Mock Case- DAY 3 of Common Final Exam, which is a maximum of four (4) hours and is likely made up of 3 to 4 short cases of 60-80 minutes. Candidates ALL play the same role and therefore cases will test the common elements. The Day 3 cases, although of similar length to Core1, are more complex and require candidates to draw upon their enabling skills and apply professional judgment in responding in a more integrative way. Day 3 will provide candidates with the opportunity to demonstrate their competence in all of the breadth areas and provide additional opportunities to demonstrate depth in Financial Reporting or Management Accounting.

Question 1 of XX (Estimated Time: 60 minutes)
(covers Fin Reporting, but also touches Mngt Acct and Ethics (ideally the question would be designed to test additional competency areas, if possible, to get more breadth coverage)

Sunkick Coffee Corp. (Sunkick) is a privately-held company that operates 100 urban coffee houses throughout Canada. Sunkick was founded 21 years ago in Vancouver by Ray Mack, who wanted to start a company that was concerned not only for the well-being of its customers, but also its employees, suppliers, and the environment. Ray is currently the CEO, and to encourage senior management to follow his example of generating high profits through socially responsible behaviour, Ray recently instituted a new bonus program. Senior management will receive a bonus based on the percentage increase in net income year over year. Ray is excited to be able to reward those employees that really deserve it.

Until the current fiscal year, every Sunkick outlet was a corporate-owned store. To finance future growth, Ray believed that he would either have to take the company public or begin selling franchises. Not wanting to lose control of the company he started, he decided to begin selling franchises.

You, CPA, have recently joined the accounting department at Sunkick as assistant controller. The corporate controller, Wendy Torrence, has asked you to work on the franchising project as your first order of business. She mentioned that she has never had to deal with franchises before, having worked her entire career at Sunkick. Wendy has not had much time to sit down with you since you joined Sunkick, but has provided you with some information regarding the new franchise operations (Appendix I). She would like you to review the information and make accounting policy recommendations for their 2013 financial statements.

Wendy has also told you briefly about a new point-of-sale system that Sunkick is considering purchasing from Eightball Consulting Inc. (ECI). She would like you to review the information she has gathered (Appendix II) and write a report on the matter.

As you begin reviewing the information Wendy has provided, you receive an e-mail from the Director of Corporate Development, Alex DeLarge. You have never received an e-mail from Alex before, so you open it immediately, wondering what it is about (Appendix III). As you review it, you realize it was sent to you in error and was intended for Frank Poole, Sunkick's Senior Vice-President.

APPENDIX I
DETAILS OF SUNKICK'S NEW FRANCHISING PROGRAM

Initial Fee

The initial purchase price of a Sunkick franchise is $250,000. This is a one-time payment to Sunkick, due upon signing of the franchise agreement. The agreement is valid for a period of ten years. Potential franchisees must have half of the $250,000 in unlevered cash, while the other half may be debt financed by an external lender. Franchisees are required to sign ten-year leases at locations chosen by Sunkick.

According to the franchise agreement, Sunkick is obligated to do the following for the franchisee:

1. Select the store location and negotiate lease terms with the landlord.

2. Provide leasehold improvements, furniture, fixtures, and equipment necessary to operate the location.

3. Provide training for the franchisee staff and manager.

4. Provide on-going advertising and promotional support for the length of the contract.

5. Provide on-going information technology support for the length of the contract.

Franchisees have many obligations as well, including meeting strict quality control standards and generally protecting the valuable Sunkick brand name. If the franchisee breaches the franchise agreement, Sunkick has the right to assume the lease and reacquire the franchisee's furniture, fixtures, and equipment for $100,000.

Supplies

Franchisees are required to purchase all coffee beans, food, and supplies directly from Sunkick to ensure consistent quality. Sunkick's latest advertising campaign emphasizes how Sunkick purchases organic coffee beans directly from the grower and roasts them using the special Sunkick process at its roasting plant in Calgary. The beans are then sold to the franchisees with an average mark-up of 50%. Sunkick orders food and supplies in large quantities from the suppliers, as requested by the franchisees, and then resells the food and supplies at no profit.

APPENDIX I (continued)
DETAILS OF SUNKICK'S NEW FRANCHISING PROGRAM

Sudbury Location

During the year, the franchisee in Sudbury began experiencing difficulties. Although the franchisee was able to open the store, it soon became obvious that it could not continue to meet its obligations. When the franchisee could not pay its staff for over a month, Sunkick took control of the operation and began to run it as a corporate-owned store.

Last week, Sunkick honoured the franchise agreement by paying the Sudbury franchisee $100,000 and assuming the ten-year lease. Unless a suitable franchisee can be found, Sunkick intends to continue to operate the location as a corporate-owned store.

Loans to Franchisees

Five of the many new franchised locations in Quebec City and Halifax were having trouble with cash flow. Sunkick agreed to loan each of these five franchisees $75,000 over five years at 12% interest per annum, secured by the leasehold improvements, furniture, fixtures, and equipment of the franchise. To date, two of the franchisees have been able to make the agreed-upon principal and interest payments, two have only been able to pay the interest on the loan, and the fifth has made no payments at all.

APPENDIX II
DESCRIPTION OF POINT-OF-SALE SYSTEM

For many years, Sunkick had a simple cash register system in each store location. At the end of each week, the store manager would generate a report from the cash registers and fax it to Sunkick's head office. The accounting department would then enter the data into the accounting system. Since this process is time-consuming and error-prone, Sunkick management decided that it needed a point-of-sale (POS) system that would allow real-time communication between the locations and head office.

ECI had recently redone Sunkick's website and, therefore, was approached to develop Sunkick's POS system. After interviewing several people in Sunkick's information technology department, ECI decided that custom software was necessary.

Company Profile

ECI has worked on Sunkick's website for several years, and management of Sunkick has always been very pleased with ECI's work. ECI has offices across Canada and has been in business since 1995. ECI specializes in web-based database solutions. According to its website, ECI recently won several design awards for websites it has created for its clients.

System Description

ECI recommends that new hardware be acquired for each corporate-owned location. Each location will require three Microsoft Windows XP™-based personal computers (PCs) with touch screens that will be linked together using a wireless local area network (LAN) system. The wireless network will also allow these Sunkick locations to become wireless "Wi-Fi hotspots," which will allow customers to wirelessly connect to the Internet using their laptop, without a password, while drinking their coffee.

Two of the PCs will be used as the actual POS terminals, running ECI's custom-written POS software, to allow staff to enter customers' orders and take payments. The third PC will collect the sales and payment data from the other two terminals and upload it to a new server installed at head office. Because of incompatibility issues with Sunkick's existing accounting software, the sales data from the POS system will not automatically import into the general ledger. Instead, the system will prepare a daily summary journal entry that will be entered manually into the general ledger.

ECI estimates that the system will cost $1,600,000 for the hardware, and between $500,000 and $800,000 for the software and related consulting and training.

Implementation

If the proposal is accepted, ECI recommends purchasing the 300 necessary computers immediately. ECI recommends installing the PCs at all corporate-owned locations within one week of their delivery. ECI will then install the server at head office to receive the data from the locations.

Once the server is installed, ECI will test the system to make sure it is accurately extracting and uploading the sales data. ECI estimates that within two weeks, the system should be up and running, and collecting data from the individual locations.

APPENDIX III
E-MAIL FROM ALEX DELARGE

To: Frank Poole [fpoole@Sunkick.ca]; you@Sunkick.ca
From: Alex DeLarge [adelarge@Sunkick.ca]
Subject: Update!

Hey Frank,

It looks like things are going as planned at the Winnipeg franchise. The store has opened up, the location is great, and the staff is well trained. As we discussed, I need you to ensure they get the "special" price list from us for their coffee beans. The franchisee has borrowed at high interest rates to buy the franchise, and I don't think the franchisee can afford to be unprofitable at that location for very long. If the franchisee gets into trouble, we walk in to a fully-furnished, paid-for location and turn it into a corporate store.

Also, I have met with our friends in Rico Planta about finding a new source for our coffee beans. They assure me that no matter how much pesticide they have to spray on the beans while they are growing, they will stamp "Certified Organic" on every sack they send to us. This will cost us about three quarters of what the beans are costing us now, for the same quality and taste.

Alex

POSSIBLE MARKING GUIDE
SUNKICK COFFEE CORP.

To: Wendy Torrence, Controller
From: CPA
Subject: Accounting policy recommendations for new franchise operations and a report on the proposed point-of-sale system

Assessment Opportunity #1

The candidate discusses the accounting issues and provides recommendations on the appropriate accounting treatments.

The candidate is demonstrating competence in Financial Reporting.

CPA Map:

1.2.2 Evaluates treatment for routine transactions (Level A- Core)
1.2.3 Evaluates treatment for non-routine transactions (Level B-Core)

Overview

Since Sunkick began selling franchises only this year, many new accounting issues need to be addressed. We must develop appropriate accounting policies to ensure proper and consistent recording of transactions in the future. A new bonus system was also put in place this year. It is based on growth in net income, so our accounting policy choices will impact the amount of senior management's bonus. I have kept this consideration in mind in making my policy recommendations.

As a private corporation Sunkick has the option of using the accounting standards for private enterprises (ASPE) or the accounting standards for publicly accountable enterprises (IFRS). Since Ray does not want to go public Sunkick the use ASPE appears appropriate. I am assuming that these are the standards currently being used by Sunkick. The following discussion is in this context.

Initial franchise fee
1.2.2. Evaluates for routine transactions – Revenue recognition (A)

Since the $250,000 initial franchise fee is received as soon as the franchise agreement is signed, one could argue that the full amount should be recognized when received. However, Sunkick still has substantial performance to deliver before the franchisee opens its location. According to the *CICA Handbook, Part II* Accounting Guideline 2 (AcG-2), Franchise Fee Revenue, par. 5 substantial performance is only achieved once the franchisor has performed all of its services, has no remaining obligation or intent to refund the fee, and has no material unfulfilled conditions. Therefore, it would be more appropriate to recognize revenue once Sunkick has constructed the location and trained its staff and managers.

However, recognizing the $250,000 once the location has been opened may still be overly aggressive since, while Sunkick will not continue to receive revenue from the franchisee, it will still have to provide advertising and IT support, as well as supplies at no profit, for the length of the contract. It may be more appropriate to defer a portion of the $250,000, since the costs are provided for as well as a reasonable profit over the 10-year franchise agreement. This approach may not apply to all costs. For example, Sunkick may have undertaken the advertising anyway to support its corporate stores, so there may not be any incremental costs for advertising.

Since the money from the franchisees is received before any money is spent by Sunkick, there are no collectability issues that would preclude revenue recognition or create the need for an allowance for doubtful accounts.

Part of the franchise fee relates to tangible assets, such as leasehold improvements, furniture, fixtures and equipment. AcG-2, par. 8 recommends recording that part of the franchise fee when title to the assets has passed. That transfer most likely occurs when the franchisee opens its location.

Costs that are directly related to the sale of a franchise for which revenue has not been recognized should be deferred until the related revenue is recognized. Indirect costs of a regular and recurring nature should be expensed as incurred. For example, external costs that should be deferred include external fees and external training. Internal overhead costs should be expensed as incurred.

Supplies
1.2.2. Evaluates for routine transactions – Receivables (A), Financial Instruments (A)

The coffee beans should be recorded as a sale once they are shipped to the franchisee. However, an allowance for doubtful accounts may be necessary, especially for the franchisees that are having problems.

Since Sunkick is acting as an agent for the food and supplies sold to its franchisees at no profit, it should not show those sales as revenue and expenses but rather as receivables and payables.

Sudbury location
1.2.2. Evaluates for non-routine transactions (B)

A franchise agreement is a contract. The $100,000 paid to the Sudbury franchisee is a repurchase of the franchise rights and the tangible assets of the franchise. AcG-2, par. 16 states that when a franchisor reacquires the franchise rights through repossession the amount refunded should be a reduction in revenue in the year the franchisee is repossessed.

Since there is no virtual certainty that the franchise will be resold to an identifiable purchaser, the $100,000 cannot be recorded as an intangible asset at the time of repossession. Due to the particular case facts, it could be a reduction of revenue (as opposed to an expense) because it is in substance a refund of part of the initial franchise fee.

However, it may be possible to record the $100,000 (or part of it) as tangible assets, since we are acquiring them as part of the repossession. In this particular situation, Sunkick apparently intends to operate the franchise (as opposed to reselling it). Therefore, the tangible assets acquired in the transaction should be recorded at fair market value at the date of acquisition, and the liabilities (lease, bank loan, etc.) should be recorded at the amount estimated to be required to discharge the obligation. Any excess of the $100,000 over the net assets acquired should be recorded as an expense.

Also, any remaining portion of the deferred revenue from the original franchise fee should be taken into revenue.

Loans to franchisees
(CPA Map: 1.2.2. Evaluates for routine transactions – Financial Instruments (A))

Three of these loans appear to be impaired because the franchisees have either paid only interest or have not made any payments whatsoever. According to the *CICA Handbook, Part II,* Section 3856, Financial Instruments, par.16 this would be an indication of impairment where an adverse change has occurred that will impact on the future cash flows that Sunkick will receive from the franchisees.

Section 3856, par 17. States that where there is an adverse change then the carrying amount of these loans should be compared to the higher of; the present value of the cash flows from continuing to hold the loans; the amount Sunkick could receive by selling the loans; and; the amount Sunkick could receive by seizing any collateral.

We should stop accruing interest on the impaired loans immediately, and write them down to their fair value. We need to determine which fair value if the highest. One option is the fair value of the present value of future cash flows, but this may be difficult to determine if franchisees are making no principal payments or no payments at all. We may have to write them down to the fair value of the assets we have as security instead. We should be able to determine the fair value of the assets since we purchased them on behalf of the franchisees when they first opened.

The impairment charge would reduce net income and potentially the bonus for senior management.

Other
(CPA Map: 1.2.3. Evaluates for non-routine transactions –Consolidated financial statements (B)—Due to the complexity of this issue, a Level C has been applied i.e. simply stating what the rule is that should be investigated further.)

We also need to obtain additional information to determine whether the franchisees should be consolidated as variable interest entities under *CICA Handbook, Part II,* AcG-15 Consolidation of Variable Interest Entities. Par. 4 (h) states that an enterprise that elects under Section 1590, Subsidiaries not to consolidate its subsidiaries, is exempt from this Guideline.

Assessment Opportunity #2

The candidate discusses several of the weaknesses with respect to the proposed IT system and suggests how they can be resolved.

The candidate is demonstrating competence in Management Accounting

CPA Map:
3.1.1 Evaluates management information requirements (Level A-Core)
3.1.2 Evaluates the types of information systems used and the role they play in an organization (Level B-Core)
3.1.3 Recommends improvements to reporting systems to meet information needs (Level B-Core)

Eightball Consulting Inc. (ECI)

I have some concerns about ECI. It seems that its specialty is designing web sites rather than developing point-of-sale (POS) systems. Although we have been pleased with EIC's work in the past, its services have related to Sunkick's website and not to accounting or POS systems.

I am also concerned about the way in which ECI was chosen. It appears that Sunkick did not consider any other vendors for the POS system, and no competing quotes have yet been sought. I recommend that Sunkick issue a formal request for proposals and ask several different vendors to respond. Senior staff at Sunkick should then evaluate the responses and determine whether ECI is the best company to hire for the job.

System

Meeting the needs of end users is critical in a POS system. It appears that ECI did not interview store managers. Therefore, the system may not work well for those who have to use it in the stores. Also, ECI's plan does not appear to take into account the franchisees' needs. They may want to use the new system, and we are obliged to support their IT systems. This could result in significant additional costs that have not been considered. I recommend that we interview the end users to ensure their needs will be met.

I am also concerned that we will be using the same wireless network to link our POS system and to allow customers to access the Internet. This situation could create a serious security problem. If we do proceed with wireless, we should ensure that there is proper WEP (Wired Equivalent Privacy) or, WPA (Wi-Fi Protected Access), both of which are wireless encryption methods, or we should have two completely separate networks. If not, our confidential company and accounting data will be at risk.

In addition, I am not sure why we need the third personal computer in each store if all it does is upload data to the server. Using only two computers per store would result in significant savings, since there are 100 stores to supply. Further, the system still does not accomplish all that we would like it to accomplish. There are still going to be manual entries into the general ledger, creating the risk of errors. Finally, we must ensure that any system we implement is integrated with the head office accounting system.

I am also concerned about the costs of the proposal: $1.6 million for 300 computers plus a server works out to an average price of $5,316 per computer, which seems excessive. Also, the numbers that ECI provided appear to be rough estimates, which may mean the final cost will be higher. If we do use ECI as our vendor, we should ensure that it provides us with firm quotations to avoid cost overruns. We may also want to explore the possibility of purchasing an off-the-shelf software package before committing to ECI.

Implementation

I am equally concerned about the implementation process, which may provide further evidence that ECI is not the appropriate vendor. There does not appear to be any plan to phase in the implementation of the system. Installing 300 computers at 100 locations across the country in a single week seems unrealistic and may result in harm to Sunkick's sales. It is also unlikely that the whole system will be working within two weeks as anticipated by ECI. Unless it has the POS system already written, it will have little time to develop a customized code for a POS system for our stores.

ECI also seems to be planning to test the system only after all the computers and the server are installed. The entire system should be thoroughly tested long before installation.

To: Wendy Torrence
From: CA
Re: Accidental receipt of an e-mail

Assessment Opportunity #3

The candidate discusses both of the ethical issues at Sunkick and either explains the consequences or makes recommendations.

The candidate is demonstrating competence in Enabling- Ethics (could be considered within Perf Mngt).

CPA Map:
2.2.1 Assesses whether management decisions align with the entity's mission, vision, and values (Core-Level B)
2.4.1 Analyzes the key operational issues and alignment with strategy (Core-Level B)

Wendy, I am very concerned about the contents of an e-mail I was sent accidentally by Alex DeLarge, Director of Corporate Development. Although it was not intended for my eyes, as a CA, I am ethically bound not to ignore the contents and to inform you. I am reporting this to you to allow you to report it to the CEO and/or the board of directors.

It appears that Alex is conspiring to take illegal or at least unethical actions at Sunkick. In addition, the e-mail suggests that Frank Poole, the Senior Vice President, is involved. They appear to be trying to force a franchisee out of business by overcharging for Sunkick coffee beans. I believe they hope to reacquire the location as a corporate store to increase company profits in the future, and therefore their bonus. This could result in lawsuits against Sunkick from the franchisees and lead to difficulties in finding future franchisees.

They also appear to be switching from the organic beans that Sunkick advertises it uses to non-organic beans. Doing so would have an extremely negative impact on the company's image and could expose Sunkick to lawsuits for false or misleading advertising. I suggest that we ensure that our current coffee bean supply is in fact organic. We should also ensure that a standard price list is used for all franchisees.

The implied actions of Alex and Frank are certainly inconsistent with the values of corporate responsibility and environmental friendliness expressed by Sunkick's founder and CEO, Ray Mack. The current bonus program does not appear to be encouraging the type of socially responsible behavior that Ray wishes to reward.

I would also like to bring the following issue to your attention to follow up with Ray. Ray has based the new bonus program solely on a percentage of net income growth. The only actions it will likely encourage are efforts to increase revenues and decrease costs. There is no way of knowing whether these actions are being carried out through ethical and socially responsible means; the contrary seems to be evidenced by the actions described in Alex's e-mail. If Ray intends the bonus program to promote environmentally healthy and ethical behaviour, then a combination of financial and non-financial measures would produce more congruent results than using net income.

It is also important to note that while the e-mail links only Alex and Frank to the unethical actions, other Sunkick employees could be involved. In addition, it is possible that Frank and Alex are responsible for the financial difficulties being experienced by some of the current franchisees—for example, the Sudbury location. I recommend that Sunkick's involvement in the Sudbury store closure be investigated, as Sunkick could face legal exposure if it is proven that Alex and Frank were responsible.