of in-store sales, one of them could be transferred from an existing location.
- Manufacturing overhead is $120,000, regardless of how many rings are sold online or in-store. Facility overhead (rent and utilities) is estimated at 4% of the selling price.
- Shipping costs are $127 per ring, and are paid by the customer. Warehousing, packaging, and distribution are handled by Fancy warehouse staff.
- One full-time employee would be appointed from head office to manage the virtual store. Their salary of $80,000 is not included in the costs above. The regional manager of the Toronto store, who earns $150,000 per year, would also be involved in the development of the virtual store.
- Fancy would need one less salesperson in-store. Sales staff earn $87,500 plus commission.

(CONTINUED ON PAGE 39)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Flagship Store

To attract and retain wealthy customers, Fancy has invested in a flagship store in downtown Toronto by renovating an existing location. The reopened location now includes a Bridal Bar, Concierge Service, and Fancy Lounge. The primary purpose of the flagship store is to generate exposure and prestige for the Fancy brand, which will allow Fancy to raise prices and increase its margins.

Many customers who visit the flagship store are referred by other locations. For example, out-of-town customers are referred to the bridal bar for fittings and VIP treatment while picking out rings and other jewellery. Fancy’s policy is to record sales at the location of first contact, as this is believed to encourage referrals of new customers. 50% of visits to the bridal bar were initiated at another location. Under the policy, the distribution costs of any jewellery purchased in the Toronto location are allocated to the store having initiated the sale. The policy also states that the wages and benefits related to the bridal bar are allocated to the Toronto flagship store.

The following sales and costs relating to the bridal bar were incurred in 2023:

Item	Amount
Sales	$ 1,150,500
Cost of goods sold	$ 563,745
Wages and benefits	$ 389,500
Sales commissions	$ 69,030
Distribution and warehousing costs	$ 98,943

The sales, cost of goods sold, and sales commissions related to the bridal bar were recorded at the store that initiated the sale. Wages and benefits, and distribution and warehousing costs were recorded at the Toronto location.

The concierge service helps customers create custom jewellery. It typically directs customers to have their order completed at the flagship store, although some customers are referred to other locations. Of the $409,000 of sales directed to other locations by the concierge service, all were recorded by the other locations. All costs (other than commissions) associated with these sales were recorded by the Toronto store.

(CONTINUED ON PAGE 40)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Flagship Store (continued)

The Fancy Lounge contains a bar and event space. The lounge serves as a venue for events, including the launch of Fancy's latest product line and the filming of a recent celebrity endorsement. The costs associated with these events totalled $2.7 million, and were recorded under the flagship store's promotion expenses.

Last year, the IT department estimated that one-third of the support time provided to the store was related to product launches. Personnel from head office are regularly seen attending or assisting with events occurring at the flagship store.

Head office expenses are allocated equally across all locations; however, non-flagship location managers believe that an allocation based on revenues would be fairer. Employee bonus pools are based on operating income at each respective location.

(CONTINUED ON PAGE 41)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Flagship Store Operating Income

	2023
Revenues	$ 18,885,000
Cost of goods sold	9,984,600
Gross profit	8,900,400
Selling and marketing	
In-store employee wages and benefits (excluding commissions)	973,500
Sales commissions	1,147,860
Distribution and warehousing costs	867,000
Local and regional marketing costs	642,000
Promotions, events, and sponsorships	3,900,000
Total selling and marketing	7,530,360
Depreciation and amortization	1,050,000
General and administration	
Maintenance, utilities, insurance, and property taxes	398,763
Store manager wages and benefits	244,389
IT support costs	345,000
Head office general and administration costs	210,800
Regional general and administration costs	206,300
Total general and administration	1,405,252
Total expenses	9,985,612
Operating loss	$ (1,085,212)

(CONTINUED ON PAGE 42)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED) ADDITIONAL INFORMATION

Fancy Sales Training

Employee training is provided in three areas: customer service, selling skills, and product knowledge. These areas have been targeted in order to uphold Fancy's reputation for trust, quality craftsmanship, and excellent customer service.

Customer service

Employees are trained to greet every customer within the first minute of entering the store. Staff are given training on how to engage customers in friendly conversation without getting too personal. After a sale, employees are instructed to call customers within two weeks, and at the one-year anniversary, to remind customers about Fancy's cleaning and repair service.

Selling skills

Due to the range of prices for Fancy's products, the number of individual sales generated is less important than the total value of sales. Employees are taught how to upsell specific add-ons, such as insurance and jewellery that compliments the main product. All sales are logged into the customers' files but are not currently tied to specific sales staff.

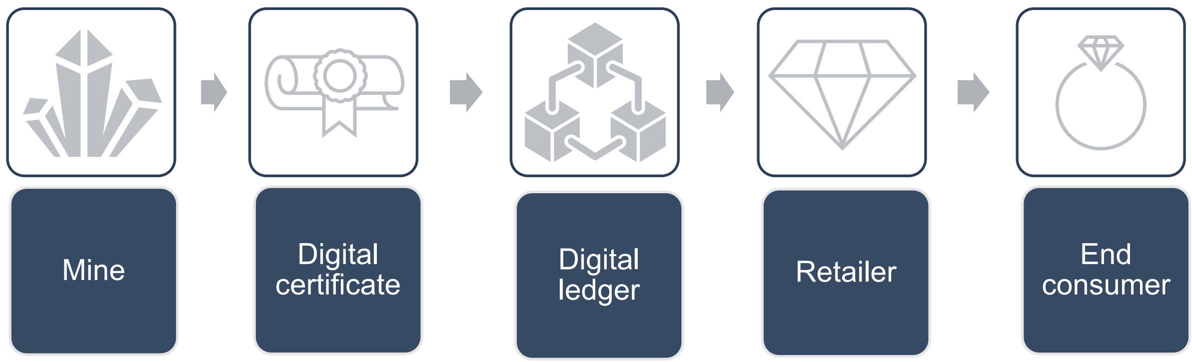
Product knowledge

Employees receive extensive training on the characteristics of precious metals and gemstones, as product knowledge is a key factor in generating sales and differentiating Fancy from its competitors. For example, Fancy sales staff are trained to be able to identify the correct grade of diamonds, and on the various gemstone certifications. They are expected to keep informed of the latest updates. Each employee must pass a product knowledge test at the end of their initial training.

(CONTINUED ON PAGE 43)

APPENDIX V – PERFORMANCE MANAGEMENT (CONTINUED)
ADDITIONAL INFORMATION

Proposed Diamond Tracking Technology



The proposed diamond tracking system uses blockchain technology. At the mine, a digital certificate for each diamond is created by the miner. This certificate is registered with the technology provider, and includes information about the date and location mined.

Whenever a transaction occurs along the supply chain, the digital certificate is transferred to the new owner. Each new transaction is recorded in a digital ledger, along with details such as the cut, weight, and colour. The ledger's encryption ensures that the transaction data cannot be modified or deleted. Each transaction is recorded within this digital ledger, and linked to the previous entry with a timestamp. This creates a chain of individual transactions that can be traced back to the diamond's source.

At the time of each sale, it is the responsibility of the owner to transfer the digital certificate to the purchaser. Creation of the digital certificates, and access to the digital ledger, can be made with any device connected to the internet.

At any stage, only the party who physically holds the diamonds will be able to consult its history and add a transaction to it. All parties wishing to create digital certificates or add a transaction to the ledger will need to have their identify verified with the technology provider.

A customer portal is provided for retailers by the technology provider. It allows them to transfer certificates to end consumers, and end consumers may use the portal to track shipments, request grading, and even offer their jewellery for resale. End consumers may transfer their digital certificate to other end consumers on the portal if both parties are verified with the technology provider.

(CONTINUED ON PAGE 44)

TAXATION ROLE
ADDITIONAL INFORMATION

(CONTINUED ON PAGE 45)

APPENDIX V – TAXATION
ADDITIONAL INFORMATION

Email from Steven Lundstrom, CFO

To: CPA
From: Heena Prasad
Subject: Fwd: Canadian Personal Taxes & Fancy Notice of Reassessment

CPA, see Steven's email below. We will calculate the instalment amounts once the tax return has been reviewed and filed, so you should only explain the instalment process to Steven for now, in addition to answering his other questions.

Heena

---------- Forwarded message ----------

To: Heena Prasad
From: Steven Lundstrom
Subject: Canadian Personal Taxes & Fancy Notice of Reassessment

Hi Heena,

I've summarized the items we discussed last week and provided additional details here.

<u>Residency</u>

I moved to Canada from Australia on July 15, 2023, along with my spouse and 12-year-old son.

I originally visited Canada on March 1, 2023, to interview with another company in the industry, and stayed for 12 days at that time. My spouse and I travelled to Canada on May 17, 2023, for 10 days, to explore the real estate market, and ultimately rented a furnished townhouse to live in. I worked for the other company from July 15 to November 19, 2023, at which point I interviewed with Fancy, and started working here on January 2, 2024.

My 16-year-old daughter stayed behind in Australia because she is attending a private boarding school and intends to pursue post-secondary education there. Our extended family resides in Australia, so she plans to stay with them on school holidays, and we will see her this summer when we visit our vacation property in Australia. We maintain our yacht club memberships in Australia near that property, so we can use their facilities when we visit.

(CONTINUED ON PAGE 46)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Email from Steven Lundstrom, CFO (continued)

My spouse, son, and I have permanent resident status in Canada, and we are covered under provincial health insurance in Ontario. Since moving here in July, I have obtained a Canadian bank account and Canadian credit cards, and we have joined a social club in the city. We have not purchased a vehicle yet because our preferred choice is not yet in stock, so we have been relying on public transit and car-sharing services to date.

I hold a Chartered Accountant designation from the Chartered Accountants Australia and New Zealand, and I am continuing to pay my annual dues and abide by their continuing professional development rules while I apply for CPA reciprocity in Canada.

<u>Notice of Reassessment</u>

A Notice of Reassessment arrived in the mail today for Fancy's December 31, 2021, taxation year. The Notice is dated May 1, 2024, and the Canada Revenue Agency (CRA) has reduced our CCA claim on the basis that we were not entitled to the immediate expensing of eligible property because an associated corporation, Montaigne Bakery Ltd. (Montaigne), had used the entire $1.5 million limit.

We've already disposed of most of our income tax documentation from the 2021 taxation year; wouldn't the CRA have missed their opportunity to reassess 2021? In any case, we will be proceeding with an objection. Therefore, I'd like to understand the objection process, and what our options are if the objection is unsuccessful.

I understand that these immediate expensing rules were a recent development. Can you explain to me how the CRA develops new tax laws and brings them into force?

Lastly, Kenji was reviewing our cash budget and noticed that we have not made any income tax instalments yet for 2024. Can you describe the CRA's corporate income tax instalment requirements?

Thanks,
Steven

(CONTINUED ON PAGE 47)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Information on Montaigne Provided by Heena

Fancy is a private corporation, and is associated with Montaigne because Kenji controls Montaigne. Montaigne was assigned the full $1.5 million immediate expensing limit in 2022 and 2023, but in 2021, the limit was assigned to Fancy.

Montaigne earns all its income from active business activities and is not assigned any portion of the business limit. Montaigne employed taxable capital in Canada of $7.1 million in 2023, and $6.5 million in 2022. Fancy is not associated with any other corporations.

Property, Plant, and Equipment for Fancy

As at December 31, 2022, Fancy's UCC balances were:

Class	UCC
8	$ 4,070,000
13	$ 10,650,000
50	$ 486,000

CCA on pre-2023 leasehold improvements for the December 31, 2023, taxation year has been calculated to be $3.05 million. Fancy did not terminate or commence any new leases during 2023.

During 2023, the Vancouver and Montreal stores were renovated, which included $5.60 million of leasehold improvements and $2.49 million of new fixtures for the stores. The leases for these stores have 10 years remaining on them, and no renewal options.

Dispositions in 2023 were as follows:

Asset	Original Cost	Proceeds of Disposition
Leasehold improvements	$ 6,250,000	$ 682,000
Furniture and fixtures	$ 1,450,000	$ 900,000
Computer equipment	$ 225,000	$ 0

The new customer relationship management system cost $1.4 million for software costs paid to the external supplier, which were included as an addition to property, plant, and equipment.

(CONTINUED ON PAGE 48)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Selling, General, and Administration Expenses

Selling, general, and administration expenses are comprised of the following:

Salaries and wages	$14,750,000
Travel	1,250,000
Meals and entertainment (Note 1)	100,000
Insurance (Note 2)	250,000
Office	2,500,000
Donations to registered charities	50,000
Bank charges, interest, and penalties (Note 3)	40,000
Other	2,451,000
Total selling, general, and administration expenses	$21,391,000

Notes:

1. Meals and entertainment consists of the following:
   - $65,000 for team lunches at various store locations
   - $5,000 for the rental of a private suite at a professional hockey game
   - $20,000 for a company-wide holiday dinner hosted at a golf course
   - $7,000 for green fees, and $3,000 for meals in conjunction with the rounds of golf

2. Insurance consists of the following:
   - $80,000 of life insurance on Kenji and Daiki
   - $170,000 of general property and casualty insurance

3. Bank charges, interest, and penalties consists of the following:
   - $10,000 of interest on late-paid supplier invoices
   - $5,000 of interest and penalties on a late-filed GST/HST return
   - $25,000 of bank charges, including $5,000 of overdraft fees

(CONTINUED ON PAGE 49)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Investment Income

Nature	2023	2022
Actual amount of eligible dividends	$ 60,000	$ 0
Interest from Canadian sources	42,000	67,000
Capital gains dividends	22,000	0
Total	$ 124,000	$ 67,000

Fancy held a $1.3 million guaranteed investment certificate (GIC) for the duration of 2022.

Other Tax Information for Fancy

At January 1, 2023, the ERDTOH balance was $0, and the NERDTOH balance was $19,013.

Fancy made instalments in 2023 totalling $500,000.

Dividends paid by Fancy in 2023 were designated as other than eligible, and were paid equally to Daiki and Kenji.

(CONTINUED ON PAGE 50)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Memorandum from Daiki

Sale of properties and personal effects

My wife Amil retired in 2022, and did not earn any income during 2023. Our kids have moved out, so we downsized in 2023 and sold both our family home, which we usually lived in, and cottage, where we vacationed each summer. Both properties were owned only by me, and Amil does not own any properties. We moved into our new home on September 1, 2023.

Description	House	Cottage
Selling price	$ 1,200,000	$ 975,000
Original cost	$ 450,000	$ 375,000
Commission paid by seller	5%	5%
Year purchased	2000	2006

When we moved, we sold some of our possessions, as follows:

Item	Proceeds	Original Cost
Miniature grand piano	$ 40,000	$ 32,000
Coin collection	$ 2,300	$ 2,000
Dining table set	$ 950	$ 900
Boat	$ 12,500	$ 20,000
Decorative sculpture	$ 1,500	$ 2,700

(CONTINUED ON PAGE 51)

APPENDIX V – TAXATION (CONTINUED)
ADDITIONAL INFORMATION

Memorandum from Daiki (continued)

Investments

During 2023, I contributed $6,500 to my TFSA, $10,000 to my RRSP, and $12,000 to my non-registered investment account. The accounts earned the following income in 2023:

Item	TFSA	RRSP	Non-registered
Eligible dividends	$ 2,500	$ 7,000	$ 12,000
Capital gains	$ 2,100	$ 4,000	$ 3,000
Interest income	$ 800	$ 1,500	$ 4,200
Gross foreign interest income	$ 210	$ 420	$ 840
Foreign tax withheld	$ 10	$ 20	$ 40

I also received a tax slip from an investment that I made in a real estate limited partnership, indicating passive net rental income of $15,000. The partnership distributed $12,000 to me this year.

In 2020, I realized $16,000 of capital losses in my non-registered portfolio that I have been carrying forward.

Other personal tax information

I contributed $1,000 to a registered federal political party and $500 to my local city councillor. I also donated $2,000 to the local food bank, which is a registered Canadian charity, and $500 to a Mexican charity.

My annual salary from Fancy was $225,000 for 2023. Income taxes of $53,000 and CPP of $3,754.45 (including $631 of enhanced contributions) were withheld.

I received an instalment notice for 2023, stating that I had to make instalments of $7,500 in each of March and June, and $12,500 in each of September and December, but I never got around to paying these amounts. I'd like to file my return by May 28, 2024, to clear it from my to-do list.

For 2023, my RRSP contribution room was $32,000 and TFSA contribution room was $6,500.

(CONTINUED ON PAGE 52)

End of Examination

(CONTINUED ON PAGE 53)

CPA COMMON FINAL EXAMINATION
REFERENCE SCHEDULE

Present Value of Tax Shield for Amortizable Assets

Present value of total tax shield from CCA for a new asset acquired after January 1, 2024, and before January 1, 2028, other than those eligible for immediate expensing, which would normally be subject to the half-year rule.

$$= \frac{CdT}{(d+k)}$$

Present value of total tax shield from CCA for a new asset acquired after January 1, 2024, and before January 1, 2028, other than those eligible for immediate expensing, which would not normally be subject to the half-year rule.

$$= \frac{CdT}{(d+k)}\left(\frac{1+1.25k}{1+k}\right)$$

Present value of total tax shield from CCA for a new asset acquired after November 20, 2018, and before January 1, 2024, other than those eligible for immediate expensing.

$$= \frac{CdT}{(d+k)}\left(\frac{1+1.5k}{1+k}\right)$$

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

(CONTINUED ON PAGE 54)

Selected Prescribed Automobile Amounts

Item	2023	2024
Maximum depreciable cost — Class 10.1	$36,000 + sales tax	$37,000 + sales tax
Maximum depreciable cost — Class 54	$61,000 + sales tax	$61,000 + sales tax
Maximum monthly deductible lease cost	$950 + sales tax	$1,050 + sales tax
Maximum monthly deductible interest cost	$300	$350
Operating cost benefit — employee	33¢ per km of personal use	33¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	68¢ per km	70¢ per km
— balance	62¢ per km	64¢ per km

Individual Federal Income Tax Rates

For 2023:

If taxable income is between	Tax on base amount	Tax on excess
$0 and $53,359	$0	15%
$53,360 and $106,717	$8,004	20.5%
$106,718 and $165,430	$18,942	26%
$165,431 and $235,675	$34,208	29%
$235,676 and any amount	$54,579	33%

For 2024:

If taxable income is between	Tax on base amount	Tax on excess
$0 and $55,867	$0	15%
$55,868 and $111,733	$8,380	20.5%
$111,734 and $173,205	$19,833	26%
$173,206 and $246,752	$35,815	29%
$246,753 and any amount	$57,144	33%

(CONTINUED ON PAGE 55)

Selected indexed amounts for purposes of computing income tax

Personal tax credits are a maximum of 15% of the following amounts:

Item	2023	2024
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	$13,520	$14,156
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	15,000	15,705
Age amount if 65 or over in the year	8,396	8,790
Net income threshold for age amount	42,335	44,325
Canada employment amount	1,368	1,433
Disability amount	9,428	9,872
Canada caregiver amount for children under age 18, and addition to spouse, common-law partner, or eligible dependant amount with respect to the Canada caregiver amount	2,499	2,616
Canada caregiver amount for other infirm dependants age 18 or older (maximum amount)	7,999	8,375
Net income threshold for Canada caregiver amount	18,783	19,666
Adoption expense credit limit	18,210	19,066

Other indexed amounts are as follows:

Item	2023	2024
Medical expense tax credit — 3% of net income ceiling	$2,635	$2,759
Old age security repayment threshold	86,912	90,997
Annual TFSA dollar limit	6,500	7,000
RRSP dollar limit	30,780	31,560
Lifetime capital gains exemption on qualified small business corporation shares	971,190	1,016,836

(CONTINUED ON PAGE 56)

Prescribed interest rates (base rates)

Year	Jan. 1 – Mar. 31	Apr. 1 – June 30	July 1 – Sep. 30	Oct. 1 – Dec. 31
2024	6			
2023	4	5	5	5
2022	1	1	2	3

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.

(CONCLUDED ON PAGE 57)

Maximum capital cost allowance rates for selected classes

Class	Rate	Additional information
Class 1	4%	For all buildings except those below
Class 1	6%	For buildings acquired for first use after March 18, 2007, and ≥ 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 ≥ 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%	

(THIS PAGE INTENTIONALLY LEFT BLANK)