CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

CPA Common Final Examination

BOARD OF EXAMINERS' REPORT

PART A — The Day 2 and Day 3 Report

May 2024 Examination

CPA EVALUATIONS

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THE BOARD OF EXAMINERS' REPORT ON THE MAY 2024 COMMON FINAL EXAMINATION

OBJECTIVES OF THE REPORT

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

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

The May 2024 CFE Report is presented in two parts: Part A is the Day 2 and Day 3 report and Part B is the Day 1 report.

The appendices provide more detailed information on the design, guide setting, and marking of the CFE, as well as the board's expectations of candidates on the simulations. Readers are cautioned that the marking guides were developed for the entry-level candidate and that, therefore, all the complexities of a real-life situation may not be fully reflected in the content. The CFE report is not an authoritative source of GAAP.

RESPONSIBILITIES OF THE BOARD OF EXAMINERS

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

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

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

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

THE CFE

PREPARATION AND STRUCTURE OF THE CFE

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

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

NATURE OF THE SIMULATIONS

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

Day 1 – The first paper is a four-hour examination consisting of a single simulation that is linked to the Capstone 1 group case. There are two versions of the linked cases, unless special circumstances require that a third version be provided. Version 1 is linked to the most current Capstone case and is written by first time writers and by repeat writers who chose to attempt the new case rather than Version 2 of the previous Capstone case. Version 2 is written by repeat writers and candidates who deferred and are writing Version 2 as their first attempt. The versions of the exams are calibrated to ensure the difficulties of all versions are comparable. For the May 2024 CFE, a Version 1 and a Version 2 were offered. The Version 2 case relates to KTI, for which a Version 1 was offered in May 2023.

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

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

Assessment Opportunities

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

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

Appendix A contains a comprehensive description of the evaluation process.

Marking Guides

Marking centre leaders and assistant leaders provide valuable input during the testing and setting of the marking guides, before live marking begins. The vice-chair, selected member(s) of the CFE subcommittee and senior evaluations staff hold meetings with the leaders and their assistants during both the guide-setting and the marking processes. See **Appendix B** for the Day 1 simulations that appeared on the May 2024 CFE and **Appendix C and D** for the Day 2 and Day 3 simulations and marking guides. The marking results for Day 2 and Day 3, by Assessment Opportunity, appear in the statistical reports found in **Appendix E** of this report. See Part B of the CFE Report for details on Day 1, Kingsdale Tea Inc. Version 1 and Version 2.

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

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

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

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

Setting the Passing Standard

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

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

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

The Decision Model

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

➢ Day 1 is linked to the Capstone 1 group case work. It assesses the candidates' ability to demonstrate professional skills. It is independent from Day 2 and Day 3.

- Day 2 assesses technical **depth** in one of four unique roles (that reflect the four CPA Elective choices) and also provides **depth** and **breadth** test opportunities in the common core competency areas of Financial Reporting and/or Management Accounting. Candidates pre-select one role and respond from that role's perspective.

- Day 3 supplements the **depth** and **breadth** tests in the common core areas of Financial Reporting and/or Management Accounting, and also provides **breadth** test opportunities for all other common core competency areas.

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

Day 1

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

Day 2 and Day 3

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

1. The response must be **sufficient**; i.e., the candidate must demonstrate competence on the Assessment Opportunities presented on Day 2 and Day 3 (Level 1).

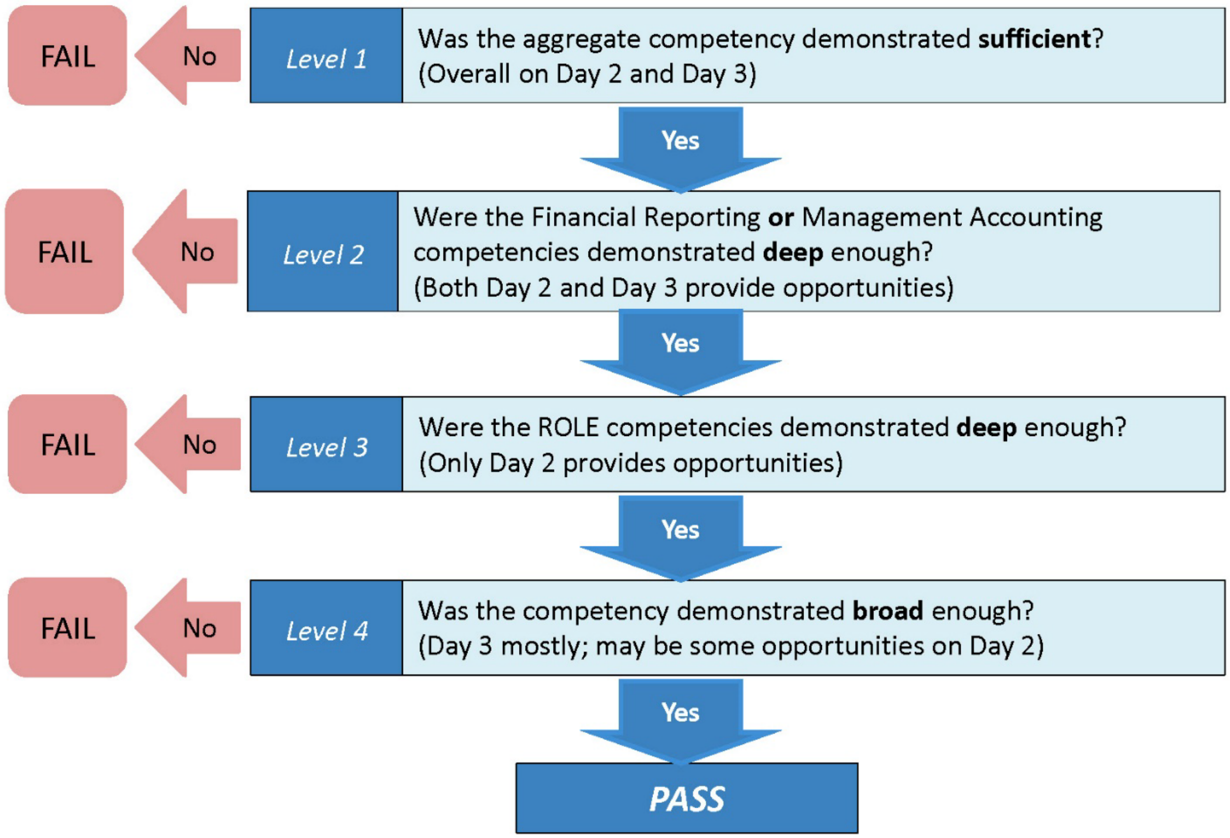
2. The response must demonstrate **depth** in the common core area of Financial Reporting or Management Accounting (Level 2).

3. The response must demonstrate **depth** in the pre-selected elective role (Level 3).

4. The response must demonstrate **breadth** across all competency areas of the *Map*, at a core level, by not having avoided a particular technical competency area (Level 4).

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

EXHIBIT I
DAY 2 AND DAY 3 PASS/FAIL ASSESSMENT MODEL



Approving the Results

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

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

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

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

Reporting

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

The board reports the following information by candidate number:

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

Thank You

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

We also wish to acknowledge the contributions made by the provincial reviewers, markers, authors, translators, and editors. The commitment, energy, and skill demonstrated by all the markers were outstanding, resulting in the sound application of marking procedures and producing an appropriate evaluation of the candidates. Everyone's commitment to the quality and fairness of the process is appreciated.

Jonathan Vandal, CPA
Chair
Board of Examiners

A MESSAGE TO CANDIDATES

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

Introduction

The May 2024 CFE Report, Part A and Part B combined, presents detailed information on all candidates' performance for all the examination cases, except for the Day 1 linked case, NPF Version 1. Detailed commentary on the performance of candidates on the NPF cases (Version 1 and Version 2) will only be available after NPF Version 2 is written in May 2025. The simulations, marking guides, marking results, and Board of Examiners' (BOE) comments on the Day 2/Day 3 portion of the examination are found in Part A of the CFE Report. Similar information on Day 1 KTI simulations (Version 1 and Version 2) can be found in Part B of the CFE Report.

The intent of this message from the BOE is to help candidates improve their performance on future CFEs by drawing their attention to the most common detracting characteristics observed in candidate responses to the May 2024 CFE. The BOE's comments are based on the feedback of the marking teams, who see the entire candidate population, and reflect the broad themes noted by the markers that apply to all candidates who wrote this sitting of the CFE. More detailed AO-by-AO commentary on candidates' performance can be found in the BOE's comments in Appendix F of Part A, or Appendix H of Part B, of the CFE Report.

Nature of the CFE

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

Both Day 2 and Day 3 require candidates to integrate the information found in the simulation in order to demonstrate competence. All three days require candidates to clearly communicate their thought process.

Strengths and Weaknesses

Time management

Overall, candidates demonstrated good time-management skills. The Day 1 simulation was not time constrained in any way and, generally, the amount of time that candidates devoted to their situational analysis and their issue analysis was appropriate. Most candidates were able to address all the strategic options presented, spending more time on the options that required more analysis and discussion. The Day 2 simulation was also not time constrained, and most candidates managed their time appropriately on Day 2, attempting all the AOs and appropriately balancing their time between the common section and the role section. On Day 3, which is designed to be time constrained and required time management on the part of the candidates, to ensure that all three simulations were completed within the four hours allotted, candidates seemed able to plan their time accordingly.

Unrelated discussions

The BOE was pleased to see that there were relatively few unrelated discussions on this exam. Candidates addressed the requireds and generally did not provide any analysis that was not necessary.

Technical ability

The BOE has noted a trend of declining technical abilities. The pattern the BOE has seen over the past few CFEs has continued, with candidates generally avoiding the more complex topics. In addition, while candidates performed well on some of the more familiar, straightforward topics, there were also familiar topics where candidates struggled.

Candidates generally performed well on the very straightforward AOs, including: Day 2, Common, AO#5 (Privacy and data security) and AO#6 (Victoria store); Day 2, Finance role, AO#7 (Net present value analysis) and AO#9 (Financing options); Day 2, Performance Management role, AO#8 (Lab-grown diamonds – qualitative) and AO#12 (Diamond-tracking technology); Day 2, Taxation role, AO#9 (CCA and taxable income (quantitative) for Fancy); Day 3, Simulation 1, AO#1 (Break-even analysis) and AO#6 (Inventory); Day 3, Simulation 3, AO#2 (Strategic fit for engagements) and AO#3 (Risks and controls – JH-Cloud).

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

One area where lack of technical knowledge was evident was on AOs requiring Handbook or Income Tax Act knowledge. For example, on Day 2, Common, AO#1 (Warranty), many candidates did not recognize that the financial reporting for warranties is based on its type. On Day 2, Assurance role, AO#7 (Bond investments), many candidates did not identify the Handbook section relevant for analyzing the issue. On Day 2, Taxation role, AO#11 (Taxes payable for Fancy), many candidates did not understand how investment income was taxed and had errors in their capital grind calculations. Also on the Day 2, Taxation role, AO#13 (Taxes payable for Daiki), many candidates struggled with the treatment of donation credits and dividend tax credits. On Day 3, Simulation 2, AO#1 (Government assistance), many candidates only identified one of the two options available for the accounting of the capital portion. On Day 3, Simulation 3, AO#4 (Change in use), many candidates provided incorrect tax advice, such as suggesting that Ming claim the principal residence exemption on the rental property for the whole period it was rented.

There was also lack of technical knowledge shown on some of the AOs requiring quantitative analysis. For example, on Day 2, Finance role, AO#8 (Distribution centre offer price), many candidates struggled with the market-based comparable approach, showing evidence that they did not understand this approach. On Day 2, Finance role, AO#12 (Gold order quantity), many candidates made errors in the calculation. On Day 3, Simulation 3, AO#1 (Capacity for engagements), many candidates did not break down the calculation by position.

Candidates should expect to see a variety of issues of varying difficulty. The BOE encourages candidates to be balanced in studying, and to ensure that they have a sufficient level of technical knowledge in all competency areas.

Failure to consider the specific context of the simulations and integrate relevant case facts

Consistent with previous CFEs, candidates on the May 2024 exam seemed to struggle with applying the specific context of the simulation to their response, or with integrating relevant case facts into their analysis. For example, on Day 2, Common, AO#3 (Cash and cash equivalents), candidates struggled to apply case facts to the Handbook criteria, such as ones related to liquidity or risk of changes in value. On Day 2, Finance role, AO#13 (Investable funds), candidates often did not connect the target working capital and/or target current assets to the rest of their analysis, or only provided a brief assessment of the investment options without incorporating case facts related to the investment options. On Day 2, Performance Management role, AO#10 (Flagship store allocations), candidates did not appear to understand the case facts presented to them, often confusing case facts related to the allocation policy with how the costs had actually been allocated. On Day 2, Taxation Role, AO#8 (Tax administration), candidates often provided general technical knowledge on deadlines without considering the dates that would be relevant to Fancy. On Day 3, Simulation 2, AO#2 (Franchise fees), candidates struggled with adequately integrating case facts for the intangible assets discussion, often arriving at a conclusion without any analysis.

The BOE emphasizes that the ability to adapt to unique scenarios and integrate information into an analysis, as well as from various parts of the case, are important skills for an entry-level CPA. Candidates should ensure that they have a good understanding of the specific context for any requests before addressing them, and ensure that any analyses incorporate elements that are specific to the case presented.

Day 2 role

On the May 2024 exam, there appeared to be more candidates who did not seem comfortable with their chosen Day 2 role. Their familiarity with, and ability to address, the topics tested on the Day 2 roles were not up to the BOE's expectations, and as a result, candidates seemed to provide responses that lacked the depth necessary at the Elective level. The BOE would like to remind candidates that the expectations differ on the Day 2 role AOs, which are tested at the Elective proficiency level. These expectations are higher than those of the remaining AOs on the exam, which are tested at the Core proficiency level. Given that all roles are equated, the BOE strongly encourages candidates to select their Day 2 role carefully, and to consider their ability to respond to that competency area at the Elective proficiency level.

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

Additional Comments Specific to Day 1 – NPF (Version 1)

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

There were two crucial developments in NPF's industry that had major strategic implications. First, the annual allowable harvest limit for some cold-water species decreased. Second, a new international seafood trade agreement was signed between Canada and China. In addition, NPF's board had a specific objective to increase the number of species the company could harvest to at least five, and three corporate objectives aimed at improving NPF's financial performance, to best ensure that the company earned a specified return on any new investments made. The board had decided to limit NPF's upfront spending on any new investments to $10 million. Candidates were expected to integrate these crucial elements of the company's broader situation within their qualitative and quantitative analyses of each strategic option. Although most candidates included some of these elements, many did not adequately address how the industry developments (the harvest limit and new international agreement) would affect the strategic options discussed.

There were four strategic options to be analyzed in this case, both qualitatively and quantitatively: whether to sign the new distribution agreement with Entero or renew an existing agreement with AOISE; whether to enter into a partnership with Acadia and offer three new seafood types; whether to acquire Sunrise, a shelf-ready shellfish processing plant; and whether to acquire Oceanfin, a bluefin tuna quota licence and harvesting operation.

For each of the strategic options available to NPF, candidates were expected to conclude on, and recommend, a course of action that was consistent with their analyses. In this case, the strategic strength of the available investment opportunities partially depended on which distribution channel the company selected (Entero versus AOISE). Within their conclusions, candidates were expected to consider how the viability of each investment opportunity would be affected by the choice of distribution channel.

Within the analysis of the major issues, three main factors differentiated strong responses from weak responses. First, a strong response identified and provided an in-depth discussion of the most important decision factors for each issue, such as the warming waters of the North Atlantic Ocean. Weak candidates tended to list case facts, often failing to explain why those elements were important and how they affected the decision-making process. Second, strong candidates provided valuable quantitative analyses to help support their recommendations, such as by linking their calculations to the stated objectives of NPF. In contrast, weak candidates' quantitative analyses were often unstructured and unclear and, therefore, challenging to follow. Many failed to perform the correct calculation to assess the decision. These candidates often struggled to explain how the results of their quantitative analyses affected the decision at hand. Third, strong candidates recognized the integration between the various strategic options. Strong candidates incorporated discussions of whether one option would fit well with the other options presented, whereas weak candidates typically missed making these links altogether. Strong candidates also typically incorporated both industry developments in their discussion and conclusions. Weak candidates tended to only perform an issue-by-issue analysis without stepping back to consider the broader perspective, and without integrating the key industry developments into their conclusions. As a result, they failed to make important links between the various aspects of each option.

On this sitting of the exam, the BOE noted that more candidates struggled with the "step-back" nature of the Day 1 simulation. There was more evidence in the responses of characteristics exhibited by weak candidates in the overall population. The BOE encourages candidates to take the time on Day 1, which is not designed to be a time constrained exam, to think through the bigger-picture issues presented in the simulation, and incorporate that analysis into their response.

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

Additional Comments Specific to Day 1 – KTI (Version 2)

Similar to NPF Version 1, most candidates dedicated the first section of their response to a relevant situational analysis. Most used this information later in their response, making relevant links back to the company's global situation when analyzing the specific strategic options that were presented, and within their conclusions.

One of the significant constraints in the case was that KTI-branded tea had higher-than-expected demand, and as a result, KTI forecasted a shortage of raw materials in the coming years, which was made worse by the significant threat of climate change. In addition, KTI's board had an objective to grow the company's revenue and achieve a gross margin of at least 20% on both private-label and KTI-branded tea sales. Although KTI decided not to access any further debt financing, the company's investment capital was sufficient to afford all the presented opportunities, and therefore, there was no cash constraint. Candidates were expected to integrate the crucial elements of the company's broader situation into their analysis.

There were five strategic options that candidates were expected to analyze both qualitatively and quantitatively: whether to develop and offer a website and online store; whether to sign a supply agreement with TT; whether to renew a long-term, private-label customer contract with SaveCo; whether to sign a supply agreement with Mandala; and whether to sign a long-term KTI-branded customer contract with ABC.

For each of the strategic options available to KTI, candidates were expected to conclude and recommend a course of action that was consistent with their analyses. Given the board's objective to increase revenue and the forecasted shortfall in raw materials, candidates were expected to address how KTI could take advantage of its opportunities to grow the company's revenue while also mitigating the risk of being unable to fulfil the sales orders that it agreed to.

Similar to NPF Version 1, strong candidates recognized and discussed the most important decision factors for each issue, provided valuable quantitative analysis, and linked their analysis to the significant entity-level issues presented in the case. Strong candidates tended to identify and discuss the potential synergies between the five strategic options that KTI was considering, such as TT's raw materials being able to meet the requirements of SaveCo's contract once TT's tea farm obtained the relevant certifications.

Weak candidates generally did not identify and discuss in depth the most relevant aspects of each strategic option presented as part of their analysis. Rather than discuss the more pertinent implications, weak candidates' analyses tended to focus on the minor considerations, such as the strategic option's fit with the vision, mission, and key success factors, rather than on the critical raw materials shortfall issue. Weak candidates also tended to simply list the case facts they thought were relevant without explaining the importance of those case facts, and what impact they would have on the viability and strategic strength of each option presented. Also, weak candidates often did not step back and consider the entity-level issues within their analysis of the options, or the synergies between the options. Again, consistent with NPF Version 1, more candidates did not meet the BOE's expectations related to the discussions of the bigger-picture issues.

As was the case with NPF Version 1, only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized approach to their response.

APPENDIX A

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

CFE Design

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

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

Day 3 is a four-hour examination containing a mix of small cases that evaluate the common Core competencies only. While the minimum allowable time for any one case is 45 minutes and the maximum is 90 minutes, historically the cases have ranged between 60 to 90 minutes. The Day 3 cases provide additional opportunities for **depth** and **breadth** in Financial Reporting and Management Accounting and **breadth** opportunities for all the other technical competency areas. Cases are time constrained and are designed to cover different competency areas within each case. A higher level of integration and judgment is required on Day 3 of the CFE than in the Core modules, although the technical competencies are tested at the common core level of expectation.

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

The Development of Marking Guides and the Provincial Review Centre

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

The May 2024 CFE Evaluation Centre

The May 2024 CFE was run 100% remotely. Approximately 120 individuals were chosen from the pool of applicants to participate in the CFE Evaluation Centre. The marking was supervised by the CPA Canada Common Final Examinations full-time CFE professional staff, with oversight by the CFE subcommittee vice-chair, and the chair of the BOE.

The Day 1 Version 1 linked case (NPF V1) was marked by a team of 11 people from June 17 to 28, 2024. The Day 1 Version 2 linked case (KTI V2) was marked by a team of three people from June 6 to 12, 2024.

The Day 2 Common assessment opportunities were marked separately from the role assessment opportunities by a team of 20 people from June 16 to 27, 2024. Day 2 Assurance was marked by a team of 18 people from June 15 to 27, 2024. Day 2 Performance Management was marked by a team of 15 people from June 15 to 27, 2024. Day 2 Finance was marked by a team of four people from June 4 to 10, 2024. Day 2 Taxation was marked by a team of four people from June 4 to 8, 2024. All three Day 3 cases were marked from June 18 to July 2, 2024. The Day 3 simulations were marked by a total of 43 people.

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

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

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

For smaller teams, all markers attended PEC, and moved directly from PEC to live marking. These teams had a leader, and two to three experienced markers, of which two were bilingual and marked all the French papers. These bilingual markers started in English and switched to marking in French once their marking was assessed as being consistent with the team. The bilingual markers arbitrated the French papers by discussing where there were differences in their markings.

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

Borderline Marking (Day 1)

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

Double Marking (Day 2)

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

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

Borderline Marking (Day 3)

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

Subsequent Request for Remark of Results and Request for Performance Analysis

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

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

Remarking of Results Approach

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

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

The results are tabulated and a decision made as to whether any candidates have been treated unfairly and should be granted a pass on the examination. The results are then forwarded to the provincial bodies for notification of the candidates.

APPENDIX B

MAY 28, 2024 – DAY 1 SIMULATIONS

COMMON FINAL EXAMINATION
MAY 28, 2024 – DAY 1

<u>Case</u> (NPF-Version 1) **(Suggested time: 240 minutes)**

It is April 1, 2026. You, CPA, continue to work at Sanderson & Harrop Consulting LLP (SHC), and have once again been assigned to an engagement with Neptune Point Fisheries Inc. (NPF).

Since SHC's last engagement with NPF in 2024, NPF has made one major strategic investment. In 2024, NPF decided to expand the company's cold storage facility, and in early 2025, the company began to offer cold storage and warehousing services to local fish harvesters and processors. So far, the investment has been very successful, as NPF's reputation and ability to provide effective cold storage has led to a high demand for this service.

In addition, two crucial developments have occurred within the industry, which could have major strategic implications for NPF. First, because the water of the North Atlantic Ocean is warming at a faster pace than anticipated, Fisheries and Oceans Canada (DFO) has reduced the annual allowable harvest limit for some species granted under government-issued quota licences. Cold-water shrimp, the species that provides most of NPF's revenue, experienced the biggest reduction. Although the maximum allowable harvest for Greenland halibut has yet to be affected, DFO has made it clear that its intention is to reduce this harvest limit in upcoming years.

Second, in 2025, a new international seafood trade agreement was signed between Canada and China. As a result, exports of Canadian seafood have significantly increased and are expected to increase further as new overseas supply contracts are signed between Canadian and Chinese companies.

Since 2024, NPF has not changed its mission, vision, or core values. However, at the beginning of 2026, NPF updated the company's objectives to reflect the recent changes that have occurred in the industry. NPF's quantitative corporate objectives are now as follows:

1. Increase the number of species the company harvests to at least five.
2. Increase the gross profit margin to 25% by 2029.
3. Increase the operating profit margin to 12% by 2029.
4. Earn at least a 12% annual rate of return on any new investments.

NPF's Board of Directors has already decided to limit upfront cash spending for any new strategic investments to $10 million.

NPF's board has asked you to review the information provided and draft a report that discusses NPF's main strategic considerations, including strategically analyzing and making a recommendation for each proposal presented. For this engagement, please ignore any tax implications within your analysis and recommendations.

INDEX OF APPENDICES

APPENDIX I
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Yvonne: Thank you, CPA, for coming today.

Given the fast-changing landscape of our industry, NPF is at a crucial phase of the company's development. Because the maximum allowable harvest limit for both species of seafood that NPF currently sells is expected to continually decrease, we need to diversify the species we can harvest and offer to our customers.

Colan: That's right, Yvonne, and it's becoming harder and harder to acquire new quota licences or harvesting partners, as more competitors enter the industry. Obtaining as many quota licences and harvesting partners as possible is perhaps the most important key success factor for NPF.

Yvonne: Another main strategic question we must consider relates to the distribution channels that we use to sell our products. At present, we use two main distribution channels, depending on whether the product is sold nationally or internationally. For national sales, we mainly sell to various grocery stores and restaurants, and for international sales, we continue to sell all of our product to Atlantic Oceania International Seafood Exporters Ltd. (AOISE). We have no long-term contracts for our national sales, and our contract with AOISE is due to renew next year. We need to decide whether to renew it or go in a different direction.

Kurt: How NPF decides to manage its distribution channels will affect the company for many years to come, so it's crucial that we make a wise decision.

Yvonne: Yes, Kurt, and that decision will be made more complicated by the fact that NPF just received a major offer from a large Canadian grocery chain called Entero Inc. (Entero). Entero is a trendy and popular grocery retailer that only sells the best products. Entero has grown significantly in the past few years and plans to continue its expansion throughout Canada. They want to enter into an exclusive distribution agreement with us.

APPENDIX I (CONTINUED)
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Allan: I am familiar with Entero and would be proud to offer our Neptune's Tasties brand through them. How does their proposed offer compare to our current arrangement with AOISE?

Yvonne: Perhaps the best part of the contract proposal is the price that Entero is willing to pay for Neptune's Tasties products. Entero has agreed to pay a 20% premium above the prevailing market price for all species of seafood we sell to them, whereas if we decide to renew with AOISE, we will continue to receive only the prevailing market price.

Colan: That's certainly attractive.

Yvonne: Indeed, but the contract comes with conditions. First, we must be able to provide Entero with at least five species of seafood, and we currently only have two. Next, the contract is exclusive, meaning that we wouldn't be able to sell our products to any other domestic or international vendor for as long as the agreement is in place. Finally, Entero requires that all products we sell to them are shelf ready.

Kurt: Shelf-ready products? Our current processing facility is not capable of doing that—it is designed to produce minimally processed products that the buyer can then sell or further process into other products if they wish.

Yvonne: We could always outsource the necessary further processing to another nearby facility.

Allan: That's true, but outsourcing would be costly.

Yvonne: Rather than move forward with the Entero contract, we could choose to renew with AOISE and continue with our current distribution strategy. Although AOISE cannot commit to purchasing all of our products, based on the demand schedule they recently provided, it looks like their demand far exceeds what we're able to provide. The new trade agreement with China has significantly increased the amount of product they wish to purchase.

APPENDIX I (CONTINUED)
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Allan: Also, if we renewed with AOISE, and another big strategic opportunity arose in the future, we wouldn't be locked into a long-term agreement that would prohibit us from moving forward with it.

Yvonne: That's true. Although AOISE would likely purchase all that we can provide, we could still choose to sell our product elsewhere.

Kurt: AOISE has always required that we provide only minimally processed products. That requirement aligns with our existing processes, especially since we now have an expanded cold storage facility.

Yvonne: Yes, but Entero has offered us other incentives. Although both Entero and AOISE are eager to sign a distribution agreement with NPF, we need to be careful.

Allan: One thing I like about the Entero option is that it would reduce much of the administrative work that's required with our current distribution strategy.

Colan: On another note, I want to introduce the next opportunity. Acadia Fisheries Co. (Acadia) is an MSC-certified shellfish harvester that wants to form a strategic partnership with NPF. Acadia has three separate quota licences, allowing them to harvest lobster, scallops, and snow crab.

Kurt: I am very familiar with Acadia's operations. They currently use our cold storage facility. Acadia's fishing crew has a strong reputation for being high-quality and successful harvesters.

Colan: That's true, Kurt. Acadia has been around for as long as NPF has, and I have a great relationship with Acadia's owners. In January, Acadia won an expanded quota for snow crab after the prior licence holder decided to wind down their harvesting operation. Going forward, Acadia expects a significantly larger harvest of snow crab, but to take advantage of the increased quota, Acadia needs to upgrade both of its fishing vessels. Acadia is proposing that NPF pay for the upgrades, which are expected to cost $5 million, and in exchange, NPF will gain access to Acadia's harvest and will earn a split on the income that Acadia's operations generate.

APPENDIX I (CONTINUED)
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Yvonne: Have you discussed which distribution channel Acadia's harvest would be sold into if we agreed to their proposal?

Colan: Yes, that's another reason Acadia wants to work with NPF. Acadia recognizes the strength of Neptune's Tasties and would like to use our brand and distribution channels to market their harvested seafood.

Also, Acadia wants us to help them remain compliant with all the requirements necessary to maintain their MSC-certifications. Given that Acadia has licences for three separate species, it is quite time-consuming for them to ensure that they remain in compliance. As part of the proposal, NPF would need to contribute time and expertise to this vital function.

Kurt: Based on the way Acadia uses our cold storage facility, I assume that Acadia's harvests are at present only minimally processed before sale?

Colan: Yes, that's right, Kurt.

Kurt: That could be a concern if we wanted to further process the harvest into shelf-ready products, since we might struggle to find a suitable shellfish processing facility, especially one that's BRCGS-certified. Facilities like this are currently in high demand, so if we were to outsource that function, our costs would increase significantly.

On that note, we should consider the acquisition of Sunrise Shellfish Processing Plant (Sunrise). The proposed acquisition would include a shellfish processing plant and all of its associated equipment, in addition to the plant's existing contracts. If we owned this plant, our processing costs would decrease significantly.

Allan: Interesting. What do you currently know about this processing plant?

APPENDIX I (CONTINUED)
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Kurt: By volume, the species the plant processes the most is snow crab. But it is also capable of processing a variety of other types of shellfish, such as lobster, shrimp, scallops, clams, and other species of crab. Also, the plant's location makes distribution simple. It currently supplies grocery stores all over Canada. Finally, the plant has been operating at 100% capacity over the past three years. This is due to both the increasing demand for shellfish products and because this facility is held in high regard as a reliable processing plant.

Colan: This sounds risky. We currently have no experience with this type of processing. I think it's a better idea to focus our investments on taking advantage of our core competency—harvesting seafood.

Allan: I disagree. This would be a great way to diversify our sources of revenue and reduce cost.

Kurt: Dad is right—we don't have experience with this type of processing at the moment, but with enough time, I can certainly learn.

Yvonne: Do we know anything about the existing contracts? If the plant is operating at 100% capacity, would NPF be able to use the plant to process its own products and forgo the cost of outsourcing?

Kurt: Great questions, Mom. According to Sunrise's current owners, they have a mix of both short-term and long-term contracts. NPF would be able to use the plant's capacity but only after the existing contracts expire. Each of Sunrise's existing contracts has a cancellation policy, which makes them very expensive to terminate prior to the end of the contract term.

Allan: Okay, last up, the parent company of Oceanfin Harvesters (Oceanfin), a bluefin tuna harvesting company, has put Oceanfin up for sale. The acquisition of Oceanfin would provide NPF with both the necessary fishing vessel and the quota licence for bluefin tuna.

APPENDIX I (CONTINUED)
BOARD MEETING WITH CPA IN ATTENDANCE

April 1, 2026

Colan: Bluefin tuna? That's one of the most prized fish on the market. Is the operation MSC-certified?

Allan: Unfortunately, no. But based on my preliminary review, the operation appears compliant with the standards necessary for obtaining certification. With our experience, I am sure we would eventually earn the certification, although this would likely take at least two years. And what's more, even without the certification, the operation is profitable.

Yvonne: Bluefin tuna is especially prized on the international market. It's rare to have the opportunity to acquire an operation like this.

Colan: As exciting as this opportunity is, fishing for bluefin tuna is certainly not easy, and requires experience and skill. For this to be successful, we would need to invest a lot of time and effort.

Allan: That's true, Dad, but Oceanfin's vessel has an experienced and dedicated crew. The fishing vessel is even capable of producing sushi-grade tuna.

Yvonne: CPA, please review all the information provided and let us know how you think NPF should proceed. Meeting adjourned.

APPENDIX II
INDUSTRY UPDATE

The demand for seafood products, both fish and shellfish, is increasing both nationally and internationally. However, because of the new international trade agreement with China, international demand is expected to grow faster than national demand. The growth of demand for bluefin tuna is especially high, given the increasing popularity of sushi. However, the growth of bluefin tuna's popularity extends beyond sushi, and as a result, the demand for both MSC-certified and non-certified bluefin tuna that is minimally processed is on the rise. The demand for premade, ready-to-eat seafood entrees is also on the rise, as more customers seek the convenience of already-prepared meals.

Given warming waters in the Atlantic Ocean, the annual allowable harvest limit granted under government-issued quota licences is expected to decrease for cold-water species such as cold-water shrimp, Greenland halibut, cod, redfish, and snow crab. On the other hand, for species that do well in warmer waters, such as lobster, scallops, salmon, and bluefin tuna, the maximum allowable harvest is expected to remain stable, or even increase, over time.

Another consequence of warming waters is that obtaining and maintaining an MSC-certification is expected to become more onerous as the Marine Stewardship Council plans to update their policies, to ensure the continued health of global fisheries.

APPENDIX III
EXCERPTS FROM NPF'S INCOME STATEMENT

Neptune Point Fisheries Inc.
Partial Income Statement
For the year ended December 31, 2025

Revenue (Note)	
Frozen-at-sea Greenland halibut	$ 5,840,000
Frozen-at-sea shrimp	5,190,000
Processed shrimp	18,942,000
Total revenue	29,972,000
Cost of goods sold	
Harvesting and procurement	9,375,500
Processing costs	10,228,680
Warehousing and shipping costs	2,273,040
Depreciation	2,083,620
Total cost of goods sold	23,960,840
Gross profit	6,011,160
Selling and administrative	3,550,000
Operating income	$ 2,461,160
Gross margin	20%
Operating profit margin	8%

Note: All sales were made at the prevailing market price.

APPENDIX IV
ENTERO INC. DISTRIBUTION CONTRACT PROPOSAL

Entero is an upscale, specialty grocery store chain with locations all across Canada.

Extracts from Entero's proposal are as follows:

- The contract term is 10 years and will begin on January 1, 2027. A penalty will be charged to either party who breaks the contract within this term.
- The contract is exclusive. Therefore, only NPF's seafood products will be offered in Entero's network of grocery stores, and NPF will agree to sell its products only to Entero.
- Entero will agree to purchase all of NPF's available products as long as they are MSC-certified.
- As long as NPF provides at least five species of seafood throughout the duration of the contract, Entero will purchase NPF's products at a price that equals 20% above the prevailing market price. However, if the number of species that NPF can offer falls below five, the purchase price premium will decrease and a penalty will be applied by Entero.
- Entero will increase the purchase price premium if NPF becomes able to also provide premade, ready-to-eat seafood entrees.
- Entero will also agree to pay half of all costs associated with maintaining NPF's MSC and BRCGS certifications.

Notes from Yvonne:

- After the third year of the contract, Entero may also be willing to help NPF finance any acquisitions or infrastructure upgrades necessary for ensuring that NPF can continue to provide Entero with a variety of high-quality seafood products.
- If we enter into the contract with Entero, given that we will only need to deliver the products to Entero's nearest distribution centre, I expect our warehousing and shipping costs to decrease by 50%, compared to NPF's 2025 expense.
- However, given that Entero requires shelf-ready products, our processing costs will increase by approximately 40% above NPF's 2025 expense.
- I expect NPF's annual selling and administrative expense will fall to only $1.5 million.
- To give the board an idea of how attractive Entero's contract is financially, I wonder what our 2025 operating income would have been if we had sold our products to Entero, assuming that NPF provided a product mix that included five species?

APPENDIX V
STRATEGIC PARTNERSHIP WITH ACADIA FISHERIES CO.

If NPF agrees to the strategic partnership, all profit from the harvest and sale of the three species will be split equally between NPF and Acadia, and all product sales will be made through NPF's distribution channel, using the Neptune's Tasties brand. Acadia will retain the right to cancel the contract if NPF does not adhere to the conditions of the contract. Acadia will also retain ownership of the quota licence for each species throughout the duration of the 10-year contract.

The size of Acadia's harvest tends to fluctuate from one year to the next, given the seasonality of each species' harvest period, and because changing weather patterns influence the size of each year's harvest. Acadia provided the following information for the 12 months ended December 31, 2025:

Species	Revenue	Cost of Goods Sold		Gross Margin
		Harvesting	Processing	
Lobster	$ 1,290,000	$ 580,500	$ 193,500	$ 516,000
Scallop	$ 1,750,000	$ 875,000	$ 210,000	$ 665,000
Snow crab	$ 3,500,000	$ 1,925,000	$ 700,000	$ 875,000
Total	$ 6,540,000	$ 3,380,500	$ 1,103,500	$ 2,056,000

All products were sold at the prevailing market price. Acadia also mentioned that they expect the prevailing market price for these products to increase by 5% annually, while the harvesting and processing costs are expected to increase by 3% annually. In addition, throughout the life of the contract, Acadia will require that NPF pay half the costs associated with maintaining Acadia's MSC-certification. Acadia's MSC-certification cost roughly $1 million in 2025.

At present, Acadia only sells minimally processed products. To further process Acadia's harvest into shelf-ready products, an estimated additional $2 million would be required to outsource the additional processing to a nearby shellfish processing facility.

APPENDIX VI
ACQUISITION OF SUNRISE SHELLFISH PROCESSING PLANT

The processing plant specializes in producing shelf-ready products and is BRCGS-certified. Although it currently operates at 100% capacity, it appears suitable for an upgrade, either to expand capacity or to include a new function, such as the ability to produce premade, ready-to-eat entrees.

The plant's equipment has not been modernized or upgraded for many years. When asked about this, Sunrise's owners said they prefer to remain with their current equipment because their current processing system works so well. As well, the processing plant does not produce its own brand of products, and instead tailors the packaging to the needs of their customers.

The plant appears to adhere to a strict quality control and food safety system, and has never experienced any major contamination or recall events. In addition, the plant has MSC Chain of Custody certification, and has a strong reputation within the local industry. The plant's ongoing success partially relies on an experienced team of managers and engineers who have worked at the plant for many years.

The asking price for the acquisition is $15 million, but Madison Bank is willing to provide us with a ten-year, $10 million loan that will be secured by the processing plant itself. With the loan, we would only be required to pay $5 million upfront, and then annual payments of $1.3 million until the loan matures.

The remaining life of the plant and its equipment is 10 years, and we expect it to generate $7.5 million of revenue in the first year we take ownership. The plant's cost of goods sold equals 65% of revenue, and its fixed operating costs are currently $950,000 per year. The plant's revenue is expected to increase by 6% annually whereas the plant's fixed costs are expected to increase by 3% annually. At the end of the plant's useful life, it is expected to have a residual value of $650,000.

APPENDIX VII
ACQUISITION OF OCEANFIN HARVESTERS

The asking price for Oceanfin, which includes the fishing vessel and the quota licence to fish for bluefin tuna, is $13 million. However, Oceanfin's parent company is willing to offer NPF a ten-year loan with an attractive interest rate. With the loan, NPF would only be required to pay $4 million upfront, and then annual payments of $1 million until the loan matures.

Oceanfin's fishing vessel has the necessary equipment to produce sushi-grade bluefin tuna. The bluefin tuna is minimally processed, and then frozen at sea before being immediately sold or transferred to a cold storage facility. Oceanfin's fishing vessel has a remaining useful life of 10 years. At the end of its useful life, the vessel is not expected to have any significant salvage value.

Although sushi-grade bluefin tuna is sold at a high premium compared with regular bluefin tuna, the process that must be followed to ensure that the quality of the fish stays high enough to be classified as sushi-grade is more complex and onerous relative to regular tuna. To ensure that these strict quality control guidelines are followed, the fishing vessel must have the necessary equipment and a trained workforce, and the bluefin tuna must be held in cold storage until the product is ready to be sold.

Oceanfin has historically sold a mix of both sushi-grade and regular bluefin tuna. Oceanfin provided the following information for the 12 months ended December 31, 2025:

		Cost of Goods Sold		
Species	**Revenue**	**Harvesting**	**Processing**	**Gross Margin**
Bluefin tuna	$5,650,000	$3,390,000	$847,500	$1,412,500

During 2025, Oceanfin's bluefin tuna sold at the prevailing market price. This price is expected to increase by 6% annually, while both the harvesting and processing costs are expected to increase by 3% annually. In addition, NPF would also need to pay $350,000 per year for expenses related to items such as maintaining the operation's quota licence with DFO.

COMMON FINAL EXAMINATION
MAY 28, 2024 – DAY 1

<u>Case</u> (KTI-Version 2) **(Suggested time: 240 minutes)**

It is January 2025, and you, CPA, are still working at F & W Consulting LLP (FWC). Kingsdale Tea Inc. (KTI) has again engaged FWC to assist with KTI's strategic planning. You have been forwarded the following update from Kathleen Galinsky, who became KTI's CEO after Michael's retirement in early 2024. At that time, he passed control of KTI to his three children, Jason, Sabrina, and Kathleen, who each now hold one-third of the common shares of KTI, and form KTI's Board of Directors.

At the end of 2023, KTI expanded beyond only selling private-label products by launching its own brand of tea. These new products are branded as Kingsdale Tea (KTI-branded tea), and currently sell exclusively in tea rooms and tea shops. To date, no long-term contracts have been signed for KTI's new branded products. This is mostly because the tea rooms and tea shops wanted to test the demand for KTI's tea before agreeing to something long-term.

So far, KTI-branded tea has been well received, due to the superior quality of the raw tea leaves used in production. Purchasers of KTI-branded tea are typically knowledgeable tea drinkers with sophisticated taste. The KTI-brand launch was promoted by tea rooms eager to showcase the unique story behind KTI's tea farmers. This has had a surprisingly positive impact on sales, with several popular tea rooms sharing the stories via social media. Overall, the demand for KTI-branded tea has exceeded expectations, despite KTI not directly marketing the new KTI-branded products.

KTI's financial results have improved due to the increase in cash flow generated from the sale of KTI-branded tea products. KTI currently has $4.5 million available for investments, and has decided not to access any further debt financing.

The global supply of raw tea leaves continues to be a significant threat across the industry. Uncertain weather patterns caused by climate change threaten crops, particularly in high mountain environments, where the highest-quality teas are grown. Currently, the average price that KTI pays to purchase raw tea is $3.64 per kilogram, while the company's average sale price per kilogram to customers is $4.23 for KTI's private-label tea, and $5.78 for the new, KTI-branded tea. Since FWC's last engagement, KTI has expanded its supply of raw tea leaves by securing a contract with a group of tea farmers in Kenya. So far, the Kenyan raw materials that KTI has received are of even higher quality than those of KTI's Sri Lankan supplier.

Since taking control of KTI, Kathleen, Sabrina, and Jason have become a cohesive team, and are dedicated to upholding the mission and vision that KTI was founded upon. If possible, the board would like to maintain the long-term relationships that have been built over the years with KTI's private-label customers. In addition, the board believes that KTI's rich history of building relationships with traditional, ethical, and organic tea farmers sets the company apart from other tea companies. The board is convinced that this provides KTI with a competitive advantage.

KTI's board is focused on growing the company's revenue each year. Currently, the majority of KTI's revenue is still generated from its private-label contracts. However, KTI would like a gross margin of at least 20% on all sales, which is becoming increasingly difficult to achieve from private-label sales, as these customers continue to put downward pressure on pricing during contract negotiations.

KTI's board has asked you to review the information provided and draft a report that discusses KTI's main strategic considerations, including strategically analyzing and making a recommendation for each proposal presented. For this engagement, please ignore any tax implications within your analysis and recommendations.

INDEX OF APPENDICES

APPENDIX I
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

January 9, 2025

Kathleen: Thank you, CPA, for assisting with our strategic planning. We are excited to build on the early success of KTI-branded products.

Jason: Yes, Kathleen. We have developed a three-year forecast for both KTI's expected sales demand and our supply of raw materials. The sales forecast is much higher than we originally anticipated. Given that we have a limited supply of raw materials, before we accept any sales order requests, we should revisit our strategy for how KTI will sell and market our new KTI-branded tea products.

Sabrina: I agree. Supply is a concern. If we cannot fulfil the sales orders that we agree to, our reputation will be harmed, and we will face penalties.

Jason: At this point in the company's evolution, I think KTI needs a website and online store where our customers can purchase tea directly from us. The website would put us in control of our marketing narrative, and the online store could help alleviate KTI from the strict supply requirements that are attached to most of the long-term sales contract offers that we have received.

Kathleen: But Jason, that might upset our existing customers. I don't think that's wise, especially because KTI's brand is still so young.

Sabrina: If we want to compete and maximize growth, an online store might be necessary. This would also allow us to leverage the unique origin stories and traditions of our tea farms. We should at least explore the idea.

Jason: I have put together some information for KTI's potential website and online store.

Kathleen: Opening an online store would only worsen our existing supply concern and would complicate our current operations. I think it makes much more sense to continue our focus on tea rooms and tea shops.

Regardless, we need to expand and secure our supply of raw tea, not only because the demand is there but also because we do not know how secure our current supply is, due to the ongoing threat of climate change.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Sabrina: Well, the good news is that we have an offer from Tea Taiwan Ltd. (TT). TT claims to be meeting the organic and Fairtrade production standards, but say they lack the experience required to complete the applications and audit processes necessary to become officially certified. TT would therefore like to collaborate with KTI. They want us to help with the certification process in return for a fixed-price raw material supply contract.

Jason: Interesting. If TT is already meeting the standards, we could certainly help them get certified. TT, which has been in operation for four years, is a modern tea processing farm with a good reputation and automated processes.

Sabrina: As long as TT is able to produce a consistent-tasting crop of black tea, it would likely satisfy the needs of KTI's private-label customers. However, for our KTI-branded tea, TT's tea is not likely to produce the unique flavours our customers have come to expect from our tea that is farmed in Sri Lanka and Kenya, so it probably won't work for our branded tea products.

Jason: I agree, Sabrina.

Also, if we agree to the collaboration with TT, we could purchase some of their oolong or green tea to augment our current product line.

Kathleen: Speaking of contract offers, we have a big renegotiation coming up with our largest private-label customer, SaveCo, for their long-term contract renewal. SaveCo represents a large portion of our overall revenue, and they want to continue to offer our products.

Jason: Excellent news!

Kathleen: Certainly. However, this is my first contract negotiation without Michael, and I am already feeling the pressure from SaveCo—their first offer seems low. I don't want to agree to a long-term contract with this low of a profit margin.

Sabrina: If we are not happy with the margin, why renew SaveCo's contract? Why not use our limited supply of raw tea to make products for KTI-branded tea, which produce a higher margin?

Jason: Good point, Sabrina.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Kathleen: Okay, but we cannot ignore that most of our revenue still comes from private-label contracts. Michael worked hard to build KTI's long-term relationships, and they provide KTI with security and stability. We have already agreed that maintaining these relationships would be ideal for KTI.

Sabrina: I guess I am just a little disappointed that we use our supply of Sri Lankan tea to satisfy our private-label contracts. It seems like a waste of these high-quality raw materials.

Kathleen: SaveCo's contract requires that they approve any changes in quality or taste, but replacing the raw materials we use to satisfy the contract is a possible negotiation tool.

Jason: We have another opportunity. As you know, some of the world's best black, green, and white teas are grown in Nepal. However, the Himalayan mountains have always presented logistical challenges, as many regions are not accessible by road. But for the Manang District, that recently changed when a newly-constructed road was opened. Vehicles can now access the remote region. In Manang, there is a tea farm called Mandala Farms (Mandala) that would like to expand operations. Mandala has proposed an agreement whereby KTI will provide its expertise in exchange for the exclusive purchasing rights to Mandala's raw tea leaves.

Sabrina: Wow, Nepali tea would be a dream to work with! Remote farms in Nepal have very traditional production processes. Everything is done by hand and the farmers' knowledge has been passed down for generations. Are these farms organic and Fairtrade certified?

Jason: Unfortunately, no. The purpose of the agreement is for KTI to help Mandala meet these standards. The process will be a challenge. However, if Mandala's current operations are high quality, I am confident that the farm will eventually meet the requirements for certification with our help. This will take at least two years, maybe more.

Kathleen: It sounds like exactly the type of raw materials we want to secure for KTI-branded tea. However, the contract's purchase price for raw materials is slightly higher than KTI's current average, and Mandala requires both an upfront and an annual payment to support their operations.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Sabrina: It would be wonderful to have another supply of high-quality raw materials that R&D could work with, to produce desirable new tea blends and flavours. Mandala's tea might be able to provide this.

Kathleen: Next up, we recently received a proposal from a tea room company, AuthenticiTea Brewing Company (ABC). In the past, ABC has purchased batches of KTI-branded tea, and their customers want more! ABC now wants to sign a long-term purchase contract.

Jason: It is great that KTI-branded tea is gaining popularity, but I am not sure that selling through tea rooms and tea shops is the best strategy. It limits KTI's scope. If we commit long-term, we will have less supply to devote to other sales channels.

Kathleen: I don't agree, Jason. ABC is a big player in the tea room segment. They only sell the highest quality tea from exclusive brands. This contract would secure our position within ABC's stores for years to come.

Sabrina: KTI-branded tea is clearly in high demand. We have received many proposals from both existing customers and potential new customers that want to sell KTI-branded tea within their stores. Some of these proposals are long-term, like ABC's, whereas others are more like the one-off batch sales that we have made for KTI-branded tea products in the past year.

Kathleen: That's true, Sabrina. But I particularly like ABC's offer, given how well known and popular their tea rooms are. ABC mentioned an interest in expanding our contract in the future to include KTI-branded tea within their entire global network of tea rooms. That is an amazing opportunity!

Jason: The margins from long-term contracts are typically lower than those from shorter term contracts. Is that the case here?

Kathleen: Yes, but that is customary. The trade-off is that we would reduce our risk by securing some long-term revenue for KTI-branded tea, something we have yet to do.

We clearly have much to consider. Meeting adjourned.

APPENDIX II
EXCERPTS FROM KTI'S FINANCIAL STATEMENTS AND FORECAST

Kingsdale Tea Inc.
Partial Income Statement
(in thousands of Canadian dollars)

	2024 Draft
Revenue	
Revenue – private-label	$ 44,945
Revenue – KTI-branded	16,446
Total revenue	61,391
Cost of sales	
Cost of sales – private-label	38,675
Cost of sales – KTI-branded	10,690
Total cost of sales	49,365
Gross profit	$ 12,026

APPENDIX II (CONTINUED)
EXCERPTS FROM KTI'S FINANCIAL STATEMENTS AND FORECAST

Kingsdale Tea Inc.
Sales Demand and Supply Forecast
(in thousands of kilograms)

	Actual	**Forecast**		
	2024	**2025**	**2026**	**2027**
Private-label	10,625	10,838	11,055	11,276
KTI-branded (Note 1)	2,845	4,268	6,402	9,603
Total sales	**13,470**	**15,106**	**17,457**	**20,879**
Current supply (Note 2)	15,000	15,000	15,000	15,000
Over/(short)	1,530	(106)	(2,457)	(5,879)

Note 1 – The forecast for KTI-branded tea is based on sales orders that have already been requested by tea rooms and tea shops. These orders have yet to be accepted.

Note 2 – KTI's current supply of raw tea leaves comes from Sri Lanka and Kenya.

APPENDIX III
WEBSITE AND ONLINE STORE DETAILS

Prepared by Jason Galinsky

Given that KTI lacks the knowledge and expertise required to both develop and maintain the proposed website and online store, these functions would need to be outsourced. The initial setup costs are estimated to be $800,000.

Once the website and online store go live, KTI will need to pay approximately 5% of online sales revenue to the service provider for things such as ongoing maintenance and website upgrades. KTI would also need to set up an internal team that would handle any customer support issues—this will cost an estimated 2% of sales. Shipping costs are estimated to be 3% of sales, and all other operating costs associated with the project are estimated to be 2% of sales. KTI would also likely need to hire several new staff members to manage this new aspect of KTI's business. KTI would like to use a 4.5% discount rate when assessing the potential value of this project.

	2026	**2027**	**2028**
Online sales forecast *(in thousands of kilograms)*	2,500	4,000	6,000

This forecast only includes the expected demand for the highest quality KTI-branded tea that we can offer. This demand can only be satisfied with the best raw materials. Based on market research, an estimated selling price of $5.80 per kilogram seems reasonable for these products. Also, it would be a great advantage to showcase the special and unique way each tea was developed, as this would help KTI gain more notoriety on social media. However, it is also likely that KTI could sell lesser-quality teas via the online store, although these tea types would need to be sold at a lower price.

If KTI were to run out of stock for a product offered on the online store, the item would be marked as "SOLD OUT," and customers could then sign up for alerts for when that item once again became available. Showing our products as sold out may help KTI's brand grow a reputation of being exclusive, because our products have limited availability.

Finally, the more variety that we can offer via the online store, the better—our research shows that the typical consumer of KTI-branded tea has a strong desire for diverse options.

APPENDIX IV
TEA TAIWAN LTD. CONTRACT DETAILS

Prepared by Sabrina McLean

Details of TT's Offer

- KTI must commit to purchase a minimum of 2,500,000 kg of black tea per year, for \$3.26 per kilogram. However, as TT's certifications are not likely to be received until the end of 2025, TT will waive the minimum purchase requirement in the first year (2025).
- TT will grant KTI the option to purchase up to an additional 4,500,000 kg of black, green, and/or oolong tea per year, at the same price as above.
- KTI will prepare and file TT's Fairtrade and organic certification applications, oversee the initial audit process, and pay any applicable certification fees. These costs are estimated to be \$2 million.
- The contract's initial term is for five years, with an option for KTI to extend the contract for another five years, at KTI's discretion.

Other Information

TT is a large tea farm close to Taipei that has taken their naturally productive, lower elevation tea farm and automated its processes, to allow for efficient tea farming. TT is mostly known for its oolong and green tea, but the farm was recently expanded to grow black tea, to meet the export demands of this popular variety.

TT's farm has withstood several extreme weather events in the past several years, which did not greatly impact TT's annual crop yield. As TT is located close to a major city and airport, the farm is well situated from a logistical perspective.

APPENDIX V
SAVECO PRIVATE-LABEL CONTRACT RENEGOTIATION

Prepared by Kathleen Galinsky

Contract Renewal Offer from SaveCo

SaveCo was one of KTI's original customers, and currently provides 16% of KTI's overall annual gross revenue. SaveCo's current contract, which is for 2,300,000 kg of tea annually, at $4.33 per kilogram, expires on December 31, 2025.

SaveCo's initial offer is as follows:
- A term of ten years.
- SaveCo will purchase 2,500,000 kg of private-label tea annually, for $4.31 per kilogram.
- SaveCo will only accept Fairtrade and organic-certified black tea.
- Packaging specifications will be updated to require 100% recycled cardboard.

Negotiation Notes

- Although KTI has the reputation of being a reliable source of quality Fairtrade and organic certified tea, there are several other suppliers that could satisfy the SaveCo contract.
- SaveCo has expressed interest in potentially expanding the contract beyond just private-label tea in the future, to include an assortment of KTI's new branded products. SaveCo has indicated that, given the two companies' long-standing relationship, our KTI-branded tea would be displayed on premium shelf space.
- The required new packaging is not available through our current packaging supplier, so KTI will have to find a new supplier in order to fulfill this aspect of the contract.
- KTI's other private-label customers are eager to know the outcome of this negotiation, so they can prepare for their own renegotiations. Most of KTI's existing private-label contracts are due to be renewed within the next three years.

APPENDIX VI
MANDALA FARM AGREEMENT DETAILS

Prepared by Jason Galinsky

From the sample of teas provided by Mandala, it is evident that the farm's current farmers have incorporated their culture's traditional knowledge of tea cultivation. The quality of Mandala's raw materials is very high. I would be proud to use it for KTI-branded tea. The issue is ensuring that Mandala earns the organic and Fairtrade certifications, which, given the remote location of the farm, could make the process more challenging.

Mandala has not begun the certification process and currently lacks an awareness of what is required to become certified. Therefore, it is likely that many steps will need to be taken before Mandala's operations meet the standards. Further, the applications need to be signed by the Nepali government, and we do not have experience working in that jurisdiction. There could be additional fees and tariffs.

Mandala's tea is grown and processed using traditional methods that have been used for hundreds of years. Mandala farms black, green, and white varieties of tea.

Agreement Terms

- KTI will provide a one-time, upfront payment of CA$1.5 million upon signing the agreement. These funds will pay for the necessary infrastructure upgrades and certification administration assistance, over the next two years.
- Starting in the second year, KTI will provide an annual fixed payment of CA$425,000, to fund export costs.
- Over the ten-year contract term, KTI must purchase 100% of Mandala's annual crop production (which will not exceed 3,000,000 kg per year, given Mandala's land size).
- KTI's cost to purchase Mandala's raw materials will be set at $3.88 per kilogram for the duration of the contract.

KTI would like to use a 15% discount rate when assessing the potential value of this project.

APPENDIX VI (CONTINUED)
MANDALA FARM AGREEMENT DETAILS

Mandala Farm
Organic and Fairtrade Tea Crop Forecast
(in thousands of kilograms)

	2025	**2026**	**2027**	**2028**	**2029**
Tea production	0	0	1,500	2,000	2,500

APPENDIX VII
AUTHENTICITEA BREWING COMPANY PROPOSAL

Prepared by Sabrina McLean

AuthenticiTea Brewing Company (ABC) is a popular tea room chain. ABC's target market is the younger tea-drinking demographic that is willing to pay a premium for a unique and ethically-sourced product. ABC was drawn to KTI's new branded products, given their superior taste and quality, and because of the unique traditions and stories behind KTI's suppliers in Kenya and Sri Lanka.

ABC has proposed a contract to purchase KTI-branded products, for resale in ABC's North American tea rooms and online store.

The contract proposal is as follows:

- The contract is for five years, beginning in 12 months, whereby ABC will purchase a guaranteed minimum of 1,500,000 kg of KTI-branded tea per year.
- KTI must provide four blends of tea, changing them annually. KTI will be responsible for creating the new blends; however, there must be two spiced, one black, and one other type of tea per year.
- ABC will pay $4.88 per kilogram.
- ABC will be responsible for paying for shipment of the product.
- If KTI is unable to meet the guaranteed purchase minimum, ABC will charge KTI a penalty equal to 20% of the contract's annual value for each year the minimum is missed.
- All tea must be Fairtrade and organic certified.
- Each tea type must also include a marketing story, detailing the origin, production methods, and tasting notes of the blend; ABC will require this information to be included on product packaging.
- ABC does not require the exclusive sales rights to the teas they purchase from KTI; therefore, KTI retains the right to sell any teas produced to other customers.

APPENDIX C

MAY 29, 2024 – DAY 2
SIMULATION AND MARKING GUIDES

COMMON FINAL EXAMINATION
MAY 29, 2024 – DAY 2

Case

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

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

INDEX

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.

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.

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.

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.

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.

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.

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.

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.

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

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.

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.

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	

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.

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.

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

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.

ASSURANCE ROLE
ADDITIONAL INFORMATION

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.

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.

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.

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.

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.

FINANCE ROLE
ADDITIONAL INFORMATION

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.

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.

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.

APPENDIX V – FINANCE (CONTINUED)
ADDITIONAL INFORMATION

Financial Information for YNJ Acquisition (continued)

<u>Inventory</u>

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.

<u>Lease</u>

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.

<u>Non-capital losses</u>

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.

<u>Other assets and liabilities</u>

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.

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.

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.

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.

PERFORMANCE MANAGEMENT ROLE ADDITIONAL INFORMATION

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%.

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%

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.

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.

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.

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.

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)

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

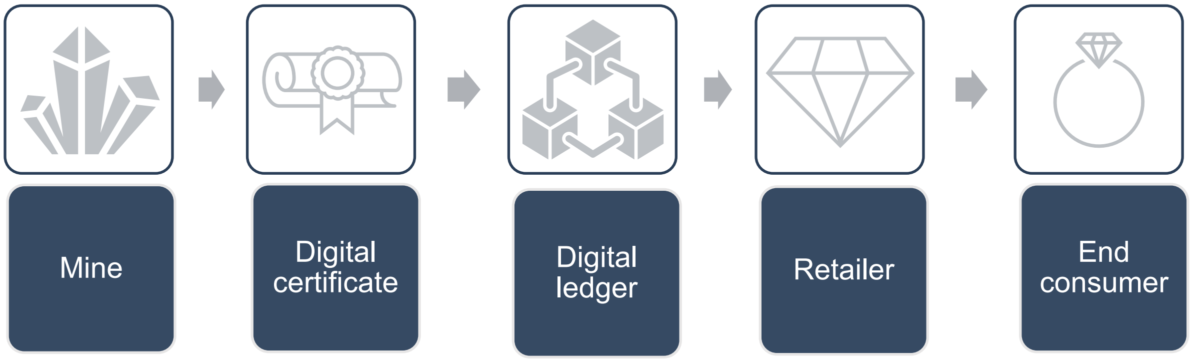
Due to the range of prices for Fancy's products, the number of individual sales generated is less important than the total value of sales. Employees are taught how to upsell specific add-ons, such as insurance and jewellery that compliments the main product. All sales are logged into the customers' files 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.

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.

TAXATION ROLE
ADDITIONAL INFORMATION

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.

Residency

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.

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.

Notice of Reassessment

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

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.

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

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.

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

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.

DAY 2 ‑ MARKING GUIDE ‑ COMMON
FANCY LUXURY JEWELLERY INC. (FANCY)

To: Kenji and Daiki Okuda
From: CPA
Re: Financial reporting and management accounting issues

Assessment Opportunity #1 (Common) (Depth and Breadth Opportunity)

The candidate discusses the financial reporting treatment for the new lifetime warranty.

The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Warranty and Revenue Recognition

IFRS 15 *Revenue from Contracts with Customers* provides guidance for the financial reporting treatment related to warranties.

> *B28 It is common for an entity to provide (in accordance with the contract, the law or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.*

That is, there are two types of warranties. Depending on the type of warranty, the financial reporting treatment is different. The first warranty type is assurance that the product will function as intended. If it does not, the company agrees to repair or replace the item. For jewellery, this might represent repairs to clasps that do not work properly or a stone setting that is loose and needs adjustment. The second type of warranty goes beyond the assurance that the product will function as intended and includes additional services that might be required.

> *B29 If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity shall account for the promised warranty as a performance obligation in accordance with paragraphs 22–30 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 73–86.*

> *B30 If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with IAS 37* Provisions, Contingent Liabilities and Contingent Assets*, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.*

In the case of Fancy, there is no additional charge for the warranty, and the customer has no choice—the warranty is simply included in the price of the good. However, although there is no additional cost to the customer, there is a question as to whether Fancy is providing both assurance and additional services. IFRS 15.B31 provides three factors to consider when assessing whether a future service is included in the contract over and above the initial assurance, as described below:

> *B31 In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity shall consider factors such as:*
>
> *(a) Whether the warranty is required by law—if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.*

In the case of diamond jewellery, the company historically has sold its products without this lifetime warranty. In addition, competitors sell this type of warranty by giving customers an option of purchasing additional warranty coverage. Based on these facts, it appears that no law exists in the jewellery industry that requires a lifetime warranty, which suggests that the warranty may represent a performance obligation.

> *(b) The length of the warranty coverage period—the longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.*

It is common in the jewellery industry to provide a warranty for up to five years on all product sales for minor repairs or replacements. For Fancy, the lifetime warranty is significantly longer than the normal practice and covers more than just initial defects. In addition, in the industry, extended lifetime warranties are offered by competitors at an additional cost to the customer of 7% of the selling price of the product. Therefore, this factor suggests that the warranty may represent a separate performance obligation.

> *(c) The nature of the tasks that the entity promises to perform—if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.*

The nature of the tasks Fancy promises to perform may be more than required for assurance purposes. In this warranty, Fancy agrees to repair the jewellery and replace the diamond after a product has been damaged if it occurred during normal wear. This could involve fixing the setting, replacing the diamond, or both. This warranty, therefore, goes beyond the promise that the jewellery will function as intended, which indicates that the warranty represents a separate performance obligation.

Given this analysis, the new lifetime warranty appears to include both an assurance-type warranty and a future service obligation. IFRS 15.B32 provides guidance for such situations:

> *B32 If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity shall allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity shall account for both of the warranties together as a single performance obligation.*

Therefore, when there is such a warranty, the assurance warranty is recognized as a provision and the promised service is recognized as a performance obligation. If it is not possible to reasonably account for each of these separately, both warranties are accounted for together as a single performance obligation.

In the case of Fancy, we do not have sufficient information to reasonably determine the amount of each of these warranties separately—in other words, what amount represents assurance and what amount represents additional services. Therefore, both warranties will be accounted for as a single performance obligation.

IFRS 15.22 states:

> *At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:*
>
> *(a) a good or service (or a bundle of goods or services) that is distinct; or*
> *(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 23).*

Therefore, under IFRS 15.22, the company has two performance obligations: the sale of the product, and the additional services to be provided in future under the warranty.

IFRS 15.73 states:

> *The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.*

Therefore, the transaction price must be allocated to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled. However, Fancy does not sell this warranty separately, but includes it in the price, so Fancy has no standalone price. In this case, the company may estimate a standalone price by using an adjusted market assessment approach, whereby it evaluates the jewellery retail market and determines what price competitors are selling this separate warranty for. We are told that competitors sell this extended warranty at a price of 7% of a product's selling price.

Based on this analysis, the revenue is allocated as follows:

Total selling price	$ 8,660,000
Revenue – product (100/107)	$ 8,093,457
Revenue – service warranty (7/107)	$ 566,543

Adjusting entry:

	Dr.	Cr.
Dr. Revenue	566,543	
Cr. Contract liability (or unearned revenue)		566,543

The next step is to determine when the service performance obligation is satisfied. It will be satisfied over the period the warranty is in effect, and in this case, the warranty is a lifetime warranty. We must determine a reasonable number of years to use for a "lifetime period" over which to recognize the warranty service revenue. In the industry, warranty claims are typically made up to 15 years from the date of purchase. Therefore, this period has been used to amortize the warranty revenue. The straight-line method has been used, but another method may be appropriate if there is information to suggest a different use pattern (for example, more claims made in earlier years while customers remember they have access to the warranty).

Since all of these sales were made during the period October to December 2023, representing approximately 25% of the year, the amount of revenue earned in 2023 is estimated as follows:

$566,543 × 25% ÷ 15 years = $9,442

	Dr.	Cr.
Dr. Contract liability (unearned revenue)	9,442	
Cr. Revenue – warranty services		9,442

Any warranty costs actually incurred under this lifetime warranty will be expensed as incurred. In addition, as the warranty is for a number of years, there is a significant financing component to this transaction. This would require an annual entry to record a financing expense and increase the contract liability. Information was not provided to perform this calculation, and the amount would be insignificant, given that the warranty has only been offered for three months.

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

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

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

Reaching competence – The candidate attempts to discuss the financial reporting treatment for the lifetime warranty.

Competent – The candidate discusses the financial reporting treatment for the lifetime warranty.

Competent with distinction – The candidate thoroughly discusses the financial reporting treatment for the lifetime warranty.

Assessment Opportunity #2 (Common) (Depth and Breadth Opportunity)

The candidate discusses the financial reporting treatment for the restructuring costs related to the change in management structure.

The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
1.2.3	Evaluates treatment for non-routine transactions	**B**

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Restructuring Provision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides guidance on recognizing and measuring a restructuring provision. First, paragraph .70 describes events that would qualify under the definition of restructuring, and under IAS 37.70 (c), "*changes in management structure, for example, eliminating a layer of management*" is a qualifying event. Fancy is eliminating all assistant managers at its stores and reallocating their responsibilities to the store managers and regional managers. This represents a change in management structure because a layer of middle management is being eliminated.

A restructuring provision can only be recognized if the general recognition criteria for a provision have been met, which are (IAS 37.14) as follows:

(a) an entity has a present obligation (legal or constructive) as a result of a past event.

IAS 37.72 provides additional guidance as to whether a constructive obligation exists, and requires that it:

(a) has a detailed formal plan for the restructuring identifying at least:

- *(i) the business or part of a business concerned;*
- *(ii) the principal locations affected;*
- *(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;*
- *(iv) the expenditures that will be undertaken; and*
- *(v) when the plan will be implemented.*

During 2023, Fancy announced and started the restructuring: the affected employees have been notified of whether their positions would be terminated, or they would be transferred to a different position in the company. This was all announced in November, and the affected employees were notified in December; therefore, this criterion is met.

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Everyone was notified by December, and in fact, the plan had already commenced prior to December 31. Therefore, this criterion is met.

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

This criterion has also been met, since outflow is likely because the restructuring was announced in November 2023.

(c) a reliable estimate can be made of the amount of the obligation.

There is a detailed plan in place, so it appears that the costs can be reliably estimated as of December 31. In addition, the fact that the amounts were paid in February 2024 provides additional support that these amounts are reliable estimates.

Therefore, a restructuring provision related to the elimination of all assistant managers in Fancy's stores can be recognized. However, IAS 37.80 and .81 give guidance on the types of costs that can and cannot be included in the restructuring provision:

> *80 A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:*
> *(a) necessarily entailed by the restructuring; and*
> *(b) not associated with the ongoing activities of the entity.*
>
> *81 A restructuring provision does not include such costs as:*
> *(a) retraining or relocating continuing staff;*
> *(b) marketing; or*
> *(c) investment in new systems and distribution networks.*
>
> *These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.*

Specifically, costs related to retraining or relocating continuing staff are not presented as restructuring costs but are recognized as operating costs, and corresponding accrued liabilities or accounts payable as they are incurred.

The items in the restructuring provision are detailed as follows:

	Original	Revised	Explanation
Severance pay for terminated employees	$560,000	$560,000	Severance pay for the terminated employees is a valid restructuring provision since it directly relates to the elimination of assistant managers.
Employee support services for retraining terminated employees	150,000	150,000	Retraining support for employees terminated is a relevant cost directly related to the elimination of assistant managers, and can therefore be included in the restructuring provision. These costs are not incurred to retrain continuing staff, so they are not excluded by 37.81(a).
Moving costs for transferred employees	213,000	0	Moving costs are part of relocation costs, and are excluded from the restructuring provision, per IAS 37.81(a).
IT changes required to accommodate the reallocation of responsibilities	175,000	0	Investments in new systems and distribution networks are not part of the restructuring since they relate to the future conduct of the business, and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognized on the same basis as if they arose independently of a restructuring, per IAS 37.81(c).
	$1,098,000	$710,000	

The adjusting journal entry required is:

Dr. Restructuring provision	388,000	
Cr. Restructuring costs		388,000

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

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

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

Reaching competence – The candidate attempts to discuss the financial reporting treatment for the restructuring costs.

Competent – The candidate discusses the financial reporting treatment for the restructuring costs.

Competent with distinction – The candidate thoroughly discusses the financial reporting treatment for the restructuring costs.

Assessment Opportunity #3 (Common) (Depth and Breadth Opportunity)

The candidate discusses the financial reporting treatment for cash, cash equivalents, and other short-term investments.

The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
1.2.2	Evaluates treatment for routine transactions	A
1.3.2	Prepares routine financial statement note disclosure	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Cash and Cash Equivalents

We need to assess the cash deposits and investments, to determine if they qualify as cash or cash equivalents for presentation purposes.

IAS 7 *Statement of Cash Flows* provides guidance on what is included as cash and cash equivalents. With respect to cash, IAS 7.6 simply states that "*cash includes cash on hand and demand deposits.*" There is no further discussion on what is defined as cash.

IAS 7.6 defines cash equivalents as "*short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.*" IAS 7.7 further states that "*cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.*"

Based on this guidance in IAS 7, each of the components of cash and cash equivalents is discussed below.

<u>Cash (bank overdraft)</u>

IAS 7.8 states:

> *Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.*

Therefore, bank borrowings can be included in cash equivalents only when the bank overdraft is repayable on demand and is an integral part of the company's cash management. In this case, all of the items listed by Steven are central to the company's cash management policies. As described in IAS 7.8, if a chequing account often fluctuates between positive and negative balances during the year, it can still be considered part of cash equivalents at the year-end date, even though it might be in an overdraft position at that time. Therefore, this account can stay as part of cash and cash equivalents.

Guaranteed investment certificate (GIC)

This GIC was purchased for a six-month term, and its cash value is known. However, although it matures within three months of the year end, it is not considered part of cash equivalents since its term at the date of purchase is longer than the three-month maximum. This investment must be shown as a current short-term investment, and not included as part of cash equivalents.

90-day term deposit

This term deposit has a fixed return, so its value is known. It matures in 90 days, which meets the requirement of three months or less. Therefore, this term deposit qualifies as a cash equivalent.

Restricted cash

This cash is sitting in a demand deposit bank account, and therefore meets the definition of cash. There are no other requirements in IAS 7 that are used to determine whether an item is cash. The definition of cash does not require that the company hold the item for meeting short-term cash commitments. In addition, IAS 7.48 and .49 state the following:

> *48 An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.*
>
> *49 There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.*

Based on this guidance, cash can be subject to contractual restrictions that cause it to be unavailable for general purposes. In this case, the cash is restricted due to the contractual requirement with a supplier, that requires a fixed amount of cash be held as security for its payables. This contractual obligation limits the use of the cash in the demand deposit for a specified purpose (for the supplier payable) but does not change the nature of the cash asset, since Fancy still has access to the cash at any time. Technically, this item can remain as part of cash. However, Fancy could present this item separately on the statement of financial position if this separate disclosure would be more relevant to the user's understanding of Fancy's financial position. In either case, note disclosure is required, to explain that this demand deposit is restricted and the nature of the restriction. For now, we have left the item as cash.

Money market funds

These units can be redeemed at any time; therefore, Fancy can quickly access this cash. However, the amount of cash received on redemption depends on the market value at the date of sale, which introduces an amount of risk. If there is little fluctuation in value and returns, the risk might be considered insignificant (and therefore, this investment could be a cash equivalent). However, the fund is invested in high credit-rated corporate bonds and government bonds, with maturity dates of one year to two years. This is longer than three months, so there is some risk due to some of the issuers being corporations, and due to the longer maturity dates of the bonds. In addition, the returns on funds have fluctuated between 2% and 7%, also indicating more than insignificant risk. Based on this assessment, we conclude that these investments do not qualify as cash equivalents, since they have more than an insignificant risk and the amount of cash value is not known. Therefore, they are presented as short-term investments.

Revised totals

	Cash and Cash Equivalents	**Short-Term Investments (Included in Current Assets)**
Cash (bank overdraft)	$ (125,000)	
Guaranteed investment certificate		$1,300,000
90-day term deposit	820,000	
Restricted cash	1,570,000	
Money market funds		1,625,000
	$2,265,000	**$2,925,000**

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

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

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

Reaching competence – The candidate attempts to discuss the financial reporting treatment for the cash, cash equivalents, and other short-term investments.

Competent – The candidate discusses the financial reporting treatment for the cash, cash equivalents, and other short-term investments.

Competent with distinction – The candidate thoroughly discusses the financial reporting treatment for the cash, cash equivalents, and other short-term investments, and calculates the revised amount.

Assessment Opportunity #4 (Common) (Depth and Breadth Opportunity)

The candidate critiques and revises the giftware quantitative analysis, provides some qualitative analysis, and recommends whether to go forward.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core
3.4.1	Evaluates sources and drivers of revenue growth	**B**

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

Giftware Line

We have been asked to assess whether the company should add a giftware line, and to make a recommendation.

We have critiqued and revised the quantitative analysis, as follows:

New revenue – giftware	$3,560,000	
Additional sales of other in-store products	600,000	
Variable costs		
Cost of goods sold – giftware	(2,314,000)	65% × giftware revenue
Cost of goods sold – other in-store products	(325,800)	Note 1
Sales commissions	(249,600)	Note 2
Distribution and warehousing costs – giftware	(356,000)	10% × giftware revenue
Distribution and warehousing costs – other in-store products	(25,800)	Note 3
Contribution margin	888,800	
Fixed costs		
Marketing	(350,000)	Note 4
Staff costs	0	Note 5
Travel and meeting costs with new suppliers	(230,000)	Note 6
Amortization of leasehold improvements in the four stores	(240,000)	Note 7
Net increase in profits	$ 68,800	

Note 1: The cost of goods sold for the other in-store products is not 65%, but is 54.3% ($48,075 ÷ $88,550). 54.3% × $600,000 = $325,800.

Note 2: In-store salespeople are paid a fixed wage plus 6% commission on the sale of new jewellery, and we assume this policy would be similar for the sale of the giftware. These commission costs have been added, for an amount of $249,600 (6% × $4,160,000).

Note 3: The distribution and warehousing variable costs on the other in-store products are 4.3% × $600,000, not 10% of sales, as required for the giftware.

Note 4: Only incremental costs should be included in the analysis, and the incremental marketing costs will be $425,000 - $75,000 = $350,000.

Note 5: There are no incremental costs for staff. Taylor will add these to his responsibilities initially, and there is no indication that Fancy will hire anyone new to replace any of his old duties, so there are no immediate additional costs.

Note 6: There will be additional travel costs of $230,000, which are fixed and occur annually.

Note 7: The four stores that have the existing store capacity to sell these new products will require new leasehold improvements. Given the estimate of five years of useful life, the annual amortization will be 4 × $300,000 ÷ 5 years = $240,000.

Based on the above revised analysis, adding giftware will increase the company's profits, provided the expected revenues are achieved.

<u>Qualitative analysis</u>

The following are the advantages and disadvantages of adding this new product line.

Advantages:
- It allows the company to target new customers who would not normally come into the stores.
- Once new customers come into the stores, they might see jewellery they are interested in and purchase it too. Additional sales may be higher than estimated.
- Giftware does not compete directly with jewellery, so there should be minimal cannibalization of sales of current products.
- Adding giftware in the four stores will use empty store capacity, which should improve total sales per square foot for each of these stores.
- Giftware that is unique and high-quality is in line with the company's current brand and its reputation for selling exclusive, high-quality products at a wide range of price points.

Disadvantages:
- Due to capacity constraints, this product line will only be sold in four out of thirteen stores. This may confuse customers, who expect to see similar products in all the company's stores, and muddy what the brand stands for. However, if the project is successful in the four stores, other options could be explored.
- There is a lot more competition in the high-end giftware segment of the market. This segment has experienced increased competition from department stores, mass merchandisers, and e-commerce platforms. Therefore, Fancy may not be able to achieve the revenues projected. The additional profits anticipated are currently low, and a small reduction in sales could result in losses.
- Giftware does not have to be tried on, unlike jewellery. Therefore, Fancy may have increased competition from e-commerce platforms because it is not yet selling its products online.

- Fancy will have to rely on a third-party provider for warehousing and distribution. Currently, Fancy does this in-house. Issues could arise, including inventory not being shipped on time, wrong inventory being shipped, or damaged inventory. These types of issues would be detrimental to the company's reputation for providing quality customer service.

Recommendation

We recommend that the company add the giftware product line. The quantitative analysis indicates that adding this new product line will increase the company's profits. In addition, many advantages can be realized by attracting a new customer base, including increases in sales of other in-store products.

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

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

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

Reaching competence – The candidate attempts to critique and revise the giftware quantitative analysis, and to provide a qualitative analysis for adding the new product line.

Competent – The candidate critiques and revises the giftware quantitative analysis, provides a qualitative analysis for adding the new product line, and makes a recommendation on whether the new product line should be added.

Competent with distinction – The candidate thoroughly critiques and revises the giftware quantitative analysis, provides a thorough qualitative analysis, and makes a recommendation on whether the new product line should be added.

Assessment Opportunity #5 (Common) (Depth and Breadth Opportunity)

The candidate analyzes Fancy's privacy and data security practices, given its new customer relationship management system, and makes appropriate recommendations.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core
3.1.2	Documents and assesses business processes, systems and data requirements and recommends improvements to meet information needs	**B**
3.1.3	Identifies ethical and privacy issues related to information technology and its use	**B**

CPA Map Enabling Competencies:
1.3.1 Maintains a skeptical mindset when performing assigned work
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Customer Relationship Management System

We have been asked to analyze Fancy's privacy and data security practices, given its new customer relationship management system, and to recommend necessary changes.

Fancy is now collecting confidential and sensitive information related to its customers. Canada's Privacy Act outlines regulatory requirements related to gathering and using customers' information, and actions to take in the case of a data breach. A data breach is the release of private information to an unauthorized environment. In addition to the Privacy Act, Canadian organizations must also follow anti-spam legislation.

With these concerns in mind, we will discuss the collection of data, maintenance and security of the data, detection of breaches, and related recommendations.

Type and necessity of data collected

The first consideration in privacy is to only collect data that the company is absolutely required to retain. In reviewing all the information that has been collected, we determined that the customer's birthdate should not be necessary. A birthdate is confidential and sensitive information that is often used for security reasons, to verify whether a person is who they claim to be. This would be useful information for hackers to try to obtain. Given the nature of Fancy's business, the birthdate does not appear to be necessary for any business reason, and should not be collected. Existing birthdate information should be deleted from Fancy's records as soon as possible. If this information is needed for marketing purposes, another option could be to request a partial date of birth (such as month and date only, or year only) from the customer.

It is also worth considering whether the customer's full address is required for any business reason. Since Fancy manages its business by geographic region, we suggest that only the city name be kept, unless there is some other valid reason for keeping the customer's full address.

Finally, although the customer's name, email addresses, and phone numbers are types of private information that could be valuable to hackers, this information needs to be retained for keeping data on sales and subsequent repairs, and for communicating with active customers. Therefore, the company needs to ensure that this information is secure and well protected.

Method of collection

Customers provide the information to the salesperson, so they are aware they are providing the information, but there is no indication that they have been told why the company is collecting the information, how it will be used, or how long it will be retained. For example, the marketing department will have access to this information for specific and targeted marketing promotions.

Under the Privacy Act, Canadian organizations must follow anti-spam legislation. This includes rules around sending messages to customers and potential customers without consent, and using email addresses without permission. Fancy should ensure that customers are aware of the information being gathered, and should obtain evidence that the customer has agreed to their emails being used for marketing initiatives. This might be a box the customer ticks, to confirm whether they have agreed to this information being used when it is collected. In addition, any emails customers receive should provide them with the ability to unsubscribe at any time, to opt out of this use of their email addresses.

Data maintenance and security

This information is stored in three locations.

1. Point-of-sale computer hard drive
Initially, the information is maintained on the local hard drive of the computer where the sale took place. Information on all these transactions is maintained on that hard drive for 60 days, and is then deleted by the store manager. This period is too long: there may not be a valid business reason for retaining this information locally on the hard drive for 60 days. The fewer locations where information is kept and accessible, the more secure it is, so ideally, this information should not be retained on local hard drives, and this practice should be changed. If it must be kept on the local hard drive for some time, access needs to be limited to the store manager only. Finally, it should not be left up to the store manager to ensure that the information is deleted. IT staff should complete this purge on a regular basis, following protocols for deleting the information securely, or an auto-deletion function could be programmed into the terminal.

2. Central database
Each night, the information is uploaded to the central database. The central database is kept on servers at head office, and all directors and IT staff have access to the entire central database.

There should be a valid business reason for all directors to have access to the entire central database. If there is not, their access should be removed. Access should be based on need only, and the company should ensure that access and duties go hand in hand. Fewer people with access to the database will increase security of the information. It may be that some of the information is required by each of the directors, but in that case, they should be able to request the specific information they require, and IT could provide the data on an as-needed basis. Alternatively, their login could give limited access to only certain areas of the database or summary reports.

3. Hard copies
A hard copy for each customer's transaction is printed and retained for seven years in a locked filing cabinet at the store where the transaction arose. It is left up to the store manager to periodically purge these files. The fact that the cabinet is locked, with the store manager having the only key, is a good, secure practice.

However, even though this was part of past practices, before records were kept in electronic format, there may now be no need to keep hard copies. Reducing this duplicate information storage will decrease the risk that the information is breached. If a hard copy does need to be maintained, the company must determine how long it needs to be stored (from a security perspective, the shorter the period, the better), and how it should be destroyed. When hard copies are destroyed, the information needs to be shredded and properly disposed of, so that theft of the information cannot occur.

Detection of access and breaches

Given that the customer relationship management system is new, Fancy will need to implement some ongoing monitoring of access and detection of any breaches. The company needs to have the following:

- Central log files to monitor activity on the database—lookups, changes, etc. The logs need to be reviewed and followed up on immediately by a senior IT manager.
- Monitoring of incoming traffic for possible hacking, and outgoing traffic for signs of a data breach. Again, any unusual activities need to be immediately followed up on, to understand the nature of the information being transmitted.
- Additional security monitoring, including security testing and investigation, and learning from security incidents.
- A plan for responding to security incidents. In the case of a breach, the company needs a plan of action that it can take immediately. This plan should designate a senior manager as a privacy officer, to take control and identify who needs to be notified of any security incidents, both internal and external to the company. If a breach of privacy is believed to have occurred, Canada's Privacy Act requires organizations to notify both the Privacy Commissioner and affected individuals.

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

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

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

Reaching competence – The candidate analyzes Fancy's privacy and data security practices, given its new customer relationship management system, or makes recommendations for its privacy and data security policies.

Competent – The candidate analyzes Fancy's privacy and data security practices, given its new customer relationship management system, and makes some recommendations for its privacy and data security policies.

Competent with distinction – The candidate thoroughly analyzes Fancy's privacy and data security practices, given its new customer relationship management system, and makes several recommendations for its privacy and data security policies.

Assessment Opportunity #6 (Common) (Depth and Breadth Opportunity)

The candidate performs a quantitative and qualitative analysis of the potential store closure.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
3.3.1	Evaluates cost classifications and costing methods for management of ongoing operations	**A**

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

For the assessment of whether the company should close Victoria, we have prepared a quantitative analysis and a qualitative analysis, as discussed below.

Quantitative: Calculation of Incremental Operating Income

		Note
Lost contribution margin (CM) from store	$ (1,904,960)	1
Fixed costs specific to Victoria, avoided if store closed		
In-store employees	324,500	
Local and regional marketing costs	160,500	2
Maintenance, utilities, insurance, and property taxes	132,921	
Store manager wages and benefits	0	3
IT support costs	115,000	4
Head office general and administration costs	0	5
Sublease revenue	520,000	6
CM of sales transferred to the Vancouver store	857,232	7
Recurring incremental operating income (loss) if Victoria is closed	205,193	
Additional one-time costs at time of closing:		
Moving costs for the store manager	(10,000)	8
Severance for in-store employees (20% × $324,500)	(64,900)	8
Incremental operating income in year of closure	$ 130,293	

If the store is closed, the company will earn $130,293 of incremental income in the year of closure, and will earn annual operating income of $205,193 afterward (until the lease expires in 2027, as explained in Note 6). From a quantitative standpoint, the Victoria store should therefore be closed.

Notes:

1. Lost contribution margin if the store is closed:

Sales	$ 5,619,000
Variable – cost of goods sold	(3,087,900)
Variable – sales commissions	(337,140)
Variable – distribution and warehousing	(289,000)
Contribution margin on total sales	$ 1,904,960

2. 75% of the local and regional marketing costs are directly related to this store. 75% × $214,000 = $160,500.

3. The store manager would be moved to Toronto; therefore, the wages and benefits related to the manager would remain.

4. These are allocated costs, based on time, plus an additional $23,000 for overtime paid to the IT staff that would not normally be paid. Therefore, this entire cost would be avoided if the store is closed.

5. The $210,800 of head office general and administration costs are allocated costs from head office that are not based on work performed. There is no indication that these costs would be reduced for the entire company if the store closed.

6. The sublease rental income will continue until 2027, when the lease expires. The lease has been capitalized, and the related amortization of the right-of-use assets and the interest on the lease obligation do not appear to be included in the store's divisional reports. The lease costs will continue to be incurred regardless of whether the store is closed. However, the sublease rental income will increase operating income until 2027 if the store is closed. Once the lease expires, the leasing costs and the sublease rental revenue will both be eliminated, and this will reduce the recurring amount of incremental impact on operating income at that time.

7. It is estimated that 45% of all sales from the Victoria store could be performed by the Vancouver store instead if Victoria closes—45% of the contribution margin generated by the store would simply be transferred, not lost. The amount of contribution margin transferred is 45% of $1,904,960 (Note 1), which amounts to $857,232.

8. There are two non-recurring costs that will occur only in the year of closure: moving costs, and severance pay. These added costs result in a higher loss of operating income in the year of closure only.

Qualitative Analysis

Before the store is closed, other factors should be considered.

Decline in revenues

Sales at the Victoria store have been declining annually since 2021. The reasons for this decline should be investigated, to assess whether the decline could be fixed with operational changes.

Employee satisfaction (restructuring)

The store closure, in addition to restructuring and laying off assistant managers, may worsen employee morale throughout the BC region, which may affect sales and lead to loss of employees.

Reputation

Victoria has been open for 25 years, and closing the store may affect Fancy's reputation in the area, since the company may have loyal, long-time customers. New customers (at the stores that are not closed) may be concerned about Fancy's ability to honour its warranties and provide repairs in future. Closing a store may also provide an opportunity for competitors to expand into Victoria, which could improve their brand reputation (and thus harm ours).

Assumptions on transferred sales

Although it has been estimated that 45% of sales will be transferred to the Vancouver store, the actual amounts may be much lower than that. The travel time between Vancouver and Victoria is four hours. Customers may be reluctant to travel this distance, and may instead purchase from local competitors. This loss of additional sales would further increase the lost incremental income.

Strategic alignment

Fancy has a strategy of closing low-performing stores, and the industry is slowly moving more toward e-commerce. Closing this store would be aligned with the strategy of closing low-performing stores, and could be mitigated or even enhanced by an increase in e-commerce activity.

<u>Recommendation</u>

Our recommendation is to not close the Victoria store, but to further investigate why sales have been declining there. Once this investigation is complete and any changes have been made, the company should reassess its future, recalculate the revised incremental income or loss amount at the end of 2024, and decide at that time whether to close it. If the incremental income of closing the store is positive at that time, the store should be closed.

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

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

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

Reaching competence – The candidate attempts to perform a quantitative and qualitative analysis of the potential store closure.

Competent – The candidate performs a quantitative and qualitative analysis of the potential store closure.

Competent with distinction – The candidate thoroughly performs a quantitative and qualitative analysis of the potential store closure, and recommends next steps.

DAY 2 ‑ MARKING GUIDE ‑ ASSURANCE ROLE
FANCY LUXURY JEWELLERY INC. (FANCY)

To: George, engagement partner
From: CPA
Subject: Fancy requests

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

Assessment Opportunity #7 (Depth Opportunity)

The candidate discusses the appropriate financial reporting treatment for the two investment alternatives.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
1.2.3	Evaluates treatment for non-routine transactions	**B**	**A**

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

Steven has asked for guidance on the appropriate financial reporting treatment for two different bond alternatives offered by Karat. Both alternatives will be issued for $950,000; however, depending on the alternative chosen, the interest rate will be either fixed at 12% (under Alternative 1) or variable, based on the prevailing spot price of gold at the date of each semi-annual payment (under Alternative 2).

A bond receivable is considered a financial asset, which is a financial instrument and should be accounted for under IFRS 9. Under IFRS 9 *Financial Instruments*, Section 3.1.1, "*an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument*." In this case, when Fancy invests in the bond receivable on June 1, 2024, the financial asset will need to be recorded; however, depending on the alternative selected, the classification of the financial asset and subsequent measurement will differ.

In classifying the bond receivable, we must refer to Section 4.1 of IFRS 9, which is discussed below.

Per Section 4.1.1, "*unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:*

(a) the entity's business model for managing the financial assets and
(b) the contractual cash flow characteristics of the financial asset."

Section 4.1.4 states that "*a financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A.*"

IFRS 9, Section 5.1.1 indicates that, "*at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.*"

Furthermore, Section 5.2.1 states that "*after initial recognition, an entity shall measure a financial asset at:*

(a) amortised cost;
(b) fair value through other comprehensive income; or
(c) fair value through profit or loss."

Initial measurement: Regardless of the classification, the bond receivable should be initially measured at the fair value, which is the face value of the bond receivable, as it is issued at par. However, there is a difference in the treatment of the transaction costs directly attributable to the acquisition of the financial asset. If the classification is amortized cost or fair value through other comprehensive income, the transaction costs are added to the initial cost of the investment and expensed over the term of the bond as part of the interest revenue. If the classification is fair value through profit or loss, the transaction costs are immediately expensed.

Alternative 1: Bond with Fixed Interest Rate

Under this alternative, the bond receivable includes cash flows that solely relate to the principal amount of the bond and the associated interest. The interest income that Fancy receives will be fixed at an annual rate of 12%, or $57,000 ($950,000 × 12% × 6/12), payable every six months for the three-year term, and it is solely the return for the credit risk associated with the bond receivable.

First, we need to consider appropriate classification of this alternative, based on Section 4.1. There are two criteria: the business model objective for making the investment, and the nature of the cash flows received.

(a) Business model objective: Under IFRS 9, there are three business model objectives to consider: (1) to solely collect the cash flows on the bond receivable and hold to maturity; (2) to hold to collect cash flows on the bond receivable or sell the asset if an opportunity arises; or (3) to hold primarily to sell. Steven has noted that Fancy's current plan is to hold the bond until maturity. Therefore, this will be a factor in determining the classification, since Fancy appears to fall into the category of collecting cash flows and holding to maturity.
(b) Cash flows: The contractual cash flows of the asset relate to interest income of $57,000 every six months. As previously noted, the interest received is solely the return for the credit risk related to Karat.

Below, we examine whether Alternative 1 meets the criteria for classification as amortized cost.

<u>Classification as amortized cost</u>

Per Section 4.1.2:

> *A financial asset shall be measured at <u>amortised cost</u> if both of the following conditions are met:*
> *(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and*

As Fancy plans to hold the bond to maturity and solely collect the cash flows on the bond receivable, without the intent to sell the bond receivable, this business model objective supports the classification of amortized cost.

> *(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.*

The second criterion related to cash flows is met, as the return is solely based on Karat's credit risk, as discussed above.

Therefore, Alternative 1 meets the criteria to be measured at amortized cost.

Initial measurement: As noted above, associated transaction costs are added to the cost of the investment.

Subsequent measurement: Measuring at amortized cost results in the balance of the investment being equal to the initial cost minus any principal repayments, plus or minus the cumulative amortization, based on the interest rate. The effective interest rate is used to record interest earned. Since the bond is to be issued at par (and assuming there are no associated transaction costs), the effective interest rate is equal to the stated rate of 12%, and no discount or premium is amortized. Since the bond is recorded at cost and there is no amortization of discount or premium, the investment will remain unchanged during the three-year term unless it becomes impaired. Expected credit losses relating to the bond receivable will be measured at each reporting period. Interest income will be recorded when it is earned on the income statement.

Alternative 2: Bond with Interest Income Tied to the Market Price of Gold

The interest to be received on the bond receivable is tied to the spot price of gold at the date of each semi-annual interest payment. Therefore, the interest return is not tied solely to credit risk, but also to changes in the spot price of gold.

Section 4.1.3 references "*for the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):*

> *(a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.*
> *(b) interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.*"

As required by Section 4.1.3, only if the interest relates to a return of credit risk can the investment be considered for classification as amortized cost or fair value through other comprehensive income. Under Alternative 2, the interest income Fancy receives will fluctuate, based on the spot price of gold at the date of each semi-annual interest payment. In this case, the interest received is not solely tied to credit risk of Karat, but is also affected by changes in the spot price of gold.

In considering Section B4.1.7A under IFRS 9, "*exposure to changes in equity prices or commodity prices do not give rise to contractual cash flows that are solely payments of principal and interest*," this bond cannot be classified at amortized cost or fair value through other comprehensive income, as it does not meet the condition of giving rise to contractual cash flows that are solely payments of principal and interest. This bond alternative would need to be classified as fair value through profit or loss, as it cannot be measured through amortized cost or fair value through other comprehensive income.

Initial measurement: The bond receivable should be initially measured at the fair value, which is the face value of the bond receivable, as it is issued at par. If there are associated transaction costs, these are immediately expensed in profit or loss.

Subsequent measurement: At each reporting period, the bond is revalued to fair value, and the changes reported immediately in profit or loss. The amount of interest received is considered in the calculation of fair value; however, interest income is not reported separately for financial assets classified at fair value through profit or loss.

Under this method, fair value needs to be determined at each reporting period, and any fluctuation in the fair value year-over-year will impact the profit or loss for that year.

Conclusion

Considering Fancy's plan to hold the bond to maturity, the company would account for Alternative 1 under amortized cost. Alternative 2, the bond with the fluctuating interest based on gold prices, must be classified as fair value through profit or loss, as discussed above. Under this method, any changes to the fair value of the bond would immediately impact profit or loss, which may not be advantageous to Fancy.

Alternative 1 will have a more stable impact on the financial statements. Measuring the bond receivable using the amortized cost method is much more straightforward than accounting for Alternative 2 under fair value through profit or loss, as it will take a significant amount of time to determine fair value at each reporting date.

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

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

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

Reaching competence – The candidate attempts to discuss the financial reporting treatment of the investment alternatives.

Competent – The candidate discusses the financial reporting treatment of the investment alternatives.

Competent with distinction – The candidate thoroughly discusses the financial reporting treatment of the investment alternatives.

Assessment Opportunity #8 (Depth Opportunity)

The candidate revises the draft preliminary audit plan.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
4.3.4	Assesses materiality for the assurance engagement or project	**B**	**A**
4.3.5	Assesses the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures	**B**	**A**
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	**B**	**A**

CPA Map Enabling Competencies:
2.2.1 Assists in identifying and monitoring risks within areas of work responsibility
2.2.2 Recognizes the importance of internal controls within areas of work responsibility
5.1.1 Applies general business knowledge to enhance work performed
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Preliminary audit planning activities were completed in September 2023, prior to year end. Since the initial planning was completed, changes have occurred at Fancy and additional issues have arisen, so the audit planning memo needs to be revised. As well, the current documentation does not adequately consider the risks present, basis for materiality, or rationale for audit approach, and needs to be revised and updated.

Risk Assessment

Given that, since September, changes have occurred in the operating environment and risks have been identified, these need to be considered and documented in the audit file.

The following factors that increase the risk of material misstatement at the overall financial statement level have been identified:

- Weaknesses have been identified within the inventory management system, including within the purchase and payment practices and the internal fulfillment processes. In addition, security weaknesses in the customer relationship management system have been identified, which may also result in risks of material misstatement in sales. These internal control issues could lead to errors being made, and not detected, in the financial statements. Control weaknesses also provide opportunities for fraud to occur.
- Fancy did not have an active CFO for the last quarter of the fiscal year or at year end, which could lead to an increase in financial reporting errors not being detected and corrected, or items being unreported. This is evident by the financial reporting issues identified relating to the accounting treatment of the new warranty, the restructuring costs, and the cash and cash equivalents. The lack of CFO increases the likelihood of additional errors being present in the financial statements.
- Sales and profits have seen little growth, and Fancy is considering adding a giftware line, which may lead to limited management oversight of current operations and inadequate control processes. The lack of growth may also lead store managers to manipulate financial results, to satisfy the board and shareholders. This could cause errors or fraud to exist in the financial statements and not be detected by management.

- The elimination of assistant managers near year end may also result in risks of material misstatement in the stores. This is because either certain controls may no longer be performed or, if those controls were transferred to store managers or regional managers, those people may not have sufficient time or knowledge to perform the controls effectively.
- The board did not have anyone with a strong background in finance and accounting until the new CFO joined in 2024. Therefore, errors may not be detected and addressed appropriately.

Based on the above, the risk of material misstatement at the financial statement level has increased since the preliminary assessment. It will be important to have experienced staff assigned to the engagement team, and we should increase supervision throughout the audit, to address the risks identified.

Approach

The preliminary audit plan indicated that a combined approach would be applied to the audit of Fancy, specifically placing reliance on the controls regarding inventory, revenue, trade payables, and property, plant, and equipment. This may not be appropriate for the 2023 audit, given the changes to the operating environment throughout the year, including having no CFO for four months, and the control weaknesses identified within the inventory processes and systems. In addition, the elimination of assistant managers in stores near the end of the year may also have resulted in certain controls at the store or regional level not being performed consistently or accurately. These factors increase the company's control risk, and we should consider using a substantive approach, at least in the areas of concern, such as for inventory and for transactions recorded in the period of September to December.

Materiality

The preliminary audit plan indicated that materiality should be calculated based on a percentage of operating income; however, we did not document the users and their needs, the reason behind using operating income as a base, and how we arrived at a materiality percentage of 5% of operating income. As well, although we calculated performance materiality, we did not discuss or support our reasoning for using 75% of materiality.

<u>Users of the financial statements</u>

The main users of the financial statements are Kenji and Daiki, as the co-owners of Fancy. Kenji and Daiki would be interested in ensuring that the financial statements are free from material misstatement, because they rely on the financial results to measure the company's overall performance and evaluate their return on investment.

Other users of the financial statements are the board and, potentially, future lenders. The board members will use the financial statements to assess the company's performance and profitability, and to make future planning decisions. Potential lenders will be interested in Fancy's ability to repay any issued debt through cash flows.

These users would be interested in income as a measure of financial performance. CAS 320 suggests that "*profit before tax from continuing operations is often used for profit-oriented entities.*" During preliminary planning, operating income was used as the benchmark for profit before tax from continuing operations. However, operating income excludes investment income and interest expense, which are components of Fancy's continuing operations. Furthermore, 2023 operating income includes the restructuring costs, which do not represent a recurring expense for Fancy. Therefore, it is recommended that normalized income before taxes be used as the materiality benchmark for the audit.

CAS 320.A8 also states:

> *Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment… For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.*

Given that 5% is recommended for profit-oriented entities, and because there are no other factors to suggest the users of the financial statements are extremely sensitive to errors, 5% should be applied to normalized income before taxes.

CAS 320 also states that performance materiality is *"the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce aggregation risk to an appropriately low level*." Performance materiality is typically set at 50% to 90% of materiality. Given the new risks that have been identified since the preliminary audit planning and the fact that Fancy had no CFO for the last four months of the year, which may have allowed material misstatements to go undetected, a performance materiality factor on the lower end should be applied, rather than the 75% originally applied. I have recommended that performance materiality be calculated at 60% of materiality.

<u>Preliminary materiality and performance materiality calculation</u>

Using the draft financial statements, income before taxes should be normalized, to adjust for the restructuring costs and the loss on disposal of PP&E. Normalized income before taxes is $7,638,000 ($5,169,000 + $1,349,000 + $1,120,000). Preliminary materiality should be set at $380,000 ($7,638,000 × 5%, rounded down), and performance materiality should be set at $228,000 ($380,000 × 60%).

<u>Revised materiality and performance materiality calculation</u>

Materiality needs to be revised as we become aware of issues affecting the calculation. Given the adjustments made to the financial statements, based on the financial reporting issues, the revised normalized income before taxes is $7,080,899 ($7,638,000 - $566,543 + $9,442). Only the adjustments related to the warranty need to be considered, as the restructuring costs are excluded from normalized income. Therefore, materiality should be set at $354,000 ($7,080,899 × 5%, rounded down), with performance materiality set at $212,400 ($354,000 × 60%).

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

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

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

Reaching competence – The candidate attempts to revise the draft preliminary audit plan.

Competent – The candidate revises the draft preliminary audit plan.

Competent with distinction – The candidate thoroughly revises the draft preliminary audit plan.

Assessment Opportunity #9 (Depth Opportunity)

The candidate recommends audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

The following audit procedures are related to specific accounting issues that arose in 2023. These audit procedures are responsive to risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures related to the warranty program, the management terminations, and the various components currently recorded in cash and cash equivalents.

Warranty revenue and contract liability

- To test occurrence, accuracy, and classification of revenue and the completeness, accuracy, and classification of the associated contract liability for the lifetime warranty, we should perform the following steps:
  - Examine evidence (approval of the lifetime warranty program by the board, promotional material provided to customers, etc.) that the warranty program for diamond jewellery started in October 2023.
  - To verify existence and accuracy of the sales under the new warranty program, select a sample of transactions from the total sales listing for the $8,660,000. For the sample of sales transactions, trace to receipt or sales invoice to validate that the sale was made, the date of the sale, the amount of the sale, what was sold (diamond jewellery), and that a lifetime warranty was provided.

   - Inquire with management about the rationale for applying the percentage of 7% of total revenue, to estimate the amount of revenue that relates to the warranty performance obligation. If based on typical warranty prices in the industry, visit Fancy's competitors' websites to assess whether they are selling warranties, and calculate the percentage in comparison to the product being purchased, to assess whether 7% is reasonable.
   - Using the information verified above, recompute the amount of revenue that relates to the sale of the diamond jewellery (100 ÷ 107), and the amount that relates to the contract liability for the warranty (7 ÷ 107).
- To test occurrence and accuracy of warranty revenue for 2023, gather industry information to support the number of years to use for a "lifetime period," and assess the appropriateness of management's estimate of using 15 years.
- To test occurrence and accuracy of warranty expenses, we should trace entries from the general ledger to employee timesheets, outlining the labour and invoices supporting the material costs required to repair the diamond jewellery, as well as to product information on the jewellery repaired, to validate that the claim was a valid warranty claim for a piece of Fancy diamond jewellery.

<u>Restructuring provision</u>

- To test the existence and appropriate classification of the restructuring costs as a provision, we should review the formal restructuring plan and details of expenditures to be made (e.g., severance pay to terminated employees, terminated employee retraining, moving costs for transferred employees, IT changes for transferred employees, etc.). In addition, we should obtain evidence supporting the date of the obligation, such as the announcement in November and the formal communications shared with employees (copies of emails or formal notices provided in December), to validate that the plan meets the criterion of a provision.
- Also related to the classification assertion, we should obtain supporting documents (invoices, quotes, timesheets, etc.), and review the nature of each type of expenditure, to ensure that it qualifies to be included in the provision under IAS 37. Only incremental costs related to terminated employees will qualify.
- To test the valuation of the restructuring provision, we should review the items that make up the provision, and discuss with management the estimates used to determine the valuation of these expenditures. We should assess the supporting documentation of the estimates for reasonability against any agreements or contracts (e.g., severance costs against actual payroll records and the severance agreement, support services for retraining terminated employees against contracts with third-party providers, etc.).

- To test occurrence of the restructuring expenses, we should inspect the expenses journal and trace to the invoice, supplier quote, or other supporting documentation. We should also review the evidence obtained, to determine the date the costs were incurred (i.e., in 2023 or 2024), to ensure that the cut-off of these expenses is accurate. For example, moving costs for transferred employees in 2023 will be an expense in 2023, but moving costs incurred in 2024 should not be recorded in 2023. As the amounts were all paid in February 2024, we can trace the amounts to the bank statement or cheque copy to confirm that the payments were made.

Cash and cash equivalents

- To test the existence and rights and obligations of the cash balance (overdraft) and investments classified as cash equivalents, we should send a confirmation request to each third party (e.g., bank, broker, etc.), to confirm the amounts and terms of each investment as at December 31, 2023.
- To test rights and obligations of the investments, we could also examine the investment statements from December, to validate that the investments are registered to Fancy. These statements should detail the types of investments held and market values.
- To test the appropriate classification and presentation of cash equivalents, we should obtain investment certificates or other supporting documentation that outlines the terms and conditions of these investments, and determine if they individually meet the definition of a *cash equivalent*. We should consider the liquidity of the investments, the term length of the investments being no longer than three months, and the nature of the investments, along with the expected returns. We should also review the current market values of the investments, to assess whether fluctuations in value and returns are insignificant.
- For the restricted cash, we should examine the contract with the supplier, to understand the restriction. This will also allow us to determine if the disclosure of the restricted cash in the notes to the financial statements is accurate.

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

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

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

Reaching competence – The candidate discusses some audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents.

Competent – The candidate discusses several audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents.

Competent with distinction – The candidate discusses many audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents.

Assessment Opportunity #10 (Depth Opportunity)

The candidate discusses the benefits of applying data analytics procedures within the audit, and explains which expense accounts QLW should consider performing data analytics procedures over this year.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
5.2.1 Uses existing knowledge in new or different ways
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Benefits of Data Analytics in Audit

QLW recognizes that data analytics procedures can be applied within an audit engagement, to increase the audit quality and improve audit efficiency.

Data analytics procedures increase audit quality because they can cover 100% of populations, which reduces sampling risk. When applying substantive procedures, a sample of the expenses incurred by Fancy is typically selected and tested for compliance against internal policies and IFRS standards. If the sample is not representative of the entire population, there is a risk that the auditor will inappropriately conclude that a balance was not misstated. Alternatively, if the sample tested indicated errors, the audit team may increase the sample size, which involves additional work, or the error may be extrapolated across the population, which could result in inaccurate adjustments made to the financial statements if the error was a one-off issue. By assessing 100% of a population, the auditor can analyze patterns, identify anomalies, and identify recorded transactions that may not comply with internal policies or IFRS standards. These items can then be investigated further by the auditor, and if an error is identified, the full impact of the error on the financial statements can be determined without the need to extrapolate it throughout the population.

We can be more effective in our audit by focusing on transactions with higher risk of material misstatement, or anomalies, identified through the data analytics procedures. Once these are identified, the auditor can focus on investigating these transactions further by inquiring with management and inspecting supporting documentation on the specific expense, to determine if the treatment of the expense was appropriate.

By applying data analytics procedures, we can be more efficient by focusing our time on more challenging matters that require significant use of professional judgment. We can leverage powerful advanced analytical tools to run the procedures in a matter of moments, freeing up the time of our audit team, to bring more value to the audit.

Finally, we can gain deeper insights into an organization’s data, systems, and controls by applying data analytics. By doing so, we may identify control deficiencies as a part of the financial statement audit, which is valuable information for Fancy’s management.

Data Analytics and Approach

Prior to conducting any audit procedures with data, we will need to ensure that the data provided by Fancy is complete and accurate; otherwise, our conclusions will not represent the populations analyzed. First, before we can rely on the data they provide, we will need to understand the IT general controls that Fancy has implemented over its IT applications, databases, networks, and operating systems that support its financial reporting. This will include testing controls over user access, change management, logical security, incident management, and backup and recovery. QLW will need to gain comfort that these controls are operating effectively before relying on data files from Fancy.

We can then perform completeness and accuracy procedures on the individual data files provided, by observing Fancy running the required queries to pull the data, and have those data files sent to us directly. If we are unable to observe Fancy running the queries live, we should request the parameters required from Fancy, and have the staff demonstrate that the file is complete and accurate by sharing screenshots of the number of records, total dollar amounts, etc., for the system from which the data was exported. Finally, we should observe the logic of the queries and parameters used to pull the data, to ensure that nothing has been excluded from the data files.

QLW should consider whether applying a data analytics approach for the testing of expenses is appropriate, in replacement of the substantive procedures performed in the past.

- Employee salaries and wages:
  - Previously, the audit team selected all employees who have a salary in the top 20% of the company, plus a statistical sample of other salaried employees and of hourly employees, to validate that the payroll expenses for these employees were accurate. While high-salaried employees may represent a significant portion of Fancy's employee salaries and wages balance, they may not be representative of the entire population of employees. We identified no issues in the samples selected, but there is a risk that an employee not included in the sample was receiving payroll amounts different than their contracted amount.
  - When assessing employee salaries and wages, we could apply data analytics procedures to cover the entire population of employees, thereby increasing the quality of the audit. For salaried employees, this may include comparing annual salaries by employee, per the human resources management system, against salaried payroll recorded in the general ledger. For hourly employees, this may include calculating their wages, based on approved hours recorded in the time entry system and their hourly wage per the human resources management system, and comparing it to the hourly payroll recorded in the general ledger. The audit team should look for significant discrepancies, to investigate further.

- Employee benefits:
  - Previously, 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, so the audit team selected a sample of 10 items to review.
  - In cases where the analytic applied in prior years was not successful, we should consider alternative approaches, such as applying data analytic procedures over the employee benefits account. This may include obtaining relevant external data set(s) from the third-party benefits provider, assessing the reliability of such external data sets, and applying an analytic tool to reconcile these expenses against what is recorded in the general ledger.
  - In the event that we are unable to successfully identify and apply an analytic that produces results as expected, we could use the data available to identify outliers. For instance, we could compare benefits per employee to their total salary or wages, to identify any individuals with an unexpected ratio of benefits. Detailed substantive procedures could be applied, to further test these outliers.
- Sales commissions:
  - Previously, the audit team performed a substantive analytical procedure, creating an expectation based on sales revenue, and comparing this to the sales commission recorded in the financial statements, with no issues identified. This would have included calculating the expected sales commissions, based on the flat 6% on all new products sold. Applying this approach to testing sales commissions is appropriate and already uses an element of analytics. Applying further data analytics procedures would not add any value because the sales commission is a flat 6% on all new products sold. Therefore, we are able to get comfort over the entire sales commissions balance through this approach, and we should continue to perform this test.
- Travel expenses (meals, accommodation, transportation):
  - Previously, the audit team selected a statistical sample of 17 expense reports for employees who travelled throughout the year. In four instances, employees had been reimbursed for amounts higher than the supporting receipts observed by the audit team. It is unclear if additional samples were selected or if the errors were extrapolated throughout the population. Where 24% (4 ÷ 17) of the employee claims sampled had errors within their expense claims, applying procedures against 100% of the population will provide the auditors with information on the exact dollar value that was recorded in error.

- Assuming the details of expense reports and supporting receipts are digitized, we could apply data analytics procedures over all travel expenses, including all employees and all expense reports, to identify any purchases that should not have been reimbursed. These procedures could include analyzing an export of all expense report details against a set of expectations, to determine any expenses that did not meet Fancy's policies (e.g., meals incurred in excess of the allowance or expense claims for non-business-related items). Additionally, if Fancy employees use a company card when incurring travel-related expenses, QLW should obtain this data and compare the transaction amounts per the credit card statements against the expense report data. Any discrepancies could be brought to the attention of management, and repayment be requested. This would increase the quality of the audit and identify the exact dollar value that was recorded in error.

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

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

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

Reaching competence – The candidate discusses benefits of applying data analytics procedures within the audit, or explains which expense accounts QLW should consider performing data analytics procedures over this year.

Competent – The candidate discusses benefits of applying data analytics procedures within the audit, and explains which expense accounts QLW should consider performing data analytics procedures over this year.

Competent with distinction – The candidate thoroughly discusses the benefits of applying data analytics procedures within the audit, and explains which expense accounts QLW should consider performing data analytics procedures over this year.

Assessment Opportunity #11 (Depth Opportunity)

The candidate discusses the control weaknesses identified in Fancy's inventory processes and systems, and provides recommendations for improvement.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
4.1.1	Assesses the entity's risk assessment processes	A	A
4.1.2	Evaluates the information system, including the related processes, using knowledge of data requirements and risk exposures	B	A

CPA Map Enabling Competencies:
2.2.1 Assists in identifying and monitoring risks within areas of work responsibility
2.2.2 Recognizes the importance of internal controls within areas of work responsibility
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations

You asked me to discuss any internal control weaknesses within the inventory processes and systems, along with recommendations for improvement.

Inventory Purchasing

Weakness: Purchase decisions

Purchasing decisions for raw materials and ready-to-wear items are made at the discretion of the buyers without input or approval from the inventory manager.

Implication

Inventory may be overstated if buyers purchase inventory that Fancy store managers are not interested in, or are unable to sell because customer preferences have changed. If this occurs, the inventory may become obsolete or there may be too much of an inventory item already on hand, leading to write-offs for Fancy. This is exacerbated when the buyers are unable to view current inventory levels in the respective systems.

Recommendation

Prior to contacting the supplier, the buyer should work with the inventory manager to review the purchase, as well as inventory on hand. The inventory manager should review and approve all purchases, using a purchase order system, before they are submitted to a supplier.

Inventory Receiving and Recording

Weakness: Receipt of inventory

Physical inventory received is not reconciled against the packing slip or purchase order, but is just put away when it arrives at the DC.

Implication

Inventory received may not be the product ordered by a buyer, or meet the quality level agreed upon by the buyer and supplier. If the inventory on hand does not agree with the inventory records, this could lead to inventory stock-outs and an inability to meet customer demands. It would also result in errors in the financial statements, since the inventory entered into the records would not be what was actually received.

Recommendation

Upon receiving inventory at the DC, the warehouse clerk should compare the physical goods received against the packing slip (bill of lading) and the related purchase order, to validate that all inventory has been received. They should document that this comparison was done, along with any discrepancies.

Weakness: Recording of inventory

A warehouse clerk only updates the DC inventory system weekly for inventory received, based on the information recorded on the packing slips.

Implication

When inventory records are updated at the end of the week, based on packing slip information rather than in real time, this can lead to inaccurate inventory balances (i.e., the packing slip may not agree to the actual inventory received). As a result, Fancy may not be able to meet customer demand, resulting in a loss of sales if the correct inventory is not in stock.

Recommendation

The warehouse clerk should record inventory in the system at the time of receipt, based on the actual physical inventory received. This is typically done from the packing slip, which has been updated and signed off by the warehouse clerk, and shows the actual inventory received.

Weakness: Lack of matching invoice with orders and packing slips prior to payment

The accounts payable clerk does not confirm that the DC has received the inventory prior to issuing payment. In fact, the suppliers issue invoices when a Fancy buyer submits a wish list. The accounts payable clerk then immediately pays the invoice, even though shipment of the goods may take place one to four months later, depending on the product, or may not occur at all.

Implication

Fancy is making payments for inventory it has not actually received. Accounts payable will be overstated, and assets will also be overstated (either inventory or a prepaid account).

Recommendation

A three-way match between the invoice, purchase order (or wish list), and packing slip (bill of lading) should be completed prior to issuing payment to a supplier. This will validate that the inventory was ordered by Fancy, has been received at the DC, and matches the agreed-upon price and quantity, as outlined in the approved purchase order.

Weakness: Lack of segregation of duties

The accounts payable clerk is responsible for printing, signing, and mailing the cheque to the supplier, without secondary review and approval.

Implication

Because the accounts payable clerk is responsible for both receiving the invoice and preparing and mailing the cheque, a lack of segregation of duties exists. The accounts payable clerk has the opportunity to commit fraud because there is no oversight on the issuing of cheques. Inappropriate payments may be made to fictitious suppliers, such as the accounts payable clerk paying themself, increasing Fancy’s expenses.

Recommendation

All cheques issued by the head office should require two signatures, to ensure that payments issued by Fancy have been reviewed by two parties. To ensure proper segregation of duties, the accounts payable clerk should not be one of the signatories, since they are preparing and recording the cheques.

Weakness: Retail store orders

When a retail store requires individual raw materials or more ready-to-wear items, the store manager emails the buyer, who then has to call the DC, to request shipment to the store. This has led to shipments being mistakenly sent to the wrong store or to the buyer directly.

Implication

This may lead to delays in inventory arriving at the correct store, resulting in customers being frustrated by delays and potentially taking their business elsewhere. This could result in reduced sales for Fancy.

Recommendation

Internal fulfillment processes should be streamlined, so the store manager places an order with the DC directly, through an ordering system or online form. This will prevent any miscommunications of ordering needs, as they will be recorded in writing along with the shipping address. At the time of shipping, a warehouse clerk should validate that the shipping address is correct.

Inventory Systems

Weakness: Tracking custom jewellery

There is no inventory system to manage the custom jewellery that has been internally designed and produced.

Implication

Fancy's inventory will be understated, as the cost of custom-designed jewellery should include more than only the raw materials. The raw material, labour, and production overhead costs related to this type of inventory should be included in work-in-progress amounts.

Recommendation

All raw material, labour, and overhead costs relating to internally-designed jewellery for custom purchases should be tracked for work-in-progress items, and up to the point of final sale to the customer. All of these costs should be tracked in a work-in-progress system, by product. This work-in-progress module should be linked to the raw materials inventory system, so that the raw materials inventory is reduced when the raw materials are used in production. Similarly, the work-in-progress module should be linked to the finished-goods inventory system, so that all costs are removed from work-in-progress and transferred to finished-goods inventory when an item of custom jewellery is complete.

Weakness: Three separate systems and access

Currently, Fancy uses three separate inventory systems to manage its inventory. Buyers do not have access to the inventory information in any of the systems. Retail stores can only access information that relates to the inventory at their specific store.

Implication

Employees who make purchasing decisions and retail sales decisions are unaware of the actual inventory on hand, which will lead to inappropriate purchases or orders being made. Due to this, retail stores could have fewer sales and higher stock-outs, and overstock issues could occur at the DC. If products are not available, this could result in disappointed customers, reducing Fancy's revenue.

Recommendation

Fancy should implement a single inventory system that can manage the inventory at the retail stores and the DC. The system should include all raw materials, ready-to-wear items, and custom jewellery across Fancy. As well, inventory records should be accessible, for look-up only, by both buyers and retail store managers, so they can make informed purchasing decisions. Finally, retail store managers should be able to view inventory records at other retail stores and the DC, so that internal transfers can occur, enabling them to fulfill customer orders that would otherwise be lost.

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

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

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

Reaching competence – The candidate discusses some control weaknesses identified in Fancy's inventory processes and systems, and provides recommendations for improvement.

Competent – The candidate discusses several control weaknesses identified in Fancy's inventory processes and systems, and provides recommendations for improvement.

Competent with distinction – The candidate discusses many control weaknesses identified in Fancy's inventory processes and systems, and provides recommendations for improvement.

Assessment Opportunity #12 (Depth Opportunity)

The candidate discusses why using the work of the auditor's expert is appropriate, and provides additional procedures QLW must perform in order to rely on the expert's report.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	**B**	**A**
4.3.11	Prepares or interprets information and reports for stakeholders using data visualization where appropriate	**B**	**A**

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

QLW engaged an expert to assist in the valuation of Fancy's raw materials inventory at year end, given the complexity of determining the fair market value of the gemstones and metals. CAS 620, *Using the Work of an Auditor's Expert* outlines the specific requirements for using the work of an auditor's expert. These requirements need to be documented in our audit file.

Determining the need for an auditor's expert

CAS 620, Section 7 indicates that, "*if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert*."

In 2023, QLW decided to use an auditor's expert for the valuation of Fancy's raw materials inventory at year end. The raw materials inventory balance is a significant account for Fancy (i.e., the fair value of raw materials inventory on hand as of December 31, 2023, is $6.15 million, which is significantly higher than materiality and performance materiality). An expert is required, to obtain sufficient and appropriate audit evidence that the amount recorded as inventory is not materially misstated, since auditors do not have expertise in assessing the various characteristics of gemstones or metals that are key to assessing value. This needs to be documented in the audit file.

For QLW, due to the nature and complexity of determining a fair market value of Fancy's raw materials inventory, using an expert to assist is appropriate. In addition, because some of these materials are commodities, the market prices can fluctuate due to market forces. Therefore, there is a risk that the replacement cost of the raw materials has fallen below cost, which is a requirement in assessing the valuation of inventory under IAS 2. Additionally, the assertion-level risk for inventory valuation is assessed as high, since the valuation of Fancy's inventory is complex (particularly for gemstones, where clarity, cut, colour, and other features must be assessed, to determine the proper value).

Competence, capabilities, and objectivity of the valuator

CAS 620, Section 9 states that "*the auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity*."

QLW has engaged a new expert for the 2023 valuation, so we will need to assess the competence, capabilities, and objectivity of the expert. William Livingston is a Qualified Asset Appraiser, which is an accredited profession, requiring the passing of a national exam and ongoing professional development. As well, he holds a certification from the Gemological Science International (GSI), which is the most respected diamond-grading agency. Based on these points, Livingston has the competence to complete the work. He has over 20 years of experience as a valuator, and most of his work is in appraising fine jewellery, indicating that he has the capabilities and expertise to complete the work. Finally, the report states that the valuator does not have any stake, directly or indirectly, in Fancy, indicating that there is no interest or relationship that may hinder the expert's objectivity.

<u>Additional work to be performed on the report</u>

CAS 620, Section 12 indicates, "*the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes*." We will evaluate the work of Mr. Livingston through the following procedures:

- Verify that William Livingston is in good standing with the Qualified Asset Appraiser organization and GSI by obtaining confirmations directly from the organizations.
- Obtain Fancy's shareholder listing, to verify that Mr. Livingston does not have a financial stake in Fancy.
- Read the expert's report and review the assumptions, calculations, and supporting documentation provided in the report. QLW should review published data, if available, to corroborate the assumptions used by the expert. This should be readily available for metals, as these commodities are publicly traded. For gemstones, we could inquire of the GSI if there is publicly available data on the market value of gemstones of various clarities, cuts, and colours.
- Ask Livingston if there were any situations in which the observed characteristics of a gemstone differed from its authenticity papers, since these are situations that are more likely to be materially misstated.
- Perform analytical procedures and reperform the calculations, including reviewing and recalculating any adjustments made by the expert.
- Assess the relevance and reasonableness of the expert's findings, and the application of any findings or adjustments with the valuation practices used by Fancy. If there are significant differences, discuss these with management, to determine the nature and cause of the differences.

These audit procedures will allow QLW to conclude as to whether the work of the expert is adequate and can be relied on.

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

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

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

Reaching competence – The candidate discusses why using the work of the auditor's expert is appropriate, or provides some additional procedures QLW must perform in order to rely on the expert's report.

Competent – The candidate discusses why using the work of the auditor's expert is appropriate, and provides some additional procedures QLW must perform in order to rely on the expert's report.

Competent with distinction – The candidate thoroughly discusses why using the work of the auditor's expert is appropriate, and provides several additional procedures QLW must perform in order to rely on the expert's report.

Assessment Opportunity #13 (Depth Opportunity)

The candidate provides procedures that would be performed by an independent third party, to provide reasonable assurance that Symmetry complies with the mine-to-market process.

The candidate demonstrates competence in the Assurance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B	A

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

To: Daiki Okuda, VP Operations
From: CPA, QLW
Re: Symmetry Diamond Co.

Symmetry Diamond Co. (Symmetry) is a new diamond supplier that has approached you about supplying diamonds to Fancy. However, Fancy will only work with suppliers that follow the mine-to-market process.

The mine-to-market process details five criteria that must be met, to ensure that diamonds are from a conflict-free area and are ethically sourced. An independent external party performing an engagement in accordance with CSAE 3531, *Direct Engagements to Report on Compliance* will assess Symmetry's level of compliance with these five criteria.

The following are examples of procedures that the independent third party would perform during the compliance engagement, to provide reasonable assurance that Symmetry is in compliance with the five criteria of the mine-to-market process.

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.**

    - Examine the organizational chart for Symmetry, to determine if an employee holds the job title of official coordinator.
    - If no one holds the title of official coordinator per the organizational chart, ask management who holds this responsibility.
    - Obtain formal documentation (such as an employment contract) that outlines the job requirements of the official coordinator or the employee assigned the role. Examine the job requirements, to ensure that the official coordinator is required to oversee the mining practices of Symmetry.
    - Obtain from the official coordinator a copy of their certification from the Institute of Mining of the country where the mine is located, and request verification directly from the relevant institute that the official coordinator is in good standing.

2. **Participants must ensure that all of their diamond mines are licensed, and that all individuals mining the diamonds are licensed.**

   - Obtain an independent listing of mine sites from the licensor that identifies the sites owned by Symmetry. Validate with the licensor that all sites owned by Symmetry are appropriately licensed and are in good standing.
     - If an independent listing of mine sites is not available from the licensor, send a confirmation request to the licensor that lists all of Symmetry's mines, and ask them to confirm that all mines are appropriately licensed and in good standing.
   - Examine the organizational chart, and identify Symmetry diamond miners. Obtain a copy of their licences and confirm whether they are valid.
   - Obtain a listing of diamonds that have been mined, and examine a diamond's supporting documentation, which should identify the location where it was mined and the diamond miner (per requirement #3). Validate that the location ties to one of the licensed mines, and that the diamond miner holds a valid licence.

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.**

   - Perform a walkthrough with management on entering digital certificates into the database, verifying that for each new entry, the system controls require the mine site, date of extraction, weight of the diamond, and name of the miner to be documented.
   - Create a new entry in the digital certificate database, excluding one of the required fields, and confirm that the system prevents the entry from saving.
   - Obtain a list of diamonds that have been mined, and confirm that a digital certificate has been created for each diamond. For a sample of diamonds, inspect the certificate, to ensure that it includes the mine site, date of extraction, weight of the diamond, and name of the miner.
   - For a sample of diamonds on hand at Symmetry, weigh the physical diamond and compare the weight to that recorded on the digital certificate.

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.**

   - Obtain information on what is considered fair pay from the relevant Institute of Mining. Compare wages against payroll records for Symmetry employees, to ensure that the amounts paid to Symmetry employees are equal to, or higher than, the wages defined as fair pay by the Institute of Mining.

- Obtain monthly health and safety inspection documentation, and observe that these were completed by the official coordinator each month. Identify if any health and safety concerns were noted in the documentation and if they were dealt with in a timely manner (i.e., prior to the next inspection), or if they created an unsafe working environment for a significant period.
- Ask the relevant Institute of Mining about the expectations for the health and safety bulletin board. On a sample of dates, review the health and safety bulletin board and confirm that it contains recent information, as provided by the institute.

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.**

- Obtain sales records for a sample of diamonds sold by Symmetry to customers outside of the country of origin. Validate that a declaration was documented and completed by the official coordinator, indicating the diamonds are from a conflict-free area on the date of export.

For Assessment Opportunity #13 (Assurance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate provides some procedures that would be performed by an independent third party, to provide reasonable assurance that Symmetry complies with the mine-to-market process.

Competent – The candidate provides several procedures that would be performed by an independent third party, to provide reasonable assurance that Symmetry complies with the mine-to-market process.

Competent with distinction – The candidate provides many procedures that would be performed by an independent third party, to provide reasonable assurance that Symmetry complies with the mine-to-market process.

DAY 2 ‑ MARKING GUIDE ‑ FINANCE ROLE
FANCY LUXURY JEWELLERY INC. (FANCY)

To: Clara Zhang
From: CPA
Subject: Items requested

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

Assessment Opportunity #7 (Depth Opportunity)

The candidate performs a capital budgeting analysis on the potential deal with a new spokesperson, calculates the maximum upfront payment that Fancy can pay while meeting its hurdle rate, discusses the qualitative considerations, and provides a recommendation.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
5.3.1	Develops or evaluates capital budgeting processes and decisions	B	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Fancy is assessing a spokesperson deal with Justine Casey, a well-known actress. Daiki has asked us to assess the deal, to determine if it meets Fancy's hurdle rate, and to calculate the maximum upfront payment amount that still meets the hurdle rate. Daiki has also asked us to discuss any qualitative considerations.

Quantitative Assessment of the Spokesperson Deal

(in thousands of dollars)	**Upfront**	**2025**	**2026**	**2027**	**2028**	**2029**
Years for discounting	*0*	*0.5*	*1.5*	*2.5*	*3.5*	*4.5*
Incremental revenue (Note 1)		1,815.28	3,757.62	5,833.89	8,051.26	10,417.29
Incremental gross margin (Note 3)		1,778.22	2,708.72	3,702.35	4,762.50	5,892.68
Sponsorship costs	(5,000.00)	(2,000.00)	(2,000.00)	(2,000.00)	(2,000.00)	(2,000.00)
Bridal magazine ads		(300.00)	(300.00)	(300.00)	(300.00)	(300.00)
Social media impressions (Note 5)		(150.00)	(165.00)	(181.50)	(199.65)	(219.62)
Social media clicks (Note 5)		(30.00)	(33.00)	(36.30)	(39.93)	(43.92)
Social media (bonus)/clawback (Note 5)		50.00	20.00	(13.00)	(49.30)	(89.23)
Incremental income	(5,000.00)	(651.78)	230.72	1,171.55	2,173.62	3,239.91
Income taxes (Note 6)	1,350.00	175.98	(62.29)	(316.32)	(586.88)	(874.78)
Incremental free cash flows	(3,650.00)	(475.80)	168.43	855.24	1,586.74	2,365.14
Discount rate	10%	10%	10%	10%	10%	10%
Discount factor	1.0000	0.9535	0.8668	0.7880	0.7164	0.6512
Discounted free cash flows	(3,650.00)	(453.68)	145.99	673.93	1,136.74	1,540.18
NPV	(606.84)					

Note 1: Incremental revenue calculation:

	2024	2025	2026	2027	2028	2029
Forecasted revenue – sponsorship agreement (Note 2)	90,763.75	94,848.12	99,116.28	103,576.52	108,237.46	113,108.15
Annual growth rate (base rate 2.5% + incremental 2%)		*4.5%*	*4.5%*	*4.5%*	*4.5%*	*4.5%*
Forecasted base revenue (Note 2)	90,763.75	93,032.84	95,358.66	97,742.63	100,186.20	102,690.85
Annual growth rate (base growth rate of 2.5%)		*2.5%*	*2.5%*	*2.5%*	*2.5%*	*2.5%*
Incremental revenue		1,815.28	3,757.62	5,833.89	8,051.26	10,417.29

Note 2: 2024 revenue is based on reported 2023 revenues plus 2.5% base growth rate.

Note 3: Incremental gross margin calculation:

	2025	2026	2027	2028	2029
Incremental revenue	1,815.28	3,757.62	5,833.89	8,051.26	10,417.29
Gross margin (Note 4)	46.7%	46.7%	46.7%	46.7%	46.7%
Gross margin on incremental revenue	847.89	1,755.13	2,724.93	3,760.64	4,865.78
Forecasted base revenue	93,032.84	95,358.66	97,742.63	100,186.20	102,690.85
Incremental gross margin	1.0%	1.0%	1.0%	1.0%	1.0%
Incremental gross margin on base revenue	930.33	953.59	977.43	1,001.86	1,026.91
Total incremental gross margin	1,778.22	2,708.72	3,702.35	4,762.50	5,892.68

Note 4: Gross margin includes incremental margins from increased sales volumes, calculated as follows:

	2023
Gross profit	40,475.00
Revenues	88,550.00
Current gross margin	45.7%
Incremental margin	1.0%
Forecasted gross margin	46.7%

Note 5: Social media costs:

	2025	2026	2027	2028	2029
Number of social media impressions (10% growth rate)	600,000	660,000	726,000	798,600	878,460
Cost per impression	$0.25	$0.25	$0.25	$0.25	$0.25
Total cost of impressions	150.00	165.00	181.50	199.65	219.62
Social media clicks – 5% of impressions	30,000	33,000	36,300	39,930	43,923
Cost per click	$1.00	$1.00	$1.00	$1.00	$1.00
Total cost of clicks	30.00	33.00	36.30	39.93	43.92
<u>Bonus/clawback calculation:</u>					
Social media clicks	30,000	33,000	36,300	39,930	43,923
Minimum social media clicks	35,000	35,000	35,000	35,000	35,000
Number of clicks – over (under) the base	(5,000)	(2,000)	1,300	4,930	8,923
Bonus/clawback per click	$10.00	$10.00	$10.00	$10.00	$10.00
Bonus/(clawback) payment	(50.00)	(20.00)	13.00	49.30	89.23

Note 6: Fancy’s tax rate is 27%.

Maximum Upfront Payment

NPV (per above)	(606.84)
Tax rate	27%
Pre-tax NPV	(831.29)
Plus: Original offer	5,000.00
Maximum upfront payment	4,168.71

The current spokesperson deal does not meet the minimum 10% hurdle rate for capital budgeting decisions. The maximum upfront payment that would meet Fancy's hurdle rate is $4,168,710.

Advantages of the Spokesperson Agreement

Justine is currently extremely popular among Fancy's target market, and could potentially influence her fans to purchase from Fancy. The fact that her photos and videos are still trending on social media is an indication of her popularity. In addition, her social media presence is through her personal accounts, so it is not paid for by Fancy, and would be a form of free advertising for the brand.

Justine recently got married, and her engagement and marriage were heavily publicized. This makes her extremely relatable to potential customers, which could influence them to purchase from Fancy. Justine's engagement ring was purchased from Fancy, which could be a form of free advertising for the brand, or used as part of the marketing strategy.

Disadvantages of the Spokesperson Agreement

The spokesperson deal has significant financial risk because it involves large direct cash payments to Justine, including a significant upfront payment, with uncertain benefits that may not materialize. However, the clawback clause somewhat mitigates the risk.

The stated financial benefits of the spokesperson deal are limited to the term of the agreement, which increases the financial risk associated with it, since Fancy has a limited time in which to capture the benefits. If there are potentially enduring benefits to Fancy following the term of the agreement (i.e., a permanent increase in Fancy's revenues), this would mitigate some of the financial risk and increase the overall NPV of the arrangement.

There is a risk that Justine's popularity in the wedding industry will diminish as time passes, which could result in less impact from her sponsorship in the outer years of the agreement. This is concerning, given the length of the agreement (five years), although the clawback clause mitigates the risk.

Justine's trending photo and video content was not created by Fancy, and therefore might not be aligned with the company's marketing strategy. Further, she may have other content that has yet to go viral or trend. This poses a risk, as this content may not be as positively received by content consumers, which could reflect on Fancy.

Justine starred in the movie of the year in 2022, but the movies she has been part of subsequently have not lived up to her previous success. This indicates that her popularity might be at risk of declining, which can negatively affect her ability to influence potential customers.

Justine's husband is rumoured to have had issues with the law in the past. If these rumours are confirmed, they may negatively impact Justine's reputation, or lead to a marital breakdown between her and Sam. This could reduce her relatability, and therefore her ability to influence potential customers.

The couple currently resides in Vancouver but has expressed interest in moving to Italy. This could create logistical complications in developing content for the marketing strategy, and could create a disconnect with Justine's relatability to the brand. Further, the distance increases travel costs. Fancy should clarify the travel policy and responsibility for travel costs.

Recommendation

We recommend that Fancy offer $4,168,710 as an upfront payment, in addition to the $2 million annual payments for the five-year term of the deal. From a qualitative perspective, there are a significant number of disadvantages. However, if Justine accepts a lower upfront payment and Fancy is able to negotiate early cancellation clauses to address some of the considerations, we recommend that Fancy pursue the opportunity, as it will accelerate Fancy's growth.

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

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

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

Reaching competence – The candidate attempts to perform a capital budgeting analysis of the potential spokesperson deal, and attempts to discuss some qualitative considerations.

Competent – The candidate performs a capital budgeting analysis of the potential spokesperson deal, discusses some qualitative considerations, and provides a recommendation.

Competent with distinction – The candidate accurately performs a capital budgeting analysis of the potential spokesperson deal, calculates the maximum upfront payment, discusses many qualitative considerations, and provides a recommendation.

Assessment Opportunity #8 (Depth Opportunity)

The candidate assesses the potential offer price for the distribution centre.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
5.4.1	Determines the value of a tangible asset	B	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Fancy has the ability to make an offer to purchase the distribution centre (DC). We have been provided with information in order to value the DC, using a market approach and an earnings-based approach. We have used this information to establish a range of values, and have provided a final recommendation.

Income-Based Valuation

Lease revenue		$ 350,000.00
Property taxes		(50,000.00)
Energy costs	Note 1	(60,000.00)
Insurance		(30,000.00)
Leasing operating income	Note 2	**210,000.00**
Multiple		12x
Established value		2,520,000.00
Less: Renovation costs ((36 - 25) × 100,000)	Note 3	(1,100,000.00)
Value of DC (excluding excess land)		**1,420,000.00**
Add: Value of excess land	Note 4	1,650,000.00
Value of DC		**$3,070,000.00**

Notes:

1. Based on 2023 energy cost and expected increase: $40,000 × (1 + 50%) = $60,000.

2. Interest on mortgage is excluded, as operating income assumes no debt.

3. Renovation cost reflects age of DC: $100,000 × (36 years - 25 years) = $1,100,000.

4. Value of excess land calculated as follows:

Total square footage of land	450,000
Required for building at 2:1 ratio	120,000
Excess land	330,000
Value per square foot	$5.00
Value of excess land	$1,650,000

Comparables-Based Valuation

	Comparable A	Comparable B	Average
Square footage of land	55,000	375,000	
Square footage of building	30,000	45,000	
Land-to-building ratio	1.83	8.33	
Adjustment required?	No	Yes	
Land			
Square footage of land	55,000	375,000	
Land required based on 2:1 ratio		90,000	
Excess land		285,000	
Fair market value of land	$130,000	$1,650,000	
Fair market value of excess land at $5 per square foot		1,425,000	
Fair market value of land used for operations	$130,000	$ 225,000	
Square footage of land used for operations	55,000	90,000	
Price per square foot of land used for operations	**$2.36**	**$2.50**	**$2.43**
Building			
Fair market value of building	$1,100,000	$1,630,000	
Square footage of building	30,000	45,000	
Price per square foot	**$36.67**	**$36.22**	**$36.44**

Valuation of DC

	Land	Building
Square footage – required for operations	120,000	60,000
Excess land	330,000	
Total	450,000	60,000

Square footage – required for operations	120,000	60,000	
Price per square foot	$2.43	$36.44	
Implied value	$291,818	$2,186,667	$2,478,485
Square footage – excess	330,000		
Price per square foot	$5.00		
Implied value	$1,650,000		$1,650,000
Total implied value, based on comparables			$4,128,485
Adjustments:			
Renovation costs (Note 1)			(1,100,000)
Implied value of DC			**$3,028,485**

Note 1: Renovation costs reflect age of DC: $100,000 × (36 years - 25 years) = $1,100,000.

Based on the above analysis, the value of the DC is in the range of $3,028,485 to $3,070,000, which is just below the DC owner's price of $3,100,000.

Recommendation

Given that other jewellers have indicated interest in acquiring the space, and Fancy has a right of first offer but does not have the right to amend its offer or make an additional offer, Fancy should offer the owner's target price of $3.1 million, even though the valuations are just below this price, in order to maximize its chance of closing on the transaction.

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

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

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

Reaching competence – The candidate attempts to assess the offer price.

Competent – The candidate assesses the offer price and makes a recommendation.

Competent with distinction – The candidate thoroughly assesses the offer price and makes a recommendation.

Assessment Opportunity #9 (Depth Opportunity)

The candidate analyzes two available financing options for acquiring the DC building, from a quantitative and qualitative perspective, and provides a recommendation.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
5.2.3	Evaluates sources of financing	**B**	**A**

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

Fancy has been presented with two options for financing the purchase of the DC. We have been asked to perform an analysis of the sources and provide a recommendation.

Quantitative Analysis

Amount available

The commercial mortgage only covers 60% of the purchase price, so Fancy would have to fund the additional amount through other alternatives, likely cash on hand. Based on the proposed purchase price of $3.1 million, $1.86 million would be available through the commercial mortgage. Fancy can fund the remaining $1.24 million through cash on hand. At December 31, 2023, Fancy had $5.19 million of cash and cash equivalents on hand (prior to consideration of accounting adjustments; $2.27 million after adjustments), suggesting that it has sufficient funds. The amount available under the unsecured debenture is limited by the debt-to-equity ratio covenant of 1.4. Based on Fancy's December 31, 2023, statements, there would be $4.4 million available under the unsecured debenture:

2023 equity preliminary draft	$32,165,000
2023 adjustments (after tax):	
Warranty liability – reversal of revenue	(413,576)
Warranty liability – revenue recognition	6,893
Restructuring costs	283,240
2023 equity final draft	$32,041,556
Maximum debt-to-equity covenant	1.40
Maximum allowable debt level (32,041,556 × 1.4)	$44,858,179
Less: 2023 total liabilities (Note 1)	40,300,444
Maximum loan amount per calculation	$ 4,557,735
Actual loan amount (capped at $3.1 million)	$ 3,100,000

Note 1:

Draft 2023 liabilities	$40,177,000
Warranty liability – reversal of revenue	413,576
Warranty liability – revenue recognition	(6,893)
Restructuring costs	(283,240)
	$40,300,444

This compares to the purchase price of $3.1 million, suggesting that Fancy could fund the entire transaction through the unsecured debenture. From this perspective, the unsecured debenture is more attractive.

<u>Cost of borrowing</u>

Commercial mortgage plus cash:

Commercial mortgage:	
Mortgage amount ($3,100,000 × 60%)	$ 1,860,000
Interest (6.5% + 2%)	8.5%
Term (10 years × 12 months)	120
Future value	0
Monthly payments = PMT(8.5%/12,120,1860000,0,0)	(23,061)
Total payments (23,061 × 120)	(2,767,361)
Loan amount	1,860,000
Cost of borrowing (mortgage) (-2,767,361 + 1,860,000)	$ (907,361)
Cash:	
Residual amount to finance ($3.1 million × 40%)	$ 1,240,000
Cost of borrowing: opportunity cost of 6% on LT bonds	6%
Future value of amount financed at 6%	2,220,651
Implied cost of borrowing	(980,651)
Total cost of borrowing (980,651 + 907,361)	$(1,888,012)

The total cost of borrowing associated with the commercial mortgage (including the opportunity cost on the cash Fancy would need to invest) is $1,888,012, compared to $3,410,000 for the unsecured debenture. From a purely quantitative perspective, the commercial mortgage is more attractive.

<u>Interest rate</u>

The current interest rate on the unsecured debenture is 11%, versus 8.5% for the commercial mortgage. This makes the commercial mortgage more attractive. However, the interest rate on the commercial mortgage is a floating rate (prime + 2%), which creates interest rate risk, because it is difficult to predict interest rate movements over the next 10 years. If interest rates increase, the cost of borrowing will also increase. However, the opposite is also true: if interest rates drop, the cost of borrowing will also decrease. Overall, from a cash flow predictability standpoint, the unsecured debenture seems to be more attractive, although historically, an interest rate of prime + 2% has yielded extremely low interest rates, and is considered to be quite attractive in the market.

Repayment terms

The commercial mortgage is amortized over 10 years, with blended monthly payments that reduce the principal outstanding over the life of the instrument. The unsecured debenture only has to be repaid at maturity (also a 10-year term), which increases the overall cost of borrowing if the entire amount remains outstanding until maturity. From the perspective of the repayment terms, the debenture is more attractive, as the principal does not need to be repaid until maturity, which is beneficial if Fancy's cash flows are constrained.

Covenant

The commercial mortgage is less restrictive in this situation, as it does not have any covenants, compared to the unsecured debenture, which has a debt-to-equity covenant. This type of covenant is restrictive because it limits Fancy's future borrowing capacity. Given that the loan has a 10-year term, this could potentially restrict Fancy's borrowing capacity for the next 10 years, although the early repayment option would allow Fancy to replace the unsecured debenture with a new debt instrument, if appropriate. Additionally, the loan can be recalled if the covenant is breached, which would lead to a significant cash flow squeeze. Fancy's debt-to-equity ratio is currently 1.26 ($40,346,101 ÷ $31,995,899). The covenant of 1.4 does not give Fancy much borrowing flexibility beyond the purchase of the DC. If the company were to borrow the full $3.1 million, this would leave it with just under $1.35 million of additional debt capacity ($44,794,259 - ($40,346,101 + $3,100,000)). This will become more flexible with time, if Fancy continues to have successful operations and generate profits. From the perspective of the covenant, the commercial mortgage alternative is more attractive.

Collateral

The commercial mortgage requires the DC to be pledged as collateral, whereas the unsecured debenture requires no collateral, leaving the DC available to be pledged as collateral against another loan if Fancy ever needs to exercise this option. Given that Fancy has a strong balance sheet, the risk of default is low, but if Fancy were to face cash flow constraints that caused it to default on the debt, the DC would get repossessed, which would be a massive setback to operations. The unsecured debenture is more attractive when it comes to collateral, as it does not have any associated collateral requirements.

Flexibility

Flexibility refers to the option to repay principal early, in part or in full. The unsecured debenture is an open loan that can be repaid at any time without penalty, which makes it more flexible compared to the commercial mortgage. This would allow Fancy to make early repayments when it has excess cash flow, reducing its cost of borrowing.

Cash flows and capital invested

Cash flows and capital invested refers to the amount of cash that each instrument leaves in the hands of Fancy. This could be attractive if Fancy's potential investment opportunities yield greater than a 10% annual return. The commercial mortgage requires a substantial upfront cash down payment of $1.24 million, and greater monthly cash outflows, since blended monthly principal and interest repayments are required. This upfront investment and incremental monthly cash outflow represent an opportunity cost, since the sum cannot be invested elsewhere to yield additional return. As the current interest rate on the commercial mortgage of 8.5% is below Fancy's hurdle rate, Fancy would generate more profits by investing excess cash on hand in different projects that yield at least the hurdle rate, rather than paying it back to the lender. In this situation, the unsecured debenture is more attractive from a cash flow and capital invested standpoint.

Other considerations: Fancy had $5.19 million of cash on hand at December 31, 2023. Consideration should be given to whether Fancy can fund the entire purchase using cash, based on its minimum cash requirements, alternative projects, and ability to generate better returns than the cost of the debt options.

Overall Recommendation

From a purely quantitative perspective, the commercial mortgage is most attractive. From a qualitative perspective, the mortgage tends to carry more risks, especially surrounding flexibility and interest rate risk. Overall, the commercial mortgage is the more viable alternative, and we therefore recommend that Fancy pursue the commercial mortgage.

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

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

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

Reaching competence – The candidate attempts to analyze each source of financing for acquiring the DC building.

Competent – The candidate analyzes each source of financing for acquiring the DC building, and provides a recommendation.

Competent with distinction – The candidate thoroughly analyzes each source of financing for acquiring the DC building, and provides a recommendation.

Assessment Opportunity #10 (Depth Opportunity)

The candidate determines an appropriate offer price for YNJ, using an asset-based valuation approach.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
5.4.2	Applies appropriate methods to estimate the value of a business	**B**	**A**
5.6.1	Evaluates the purchase, expansion, or sale of a business	**B**	**A**

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Fancy is considering the purchase of YNJ, a distressed business. We have performed an asset-based valuation, making relevant fair market value adjustments as required.

Accounts receivable (Note 1)	$ 2,241,500
Inventory (Note 2)	1,568,900
Fixed assets	0
Favoured lease terms (Note 3)	416,222
Non-capital loss pool (Note 4)	2,342,975
Fair value of current liabilities	(2,600,000)
Fair value of non-current liabilities	(3,000,000)
Value of YNJ	$ 969,597

Note 1: Accounts receivable

	Amount	Probability	Fair Value
< 30 days	1,600,000	95%	1,520,000
30 to 60 days	725,000	70%	507,500
61 to 90 days	260,000	70%	182,000
> 90 days	80,000	40%	32,000
Total			**2,241,500**

Note 2: Inventory

	Quantity	**Fair Value per Unit**	**Fair Value**
Gold	130 ounces	CA$2,860 (US$2,200 × 1.3)	371,800
Diamonds	450 carats	CA$1,780	801,000
Other gemstones (undamaged)	1,398 carats	CA$250	349,500
Other gemstones (damaged)	932 carats	CA$50	46,600
Total			1,568,900

Note 3: Lease terms

	i	*ii (PY × 1.02)*	*iii (PY × 1.04)*	*iv (iii-ii)*	*v (iv × (1 - 0.27))*	*vi (1 ÷ (1 + 10%)^i)*	*v × vi*	
Year	**Year (Discounting)**	**Contractual CFs (Note A)**	**FMV (Note A)**	**Difference**	**Difference (Net of Tax)**	**Discount Factor**	**DCF**	
1	0	306,000.00	364,000.00	58,000.00	42,340.00	1.0000	42,340.00	
2	1	312,120.00	378,560.00	66,440.00	48,501.20	0.9091	44,092.00	
3	2	318,362.40	393,702.40	75,340.00	54,998.20	0.8264	45,453.06	
4	3	324,729.65	409,450.50	84,720.85	61,846.22	0.7513	46,465.98	
5	4	331,224.24	425,828.52	94,604.27	69,061.12	0.6830	47,169.67	
6	5	337,848.73	442,861.66	105,012.93	76,659.44	0.6209	47,599.48	
7	6	344,605.70	460,576.12	115,970.42	84,658.41	0.5645	47,787.46	
8	7	351,497.81	478,999.17	127,501.35	93,075.99	0.5132	47,762.70	
9	8	358,527.77	498,159.13	139,631.36	101,930.90	0.4665	47,551.52	**416,222**

Note A: Cash flows and FMV are adjusted, as the amounts of $300,000 and $350,000 stated are in Year 0.

<u>Note 4: Non-capital loss pool</u>

Use of non-capital losses are assumed to take place after year end; therefore, they are at the end of the period, and not the beginning.

PMT = 10,000,000 ÷ 2 × (27%) = $1,350,000
N = 2
I/Y = 10
CPT PV = 2,342,975

Conclusion

The estimated fair market value of YNJ, based on the asset approach, is $969,597. Therefore, a reasonable offer price for YNJ would be approximately $970,000.

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

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

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

Reaching competence – The candidate attempts to calculate an appropriate offer price for YNJ.

Competent – The candidate calculates an appropriate offer price for YNJ.

Competent with distinction – The candidate accurately calculates an appropriate offer price for YNJ.

Assessment Opportunity #11 (Depth Opportunity)

The candidate discusses the gold-backed zero-coupon bonds and the futures contracts hedging alternatives, and provides a recommendation.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
5.5.2	Analyzes the use of derivatives as a form of financial risk management	C	B

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations

Fancy is looking to secure 180 ounces of gold in 24 months. Fancy has identified two options: invest in gold-backed zero-coupon bonds, or in gold futures contracts.

Cost

Fancy would invest US$350,000 in gold-backed zero-coupon bonds to receive 180 ounces of gold in 24 months. If Purity's gold mine is not operational in 24 months, Fancy would receive US$350,000 × (1 + 20%) = US$420,000, but would have to spend US$2,425 × 180 ounces = US$436,500 to meet its gold requirement. This requires Fancy to spend an additional US$16,500 beyond its initial investment, making the total cost US$350,000 + US$16,500 = US$366,500.

The total cost of the futures contracts is US$2,150 × 180 = US$387,000. Therefore, the gold-backed zero-coupon bonds are more cost effective, even if Purity's gold mine is not operational in 24 months.

Hedge Effectiveness

The gold-backed zero-coupon bonds do not fully hedge against fluctuations in the price of gold.

If Purity's gold mine is not operational in 24 months, Fancy would receive US$420,000 and would need to purchase gold at the spot price at the time. Based on the expected gold price in 24 months of US$2,425 per ounce, Fancy would only be able to purchase 173 ounces of gold, which is insufficient for meeting its gold requirement. As such, this hedging option is not fully effective.

On the other hand, the futures contracts fully hedge against fluctuations in the price of gold, as Fancy would be committed to purchasing gold at US$2,100 per ounce.

Default Risk

Purity is a US-based private company looking to raise money to invest in a gold mine, which would be its first operational mine. There is a high level of default risk that is offset by the gold collateral, although this collateral has full value only when it has been extracted and processed by a mine operator. Until Purity extracts and processes this gold, or a mine operator is put in place, the value of the company (which is based on the value of the mine) is likely to be based on a fraction of the value of an ounce of gold. If Purity defaults, Fancy may not be able to realize on the value of the collateral. Further, Fancy should perform some due diligence on the underlying asset. The mine appears to be in the exploration/development stage, and further engineering studies on the quality of the asset could reduce its value (for example, if the amount of gold in the deposit is less than initially expected).

Default risk for futures contracts is remote, given that they are heavily regulated and traded on an exchange. With the use of margin accounts, counterparty risk is eliminated. As a result, default risk is much greater for the gold-backed zero-coupon bonds.

Liquidity

As part of the gold-backed zero-coupon bonds alternative, Fancy will need to hold the bonds until maturity because they are not transferrable, redeemable, or retractable, meaning that no liquidity exists for these instruments.

The futures contracts are openly traded on the exchange, and can therefore be sold at any time, so liquidity risk is minimal. Further, the funds to exercise on the futures contracts are held by Fancy, and can be used at any time.

If Fancy finds itself in a liquidity crunch, it will be marginally better off under the futures contracts, rather than the gold-backed zero-coupon bonds, alternative.

Conclusion

Although the gold-backed zero-coupon bonds alternative has a lower cost, it has more disadvantages due to the risk associated with the underlying mining operation and the operator. Therefore, we recommend that Fancy pursue the futures contracts.

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

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

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

Reaching competence – The candidate attempts to discuss both hedging alternatives.

Competent – The candidate discusses both hedging alternatives and provides a recommendation.

Competent with distinction – The candidate thoroughly discusses both hedging alternatives and provides a recommendation.

Assessment Opportunity #12 (Depth Opportunity)

The candidate assesses the quantitative and qualitative considerations associated with each gold order quantity, and provides a recommendation.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
5.2.1	Evaluates the entity's cash flow and working capital	A	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Steven has asked us to assess the qualitative and quantitative considerations associated with each gold order quantity, and make a recommendation.

<u>Current scenario: 500 ounces</u>

Annual orders	8	
Shipping cost per order	$18,750	$5/km × 3,750 km
Total shipping costs	**$150,000**	
Average gold inventory	600	
Price of gold (US$)	$2,200	
Exchange rate	1.30	
Value of inventory	$1,716,000	
Interest rate (hurdle rate on working capital)	10%	
Financing cost of holding inventory	**$171,600**	
Insurance and warehousing costs	$129,600	$18 × 600 ounces × 12 months
Financing cost of holding inventory	171,600	
Shipping costs	150,000	
Total cost	451,200	
Tax	121,824	
Total after-tax cost	**$329,376**	

<u>Alternative scenario: 250 ounces</u>

Annual orders	16	
Shipping cost per order	$35,000	$15,000 + $20,000
Total shipping costs	**$560,000**	
Average gold inventory	400	
Price of gold (US$)	$2,200	
Exchange rate	1.30	
Value of inventory	$1,144,000	
Interest rate (hurdle rate on working capital)	10%	
Financing cost of holding inventory	**$114,400**	
Insurance and warehousing costs	$ 86,400	$18 × 400 ounces × 12 months
Financing cost of holding inventory	114,400	
Shipping costs	560,000	
Total cost	760,800	
Tax	205,416	
Total after-tax cost	**$555,384**	

Further, reducing the order size to 250 ounces results in a reduction in the average inventory held from 600 ounces to 400 ounces. As such, there would be a one-time reduction in orders in the first year, from 16 to 15 orders, to use the excess inventory and reduce the inventory on hand. This would result in a one-time capital gain of 250 ounces × US$2,200 = US$550,000. However, this would not be a recurring savings.

Although reducing the order size to 250 ounces reduces the cost of holding inventory (insurance, warehousing, and financing costs), this is more than offset by the increased shipping costs. Therefore, maintaining the current order quantity of 500 ounces is optimal from a quantitative perspective.

Qualitative Analysis

Theft of held inventory

There is a greater risk of theft when holding a higher amount of inventory. This proves especially true for gold, which has both utility and economic demand. This risk is partially mitigated by the fact that Fancy has insurance coverage.

Reducing the order size to 250 ounces reduces the amount of gold Fancy has on hand, and reduces the risk that the gold in its inventory will be stolen, which is advantageous to Fancy.

Theft or loss during transit

There is also the risk of theft or loss when the gold is in transit. Given that Fancy purchases insurance for the shipments, its losses are limited to that not covered by insurance (and the financial penalty associated with future increased insurance costs). However, there is a higher likelihood of theft or loss during transit associated with reducing the order size to 250 ounces, due to the distance the gold travels, increased incidents of theft when gold is being transported to the airport, and increased losses when the gold is being air freighted.

Reducing the order size to 250 ounces increases the risk of theft or loss during transit, which is disadvantageous to Fancy.

Product damage

As the lead time to sell the inventory is extended, the risk of potential damage to inventory increases. Damages can be caused by fire, flood, earthquake, human error, etc. This is partially offset by having adequate insurance.

Reducing the order size to 250 ounces reduces the amount of gold Fancy has on hand, which reduces the risk of product damage, which is advantageous to Fancy.

Supplier reliability

Fancy has an existing relationship with its current supplier (the Nevada mine), whereas the overseas mine is a new operation that has recently accepted many new customers. As a new operation, the overseas mine could have challenges ramping up their supply, to meet the requirements of all of their customers, which could impact the reliability of Fancy's supply. Further, Fancy does not have an existing relationship with this new mine, and therefore may not be prioritized by them in such a situation.

Unreliable supply could lead to Fancy not having enough gold on hand to meet its production requirements, which would lead to lost sales. This is a risk of reducing the order quantity to 250 ounces.

Inventory forecasting

A smaller order quantity allows Fancy to be nimbler in ordering. If there is a decrease in demand for gold jewellery, Fancy can reduce its orders and amount of gold on hand more quickly, to better match the demand. Similarly, if there is an increase in demand for gold jewellery, Fancy can increase its orders by a smaller amount and meet the demand without having to increase the gold on hand substantially.

The increased flexibility is a benefit of reducing the order quantity to 250 ounces.

Recommendation

Although lowering the order quantity to 250 ounces lowers the amount of gold Fancy keeps on hand and improves the efficiency of its working capital, it comes at an increased cost (due to the increase in shipping costs). Qualitatively, it appears that there are many risks and disadvantages to lowering the order quantity, which is not balanced out by the benefits and advantages.

Therefore, we recommend that Fancy maintain its current order quantity of 500 ounces.

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

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

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

Reaching competence – The candidate attempts to assess the quantitative and qualitative considerations associated with each gold order quantity.

Competent – The candidate assesses the quantitative and qualitative considerations associated with each gold order quantity, and provides a recommendation.

Competent with distinction – The candidate thoroughly assesses the quantitative and qualitative considerations associated with each gold order quantity, and provides a recommendation.

Assessment Opportunity #13 (Depth Opportunity)

The candidate determines the amount of investible funds, taking into consideration Fancy's minimum cash requirements and the impact of the proposed projects, and discusses the investment options presented.

The candidate demonstrates competence in the Finance role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
5.2.1	Evaluates the entity's cash flow and working capital	A	A
5.2.2	Evaluates the entity's investment portfolio	B	A

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

The board has asked that we calculate Fancy's amount of investible funds, after considering minimum working capital requirements. The board has also asked us to allocate investible funds to potential investments and projects we have analyzed, and to discuss additional potential investments.

Working Capital Requirements

Current assets	[A]	$28,020.00	
Trade payable		11,955.00	
Accrued liabilities		2,020.00	
Liabilities included in working capital	[B]	$13,975.00	
Current working capital ratio	[A] / [B]	2.01	
Target working capital ratio (provided in case)	[C]	1.75	
Target current assets	[D] = [B] × [C]	$24,456.25	
<u>Minimum cash balance check:</u>			
Target current assets (as above)	[D]	$24,456.25	
Less: Inventories		(21,750.00)	
Less: Prepaid expenses		(1,080.00)	
Cash required to be kept on hand to meet target current assets		$ 1,626.25	
Required minimum cash balance		$ 400.00	

The target working capital ratio requires Fancy to keep $1.6 million of cash on hand, based on its current inventories and prepaid expenses, which is higher than the required minimum cash balance and also more than the amount of cash that they need to keep on hand for the new diamond supplier (being $1.57 million).

Sources of Funds			
Excess cash from operations	[A] - [D]	$3,563.75	Note 1
Add: Cash injection (Daiki and Kenji @ $1.5 million each)		3,000.00	
Total investible funds		**$6,563.75**	

Uses of Funds	
Acquisition of distribution centre (cash portion)	$1,240.00
Sponsorship deal (based on Fancy's maximum upfront payment)	4,168.71
Acquisition of YNJ	969.60
Gold futures (upfront payment = 180 × US$50 × 1.30)	11.70
Amount available for investments	173.74
Total investible funds	**$6,563.75**

Note 1: Excludes cash required to be kept on hand to meet target current assets.

Investment Opportunities

Fancy is considering two potential investments in equities: EV Co., and an EV ETF.

EV Co. has significant entity-level risk. First, it has a substantial number of manufacturing plants in politically unstable countries. If the instability worsens, this could lead to supply chain and delivery issues, which would ultimately impact the stock price negatively. Additionally, the build quality of the vehicles produced by EV Co. is subpar. If the build quality issues persist, the brand may lose popularity, which would negatively impact the share price.

EV ETF is a well-diversified basket of equities that considers multiple companies at each level of the supply chain within the industry. Additionally, entity-specific risk is mitigated due to the ETF's diversification. EV ETF has foreign exchange risk, given that it is traded on a US exchange, but it would have greater liquidity because of this fact as well.

Historically, EV Co. has had better returns, but this will not necessarily persist, given the entity-specific risks discussed above. In particular, EV Co. has only been in existence for three years whereas five-year returns have been presented. We have assumed that the returns provided for EV Co. are three-year returns, but there is a risk that over a five-year period, EV Co. would not be able to sustain these returns. In addition, the EV Co. returns range from -25% to 60%, and the stock carries a beta of 1.75, which indicates that it is highly volatile. EV ETF returns range from -15% to 20%, with a beta of 0.95, which indicates much lower volatlity when compared to EV Co.

Both options are within the same industry, so there is a high degree of industry-specific risk. As a mitigating measure, it would be beneficial to explore potential equity investments in different industries, to further diversify the portfolio.

Overall, from a risk perspective, we recommend investing in the EV ETF alternative because it clearly carries the least amount of risk of the two proposed alternatives.

For Assessment Opportunity #13 (Finance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to determine the amount of investible funds, and attempts to discuss the investment options presented.

Competent – The candidate determines the amount of investible funds, and discusses the investment options presented.

Competent with distinction – The candidate accurately determines the amount of investible funds, thoroughly discusses the investment options presented, and provides a recommendation.

DAY 2 ‑ MARKING GUIDE ‑ PERFORMANCE MANAGEMENT ROLE
FANCY LUXURY JEWELLERY INC. (FANCY)

To: Daiki Okuda
From: CPA
Subject: Items requested

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

Assessment Opportunity #7 (Depth Opportunity)

The candidate develops a price for Fancy's lab-grown diamond engagement rings, using cost-based and demand-based methods, and qualitatively analyzes which pricing strategy Fancy should use.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
3.4.1	Evaluates sources and drivers of revenue growth	B	A

CPA Map Enabling Competencies:
2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Quantitative Analysis

As per the calculations that follow, under the cost-based approach, the price to be set for the engagement rings featuring lab-grown diamonds would be $10,140. This represents a profit margin of 30% of the cost, or 23% of the selling price.

Under the demand-based approach, the price should be $7,900, representing a profit margin of 1.28% of the cost, or 1.26% of the selling price.

Cost-based approach		
Cost of lab-grown E2-graded diamond	$6,500	
Other finishing costs	$1,300	
Cost of ring featuring lab-grown E2-graded diamond	$7,800	
Markup	30%	
Price of finished ring featuring lab-grown E2-graded diamond	**$10,140**	
Profit margin, as a percentage of the cost	30%	
Profit margin, as a percentage of sales	23%	
Demand-based approach		
Price of D1-graded diamond	$22,888	
Discount for E2-graded diamond	42%	
Price of E2-graded diamond	$13,275	
Discount for increased supply of mined diamonds (3 × 10%)	30%	Note 1
Price of E2-graded diamond in high-supply environment	$9,293	
Discount for GIA grade (95% of GSI price)	5%	
Price of E2 GIA-graded diamond in high-supply environment	$ 8,828	
Other finishing costs	$1,300	
Total cost of ring featuring E2 GIA-graded diamond in high-supply environment	$10,128	
Markup	30%	
Price of ring featuring E2 GIA-graded diamond in high-supply environment	$13,166	
Lab-grown markdown (40% discount on the price)	40%	
Price of ring featuring lab-grown E2 GIA-graded diamond in high-supply environment	**$7,900**	Note 2
Profit margin, as a percentage of the cost	1.28%	
Profit margin, as a percentage of sales	1.26%	

Note 1: 33 million carats leaves the market neutral. Therefore, at 36 million carats, the additional supply is 3 million, which would push prices down by 30% (3 × 10%).

Note 2: $13,166 × (1 - 40%) = $ 7,900.

Qualitative Analysis

While the cost-based approach clearly results in greater profit margins for Fancy, several qualitative considerations influence which pricing model should be selected:

- Although the cost-based approach results in a higher profit margin per ring, this approach does not consider consumer demand. It has priced the ring as if it carries a mined diamond, even though consumers do not value mined and lab-grown diamonds the same. Sales volumes would likely be limited for a lab-grown diamond ring at this price, and thus it is unlikely this price would result in a higher profit margin overall for Fancy.
- The demand-based approach to developing the selling price accounts for more external factors that influence customer demand. Given the lower price, Fancy would certainly sell more units under this approach; however, it is unclear if the higher volume of sales would result in a higher profit margin overall.
- Considering that a diamond is a luxury item, consumers are generally less sensitive to price. Given such inelasticity, Fancy could set the price using the demand-based approach without significantly affecting demand.
- Setting a higher price, such as the one developed under the demand-based approach, might signal higher quality to the market, which would be in line with Fancy's reputation for quality and brand prestige.
- Under both approaches, no impact was considered for the places of origin of both the mined and lab-grown diamonds. If customers place additional value on lab-grown diamonds because they are not from a conflict zone or have a lower environmental or social impact than mined diamonds, the price of the rings may be set higher.

Recommendation

Given the above, and consumers' apparent price inelasticity, we recommend the demand-based pricing approach for the lab-grown product line. However, further analysis, using projected sales volumes at both price points, should be performed because it would provide valuable information regarding the overall profitability of each approach.

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

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

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

Reaching competence – The candidate develops a price for Fancy's lab-grown diamond engagement rings, using cost-based and demand-based methods, or qualitatively analyzes which pricing strategy should be used.

Competent – The candidate develops a price for Fancy's lab-grown diamond engagement rings, using cost-based and demand-based methods, and qualitatively analyzes which pricing strategy should be used.

Competent with distinction – The candidate develops a price for Fancy's lab-grown diamond engagement rings, using cost-based and demand-based methods, and thoroughly qualitatively analyzes which pricing strategy should be used.

Assessment Opportunity #8 (Depth Opportunity)

The candidate analyzes whether Fancy should offer lab-grown diamonds.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
2.3.3	Evaluates strategic alternatives	B	A
3.4.1	Evaluates sources and drivers of revenue growth	B	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Lab-Grown Product Line Considerations

Pros:

- Customer demand for lab-grown diamonds is growing, since customers are attracted to the idea of getting a bigger stone for the same amount of money. There appears to be growth in this segment of the industry, compared to annual revenue growth in the industry of negative 0.6%. Offering this product line will allow Fancy to tap into the growth of this segment.
- The composition of mined and lab-grown diamonds is the same. Thus, the lesser value attributed by consumers to lab-grown diamonds may be unfounded, as it solely results from a perception by consumers.
- Though margins for jewellery featuring lab-grown diamonds are lower, Fancy risks losing sales altogether if it does not offer such products. This product line will allow Fancy to increase sales volumes.
- The artificial increase of supply by major mined-diamond suppliers such as DeWines drives down the prices of all diamonds, including lab-grown. It is not clear how long this strategy can be maintained for diamond miners. It is possible that, in future, as these firms ease supply, prices of mined diamonds will rise, and with them, the margins for lab-grown diamonds. If the 30% discount for the increased supply of mined diamonds is removed, Fancy's profit margin for these rings increases to 39%, using the demand-based pricing approach.
- Diamonds with certificates of origin, or that come from conflict-free zones, tend to fetch higher prices than those with no certificates or that originate from areas with conflict. It will be easy for lab-grown diamonds to come with a certificate of origin, since Fancy will know the exact source. Further, it will be easy to confirm that such diamonds do not originate from conflicted areas. Therefore, it is possible that the price consumers are willing to pay for such diamonds will continue to increase.
- Lab-grown diamonds have a smaller environmental and social footprint than mined diamonds, which has obvious, positive external benefits. This also appeals to Fancy's consumers, which could lead to greater demand, sales, and prices, and it reduces organizational and reputational risk for the company.
- The costs of creating lab-grown diamonds are less volatile than the costs associated with mined diamonds. This stability could enable Fancy to better plan for long-term investment decisions, and provide certainty around costs.
- While lab-grown diamonds do not currently get graded by the most reputable labs, there are indications that this may change in the future and would no longer be a consideration.
- The widespread introduction of lab-grown diamonds is expected to have a major impact on the entire diamond-mining industry, and is expected to generate uncertainty in that market. The introduction of lab-grown diamonds at Fancy would alleviate the consequences of this additional uncertainty.

Cons:

- Customers currently attribute less value to lab-grown diamonds. Offering this product line may dilute Fancy's brand prestige and reputation for quality. The impact of this may be mitigated by Fancy's use of high-quality E2 diamonds in their lab-grown line, as well as the fact that lab-grown diamonds are compositionally identical to mined diamonds.
- The margins for products with lab-grown diamonds are lower, owing to the discount that consumers place on such gems. This reduction in margins could eat into Fancy's existing margins, if customers migrate from buying Fancy's existing higher-margin products. On the other hand, Fancy might lose these margins anyway if customers migrate to Fancy's competitors to buy lab-grown diamonds.
- As seen in the demand-based approach, the margins for rings with lab-grown diamonds can be extremely thin (1%, when sold at the demand-based price). Using a demand-based price, which we recommend, may not be enough to cover the variable cost of the ring (calculated as $7,800 above) if the demand for lab-grown rings decreases.
- There is a possibility that demand for lab-grown rings could decrease. More suppliers could enter the segment, or suppliers of mined diamonds could continue to release large quantities, to lower demand for synthetic ones. This possibility, in conjunction with the point above, results in a risk that the price Fancy is able to charge for these rings falls below their cost.
- Despite more certainty around the costs of lab-grown diamonds, it appears that the volatility of diamond prices is due to external factors rather than to the actual cost of the diamond itself. As such, it is unlikely that the use of lab-grown diamonds will completely reduce the volatility of diamond prices.

Conclusion

Despite their identical composition to mined diamonds, lab-grown diamonds fetch lower prices than mined diamonds. However, these diamonds appear to have a place in the industry, as they are growing in popularity. Further, these diamonds offer some stability in terms of cost, tracking, and footprint. While the margins are low, it is possible that the supply of mined diamonds will gradually decrease, and margins on the sale of the lab-grown diamonds will increase.

Overall, due to the stalled growth in the rest of the industry and the growing demand for lab-grown diamonds, we recommend that Fancy pursue this product line. The likelihood that lab-grown diamonds will diminish Fancy's brand exists, but this risk appears low. If brand dilution remains a concern, Fancy could provide some separation between its existing products and the lab-grown line by offering the lab-grown diamond rings only on the website, or even under a different brand name. It is not clear what barriers currently exist to producing lab-grown diamonds, other than cost. It is possible that the supply of lab-grown diamonds will continue to increase, as more producers enter the market. This would likely result in a continuous decline in prices, until margins are such that only the most efficient firms can remain in this segment of the industry. To stay competitive over the long term with this strategy, it would be necessary for Fancy to continue to invest in processes that increase its organizational efficiency and lower its costs. Thus, a strategy such as Fancy's virtual store, which allows the firm to generate sales with lower overhead, would be a natural fit for combining with a lab-grown product line.

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

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

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

Reaching competence – The candidate attempts to discuss whether Fancy should offer lab-grown diamonds.

Competent – The candidate discusses whether Fancy should offer lab-grown diamonds.

Competent with distinction – The candidate thoroughly discusses whether Fancy should offer lab-grown diamonds.

Assessment Opportunity #9 (Depth Opportunity)

The candidate quantitatively determines whether it would be a good idea to sell some products online or whether it would be better to maintain the status quo.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
3.3.2	Evaluates and applies cost management techniques appropriate for specific costing decisions	B	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Below is a calculation of the profit generated by the virtual store, compared to the profit generated by sales at the brick-and-mortar locations. Refer to the notes following the calculation for key assumptions.

	Note	Online	In-Store
Sales price	1	$ 3,150	$ 3,705.88
Variable costs:			
Gemstones		1,200	1,200
Other costs of finished rings	2	1,300	1,300
Commission – 6%	3	0	222.35
Total variable costs		2,500	2,722.35
Contribution margin, per unit		$ 650	$ 983.53
Projected sales, units	4	2,700	500
Total revenue		8,505,000	1,852,940
Gross profit		$1,755,000	$ 491,764
Fixed costs:			
Custom scanning and design software		35,000	0
Jeweller salaries	5	540,000	90,000
Allocated staff	6	80,000	0
Sales staff salary	7	0	87,500
Total fixed costs		$ 655,000	$ 177,500
Incremental profit		$1,100,000	$ 314,264

Notes:

1. The sales price of the rings sold online is listed as \$3,150, which is 15% less than the in-store price. The in-store price would be \$3,706 (\$3,150 / (1 – 0.15)).
2. The average costs of producing a finished ring (including precious metals, design, moulds, and settings) are, on average, \$1,300, excluding the gemstone (as provided under the Fancy lab-grown diamond information).
3. Fancy sales staff earn 6% commission on each in-store sale. It is assumed that no commission will be earned on online sales, as no sales staff are associated with the sale.
4. The projected sales at the virtual store are 2,700 units per year. The status quo sales amount would be 500 units, which is the volume of sales from customers who would have purchased a ring at a brick-and-mortar location, if purchasing via the virtual store was not an option.
5. Six jewellers will be needed, to produce the sales volume of rings at the virtual store, at a rate of \$90,000 each year. Since one jeweller would be displaced by the 500 units now sold online, it is assumed that one jeweller will be needed for producing the 500 units, if they continue to be sold in-store.
6. The salary of the full-time employee allocated from head office to manage the virtual store was included as a fixed cost for the virtual store, since it is assumed that someone will be needed to replace the employee's previous position at head office.
7. The salary of the sales staff that Fancy would no longer need is a cost for the brick-and-mortar locations, since this cost would remain if the status quo were to continue.

Excluded Costs

Shipping costs were not included, since these costs are paid for by the customer.

The salary of the regional manager was not included, as their salary would be incurred regardless of the scenario.

The cost to build the virtual store into Fancy's existing website was not included, since this is considered a sunk cost that will be similar under both options.

The above analysis was performed to see which option is more profitable. As a result, manufacturing overhead, facility overhead, distribution and warehousing, and the regional manager salary were excluded from the analysis, since all would be incurred regardless of which method is chosen. It is noted that, while the virtual store does not require rent and utilities itself, since Fancy will not be operating the virtual store in lieu of the brick-and-mortar locations, these costs will remain the same under both scenarios.

Profitability

The rings sold at Fancy's brick-and-mortar locations have a greater contribution margin per unit, since the rings can be sold at a higher price. However, the virtual store will result in a higher number of sales (2,700 per year, compared with 500 in-store). This translates to a greater total gross profit for the online sales. Incremental fixed costs are higher for the online store, at $655,000, compared to $177,500 in-store. This is mostly due to the fact that the virtual store has higher volumes and requires more salaries for jewellers, as well as some costs for the software required, and thus has more incremental costs associated with it and its additional sales. The status quo option has limited incremental fixed costs.

The total profit is significantly higher for the virtual store, due to the greater sales volumes experienced by the virtual store. The incremental profit of creating the virtual store is $785,736 annually (1,100,000 – 314,264).

The same incremental profit calculation could also be performed, using the following differential approach.

	Virtual store	
Sales (2,700 rings)	$ 8,505,000	2,700 × 3,150
Gemstones (2,700 rings)	3,240,000	2,700 × 1,200
Other costs (2,700 rings)	3,510,000	2,700 × 1,300
Commissions		
Gross profit	1,755,000	
Custom scanning	35,000	
Additional jeweller salaries	450,000	
Allocated staff	80,000	
Additional profit – virtual store	1,190,000	
Lost sales in-store (500 rings)	(1,852 940)	(3,705.88 × 500)
Saved cost (lost sales) – gems (500 rings)	600,000	(1,200 × 500)
Saved other costs (lost sales) (500 rings)	650,000	(1,300 × 500)
Saved cost (lost sales) – commissions	111,176	
Additional sales staff costs saved	87,500	
Incremental profit	$ 785,736	

Therefore, on a purely quantitative basis, the virtual store is more profitable than the status quo.

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

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

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

Reaching competence – The candidate attempts to calculate the profit of the virtual store.

Competent – The candidate calculates the profit of the virtual store, and concludes on whether it is more profitable than the status quo.

Competent with distinction – The candidate thoroughly calculates the profit of the virtual store, and concludes on whether it is more profitable than the status quo.

Assessment Opportunity #10 (Depth Opportunity)

The candidate revises the financial results for the flagship store to comply with Fancy's policy, and comments on the company's current allocation policy.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
3.3.1	Evaluates cost classifications and costing methods for management of ongoing operations	A	

CPA Map Enabling Competencies:
5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization
5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Below is a revised statement of operating income for the Toronto flagship store, and associated notes/assumptions.

Toronto Store Operating Income

	2023 ($)	**Adjustments ($)**	**2023 Revised ($)**	**Notes**
Revenues	18,885,000	409,000	19,294,000	1
Cost of goods sold	9,984,600	0	9,984,600	
Gross profit	8,900,400	409,000	9,309,400	
Selling and marketing				
In-store employee wages and benefits (excluding commissions)	973,500	0	973,500	2
Sales commissions	1,147,860	24,540	1,172,400	1
Distribution and warehousing costs	867,000	(49,472)	817,528	2
Local and regional marketing costs	642,000	0	642,000	
Promotions, events, and sponsorships	3,900,000	(2,700,000)	1,200,000	3
Total selling and marketing	7,530,360	(2,724,932)	4,805,428	
Depreciation and amortization	1,050,000	0	1,050,000	4
General and administration				
Maintenance, utilities, insurance, and property taxes for the store	398,763	0	398,763	5
Store manager wages and benefits	244,389	0	244,389	5
IT support costs	345,000	(115,000)	230,000	6
Head office general and administration costs	210,800	999,656	1,210,456	2, 6, & 7
Regional general and administration expenses	206,300	0	206,300	8
Total general and administration	1,405,252	884,656	2,289,908	
Total operating expenses	9,985,612	(1,840,276)	8,145,336	
Operating income (loss)	(1,085,212)		1,164,064	

Notes:

1. It appears that the $409,000 of sales directed by the Concierge Service to the other locations was not recorded at the Toronto location. According to company policy, which is to record a sale at the location of first contact, these should be recorded at the Toronto location. As a result, an adjustment has been made to add these sales to the flagship store's revenue.

   Cost of sales and other costs were not adjusted, since it was stated that all costs associated with the above sales were already recorded by the Toronto store.

   An adjustment has been made to add commission expenses related to the above sales, at a rate of 6% ($409,000 × 6% = $24,540). We assumed these were not recorded at the Toronto location, since the sales were not recorded there.

2. Of the sales generated at the Bridal Bar, 50% were recorded at the store that initiated the transaction. It could be argued that the Toronto location should be awarded those sales, or at least a portion of them, since they are responsible for providing the fittings, VIP service, and distribution of the jewellery. However, it is Fancy's policy to record the sale at the location of first contact, since that location was responsible for generating the transaction. Therefore, we will not adjust sales at the present time for the bridal bar because they were recorded in line with company policy. Cost of sales, wages and benefits, as well as the distribution and warehousing costs, will remain the same as well, since they were also recorded at the store that initiated the sale.

   Commissions have not been adjusted, as we assumed these have been correctly recorded at the location that claimed the sale. This can be verified by seeing that the commission expense of $69,030 is exactly equal to 6% × $1,150,500 (the Toronto sales allocation).

   Distribution costs related to the sales that took place at the bridal bar were entirely allocated to the Toronto flagship store. However, under the policy, the distribution costs are to be allocated to the store having initiated the sale. Since 50% of visits to the bridal bar were initiated at another location, it can be assumed that half of the sales, and half of the distribution costs, of the bridal bar should have been allocated to the store that generated the sale. Half of the distribution costs of the bridal bar (50% × 98,943) should therefore, under the policy, have been allocated to another store rather than to the Toronto flagship store. A corresponding adjustment of the distribution costs of the Toronto flagship store is therefore required.

3. The $2.7 million related to the product launch and celebrity endorsements were recorded under promotion expenses at the Toronto location. Since the endorsement and launch benefit all locations, this amount was removed and added to head office costs, as it should be attributed to head office. If there are additional promotional costs that are likewise beneficial for the entire company, these should also be removed and attributed to head office.

   Since head office costs are later allocated to all the locations, a portion of these costs will be borne by the Toronto location on this line item.

4. Depreciation and amortization were not adjusted because we assumed that all assets attributed to the Toronto store are in use at this location.

5. Maintenance, utilities, property taxes, and store manager wages and benefits have not been adjusted because these are directly attributable to costs incurred at the Toronto location.

6. Since 33% of IT support time was related to the product launch, which benefits all locations, it is reasonable to remove this amount from IT support costs at the Toronto location, and reattribute it to head office.

7. Head office costs are currently allocated to each store on an equal basis. However, as noted by the managers of the other locations, revenue may be a more appropriate basis to use for attributing such costs.

   It was noted that personnel from head office are regularly seen attending or assisting with projects occurring at the flagship store. It is apparent that the varied and extensive activities of the flagship store require more head office attention than Fancy's regular stores. Because of this, and the fact that the Toronto store drives over one-fifth of Fancy's total sales, it seems more appropriate to allocate head office costs on the basis of proportionate share of revenue, rather than to share these costs equally across locations. As a result, in the calculation below, the allocation is based on revenue.

   Toronto's share of revenue (after adjustments to the concierge service revenue) is 22% ($19.3 million ÷ $88.6 million). Adding the costs of the product launches, endorsement, and additional IT services to the head office expenses, Toronto's share of such costs would be $1,210,456, instead of $210,800.

Total Fancy revenue	$88,550,000
Toronto adjusted revenue	$19,294,000
Toronto share of revenue	21.79%
Toronto share, based on locations	7.69%
Total head office expenses, prior to adjustments	2,740,400
Adjustments to head office expenses:	
Launch and endorsement expenses	2,700,000
IT support cost adjustment	115,000
Total head office expenses, after adjustments	5,555,400
Toronto store's share of head office expenses (21.79%):	$ 1,210,456
Adjustment required ($1,210,456 - $210,800)	$ 999,656

8. Regional general and administrative expenses are assumed to be attributed correctly, since there is no information to suggest otherwise.

Conclusion

After the adjustments noted above, the Toronto location's operating income is positive, at $1,164,064. The recalculated operating income suggests that the additional services that the flagship store provides to the rest of the company are responsible for the location's negative operating income.

There is some question of fairness related to how sales in the bridal bar and concierge service are allocated to various locations. Although it is company policy to record sales at the location of first contact, this may not be completely fair, considering that it is often employees at other locations doing the bulk of the work associated with the sale. For example, the staff at the bridal bar are responsible for providing VIP treatment and performing the fittings, yet do not earn commissions or bonuses, based on the sales generated by these activities. We advise reviewing this policy and determining a fairer method of allocating the sales, which aligns with the actual effort involved. This would help incentivize employees who provide the various services to perform well.

It would be beneficial going forward to continue to separate extraordinary expenses related to activities that benefit the company as a whole from the operations of the Toronto store. Alternatively, Fancy could consider treating the flagship elements of the Toronto store (such as the bridal bar, concierge service, and lounge) as their own cost centre. Rather than one cost centre for the Toronto store, Fancy could create two cost centres: one for the location’s normal operations and the other for the flagship operations (or one each for the lounge, concierge service, and bridal bar). The former centre would cover actual sales and costs at the store, while the latter centre(s) would cover operations related to the flagship elements. These reporting options would help provide a clearer picture of the profitability of both the Toronto store and the flagship operations.

Further, it is important to note that these expenses are simply moved from one store to another; there is no impact to company profit overall.

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

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

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

Reaching competence – The candidate attempts to revise the operating income for the Toronto flagship store to comply with Fancy’s policy.

Competent – The candidate revises the operating income for the Toronto flagship store to comply with Fancy’s policy, and comments on the company’s current allocation policy.

Competent with distinction – The candidate thoroughly revises the operating income for the Toronto flagship store to comply with Fancy’s policy, and thoroughly comments on the company’s current allocation policy.

Assessment Opportunity #11 (Depth Opportunity)

The candidate proposes metrics for assessing sales employee performance, and discusses the potential drawbacks of the metrics proposed.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
2.3.1	Evaluates the entity's strategic objectives and related performance measures	B	A
3.1.2	Documents and assesses business processes, systems and data requirements and recommends improvements to meet information needs	B	A
3.7.1	Analyzes the implications of management incentive schemes and employee compensation methods	B	A

CPA Map Enabling Competencies:
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.2.2 Identifies patterns from data analysis
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Customer Service

<u>Greet-rate</u>

Mystery shoppers could record their interactions with specific sales staff at certain Fancy locations. Information could be collected on how the mystery shoppers are greeted, the time to contact, and whether the engagement was unfriendly or too personal. This data could be collated into a metric that provides employees with a greet-rate score, to rank how closely sales staff interactions align with the training they receive.

One potential drawback is that mystery shoppers would likely only be able to generate data for one employee at a time. This could lead to an incomplete picture of how well employees are greeting customers, or to consistency issues with the scores. This would also result in a low sample size of interactions, and might disproportionately affect an employee having one really good or bad day that is not representative of their usual performance. A potential solution is to have the mystery shopper return to the store multiple times to interact with different employees, or to have managers observe sales staff in order to provide further data. Note that customer interactions may vary depending on the times observed (i.e., during busy times, it may not always be possible for sales staff to have a high greet-rate).

Follow-up calls

Fancy could implement a policy of requiring sales staff to log their follow-up calls in the customer file. Managers could perform a review of the adherence to this policy as part of the employee's performance assessments.

A potential drawback of this system is that it may not capture the quality of such calls, and could potentially create an incentive for employees to falsely record calls in the system. It would be difficult for management to know how effective these calls were, or if they actually took place.

A system-generated log, based on actual calls made from Fancy's system may be more effective at tracking these calls. Fancy could also consider recording calls to spot check their quality, although management would have to ensure that the collection and retention of this data meets applicable privacy laws.

Customer-satisfaction score

Fancy could leverage information provided in the customer-satisfaction surveys, to generate a customer-satisfaction score for the salespersons who completed the sales. Even if the customer did not know the name of the sales staff who helped them, the customer data could be cross-referenced with the customer file, to determine the applicable sales staff. (Note that the salesperson making the sale is included in the data entered and retained in the customer file, as per Appendix IV.)

A drawback of this system is that it places a burden on customers to provide the data, and may not be representative of performance, if only 20% of customers complete the survey (customers may be more motivated to respond to a survey if they are dissatisfied, for example). One potential solution is to offer incentives, such as entries in prize draws, to increase customer response rates.

Online reviews

Fancy could leverage feedback in customer reviews, to further contribute to the employee customer-satisfaction scores. While it may be difficult to corroborate which salesperson was directly responsible for the customer's experience, it may be possible to determine the corresponding salesperson by using the customer data that Fancy currently collects.

A drawback of this approach is that customers may leave negative reviews when they receive poor service, but not leave positive reviews when they receive good customer service. This could lead to an incomplete profile of the sales staff's performance. This could be mitigated by associating only a small part of the employees' performance with such feedback.

Selling Skills

Total sales per employee

Fancy currently does not track which salespersons are responsible for which sales. Fancy could start linking the salesperson to the sale, by entering the identity of the salesperson along with the customer data for each sale. This data could be used to track the total sales per period for each salesperson. Sales staff could be given a ranking or weighting, based on their total sales made, compared to individual sales targets.

A potential drawback of this system is that it might create unwanted competition among sales staff, lead to sales staff helping only high-net-worth customers, or lead to aggressive sales tactics. This could also favour employees who work at times of the day or week that are busier, even though they might not have control over this element of their work. To mitigate this, Fancy could balance the weighting of this metric with the other metrics that track overall employee performance, including the customer-satisfaction score noted above.

Average selling price / basket size per sale

Similar to the metric above, Fancy could use customer sales data to determine sales counts, or "basket size" (i.e., number of items), of the number of add-ons sold per sales staff. Employees who generate more sales of add-ons, such as complementary pieces or insurance, would receive a higher score.

Similar to the total sales metric, a potential drawback of this system is that it might create unwanted competition among sales staff or lead to aggressive upselling sales tactics. To mitigate this, Fancy could balance the weighting of this metric with the other metrics that track overall employee performance, including the customer-satisfaction score noted above.

Customer-satisfaction score

As noted under customer service above, incorporating data from the customer-satisfaction scores would help balance purely sales-based metrics, to ensure that salespersons do not become overly aggressive.

Product Knowledge

Knowledge tests

To evaluate the ongoing product knowledge of its sales staff, Fancy could consider administering annual (or more frequent) knowledge tests, similar to the tests employees must pass at the end of their training. These tests could be developed to be congruent with the experience level of the sales staff, and updated according to the characteristics of the current product offerings and latest industry certifications.

A potential drawback of this approach is the time and effort it would take to develop and evaluate such tests. This drawback may be mitigated by leveraging the evaluations administered during the initial training.

Customer-interaction score

To further evaluate the product knowledge of its sales staff, Fancy could consider providing mystery shoppers with a set of questions on which the sales staff could be evaluated. For example, the mystery shopper could ask questions about the cut, clarity, and colour of specific diamonds, to determine if the salesperson has accurate knowledge of the product. Questions could also test the salesperson's knowledge about the latest gem certifications. The responses to these questions could provide additional data on how well the employees know the products offered.

Drawbacks of this approach are similar to the drawback of the greet-rate metric generated by the mystery shoppers: these shoppers are likely only able to generate data for one employee at a time. This could lead to an incomplete picture of how well all employees are greeting customers. A potential solution is to have the mystery shopper return to the store multiple times to interact with different employees, or to have managers observe sales staff, to provide further data. Note that the observance by managers could lead to some inconsistency, depending on time observed. It could also lead to some awkwardness, if customers feel their interactions are being observed and recorded.

Overall

A number of Fancy's existing processes can be leveraged to create metrics and collect objective data on the performance of its sales staff. While there are some drawbacks to each of the items noted, there would likely be greater benefit in generating a more objective evaluation of the performance of its sales staff. Fancy could pilot some of the approaches noted above, to determine which metrics produce the desired results, and collect additional data if required.

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

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

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

Reaching competence – The candidate proposes some metrics for assessing sales employee performance, and attempts to discuss the potential drawbacks of the metrics proposed.

Competent – The candidate proposes several metrics for assessing sales employee performance, and discusses the potential drawbacks of the metrics proposed.

Competent with distinction – The candidate proposes many metrics for assessing sales employee performance, covering each of the training areas, and discusses the potential drawbacks of the metrics proposed.

Assessment Opportunity #12 (Depth Opportunity)

The candidate discusses the benefits, and potential issues, related to the use of the diamond tracking technology.

The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
2.4.1	Analyzes key operational issues including the use of information assets and their alignment with strategy	**B**	**A**
3.1.2	Documents and assesses business processes, systems and data requirements and recommends improvements to meet information needs	**B**	**A**

CPA Map Enabling Competencies:
2.2.1 Assists in identifying and monitoring risks within areas of work responsibility
5.1.1 Applies general business knowledge to enhance work performed
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Benefits

The diamond-tracking technology will help Fancy improve the transparency and traceability of the diamond's journey along the supply chain. Since each transaction along the supply chain is recorded in the digital ledger, it will be possible for each party to review the history of the diamond, back to its original source.

This technology will increase Fancy's ability to track its inventory, as well as track diamonds from source to customer. This will provide Fancy with greater confidence about the origins of the diamonds it purchases, and will ensure that the diamonds are conflict-free.

The fact that the ledger data cannot be modified or deleted increases the integrity of the gem's recorded history. It would not be possible for a party to make false claims about a diamond if it is accompanied by the applicable digital certificate, since the previous transaction data cannot be altered.

A robust certification process that establishes the origin of the diamonds in conflict-free zones can result in higher selling prices for diamonds of equivalent grades. Therefore, the introduction of this technology into Fancy's tracking of diamonds could result in greater profit margins for the company.

The customer engagement portal could increase customer engagement between the end consumer and Fancy. It also appears to reduce the impact of shipment issues and reduce the legitimacy of counterfeit items. In addition, the portal will provide Fancy with opportunities to engage with more consumers, if secondary owners are linked to the company via the digital certificate.

The technology will help reduce potential forgery of Fancy pieces because forgers would not be able to access the digital certificates. This would help maintain Fancy's reputation for quality and craftsmanship, since all pieces could be verified as authentic via their digital certificate.

This technology also reduces the possibility of theft. Stolen diamonds would not be accompanied by a digital certificate, which would lessen their value. The descriptions of the diamonds contained in the certificate may also be useful to law enforcement authorities or insurance agencies looking to recover the items. This could lead to lower insurance costs for Fancy.

Potential Issues

Creation of the digital certificate and access to the digital ledger requires users to have access to the internet. This may not be feasible in remote areas where the diamonds are mined, which could create an opportunity for the diamonds to be swapped during transit. It may be preferable to have an option for the digital certificates to be created offline.

It does not appear that the information in the digital certificate is audited or verified at the source. Thus, it would be possible for the creator of the digital certificate to enter fraudulent details about the gem when the digital certificate is created. Third-party assurance or a series of controls at the time of creating the digital certificate would help ensure that the information entered is accurate.

The diamond is not physically associated with the certificate. Therefore, it is possible for the diamond to be swapped along the supply chain, which could occur unnoticed by the digital certificate that travels alongside the gem. Coupling this technology with physical tracers, such as laser inscriptions or embedded nanoparticles, would provide an additional layer of integrity to the process.

It appears that it might be possible for the owner of a gem to not transfer the digital certificate at the time of the sale, even though this is a requirement. The lack of transfer may be due to nefarious or technological reasons; however, it would represent a break in the tracing of the supply chain. Fancy could mitigate this risk by implementing a policy of only purchasing gems with a valid certificate.

While this technology will be effective at improving the integrity of a diamond's origin, it alone cannot ensure that the stone is mined responsibly. For example, the existence of a certificate cannot guarantee that the diamond was mined in a conflict-free zone, or that it is even a mined diamond. Third-party oversight or assurance at the time of creating the digital certificate would help verify the validity of the diamond, and the manner in which it was mined.

It is not clear how the technology provider performs its verification process. A bad actor could still participate in the supply chain if they were able to circumvent this verification process, or if the controls surrounding these checks were not robust. It would be beneficial to check with the technology provider about the verification process. It should likely include a background check, to identify parties with a problematic track record, such as being mentioned in a sanction or listed on a law enforcement list.

Since the visibility of the history of the diamond is only granted when the specific gem is in the party's ownership or custodianship, a potential purchaser would not be able to see the existing transactional data until the diamond was transferred. Thus, unless the existing custodian is willing to grant the purchaser access to the history, the source may not be completely transparent to the purchaser, limiting the traceability benefits of the technology.

It is possible that the existence of a secondary market on the customer portal for Fancy erodes its profit margins on new jewellery. Further research should be done, to investigate the impact of this market on Fancy sales. This analysis should also weigh the positive impact the portal will have on reducing the potential sales of counterfeit Fancy jewellery.

Conclusion

Overall, this technology appears to be a step in the right direction for improving the transparency and traceability of diamonds along the supply chain. While there are several issues to consider, Fancy can take certain steps to mitigate the potential risks of these issues.

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

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

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

Reaching competence – The candidate attempts to discuss the benefits and potential issues related to the use of the diamond-tracking technology.

Competent – The candidate discusses the benefits and potential issues related to the use of the diamond-tracking technology.

Competent with distinction – The candidate thoroughly discusses the benefits and potential issues related to the use of the diamond-tracking technology.

Assessment Opportunity #13 (Depth Opportunity)
The candidate discusses how the decisions and initiatives mentioned fit into Fancy's existing strategy and whether changes to the strategy are needed, and proposes potential changes to the strategy going forward.
The candidate demonstrates competence in the Performance Management role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
2.3.2	Evaluates the entity's internal and external environment and its impact on strategy development	**B**	**A**

CPA Map Enabling Competencies:
2.1.2 Assists managers and works on teams to support business- and functional-level strategy planning, implementation or monitoring *5.1.3 Develops and uses knowledge of the organization, industry and stakeholders* *6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems* *6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives* *6.3.1 Uses evidence and judgment to recommend and justify solutions*

Overall

The industry appears to be moving in two directions: toward a high-margin strategy that is focused on quality and brand reputation, and toward a low-cost approach that is focused on sales volumes. Fancy appears poised to invest in aspects of both strategies.

<u>High-margin approach</u>

In response to decreasing sales volumes, some firms in the industry are targeting high-end customers to increase their margins. Under this approach, these firms are focusing on quality and brand reputation.

Fancy is already invested in this strategy. The company's existing strategy is to sell distinctively designed, exclusive, and high-quality merchandise, and Fancy's upscale retail stores are decorated with elegant surroundings, to entice high-income customers to visit. This has resulted in a Fancy brand that is highly reputable and known for being trustworthy, with quality craftsmanship and excellent customer and after-sales service.

Fancy has recently invested in the creation of a flagship store and in adding a line of high-end giftware, which further supports this strategy. The primary purpose of the flagship store is to increase awareness and prestige for the Fancy brand. This approach appears to be effective, as it has led to greater sales in Fancy's other locations and attracted high-net-worth customers to its flagship store, as seen with the sales in the bridal bar and concierge service. Fancy has also considered investing in diamond-tracking technology, to provide greater transparency regarding the source of its mined diamonds, which will support assertions regarding quality, and limit reputational risk.

Low-cost approach

The other strategy employed in the industry is to provide lower-cost offerings in order to drive sales volumes. Fancy is considering pursuing initiatives that are more tailored to this approach, such as a virtual store and a product line featuring lab-grown diamonds. Both the new online distribution channel and new product segment, using lab-grown diamonds, have experienced greater growth than the industry as a whole, and when considered in isolation, it has been determined that Fancy should pursue these projects.

As noted previously, it is not clear what barriers currently exist to producing lab-grown diamonds, and the same may be said for virtual stores. It is possible that the benefits of each will diminish as more suppliers enter the market. However, given the low-growth outlook for the industry as a whole, the prospects of growth in both of these areas may make it necessary for Fancy to adopt them.

It is likely that only the most efficient firms can remain profitable under a low-cost approach. Therefore, if pursuing such a strategy, it would be necessary for Fancy to continue to invest in processes that increase its operational efficiency and lower costs, to stay competitive over the long term.

Potential conflicts and synergies

The initiatives proposed by Fancy that target a low-cost approach (virtual store and lab-grown product line) could undermine the company's existing high-margin strategy. High-net-worth individuals may associate less prestige with a brand that sells rings online and offers lab-grown diamonds.

These strategies could also attract customers in different strata of the industry, and allow Fancy to broaden its sales reach and grow revenues. Fancy currently offers merchandise at a wide range of price points, so expanding on this approach may not be anything new for customers. It may also allow Fancy to generate further economies of scale, as there appears to be some overlap in the manufacturing and administrative processes of virtual versus in-store sales, and lab-grown versus mined diamonds.

Also common to both strategies is a growing concern about the industry's impact on environmental and social issues. In particular, consumers are increasingly interested to know that their purchases of gemstones do not contribute to armed conflicts. These issues are partially addressed by two projects considered by Fancy: using technology to track gemstones from mine to market, and introducing lab-grown diamonds. These projects may help Fancy mitigate many of the environmental and social concerns associated with mined diamonds.

Multiple brands

Fancy should consider a third option, which is creating multiple brands, to attract customers at varying price points. Fancy is well poised to pursue such a strategy, as it has an existing reputable brand that is difficult to replicate, already sells merchandise at a range of price points, and has surplus cash. This cash could be used to cover the upfront legal, design, and marketing costs of creating secondary or tertiary brands. This would allow Fancy to offer lab-grown diamonds and benefit from online jewellery sales without diluting the value of its high-end brand. These new brands could be based entirely online, which would allow Fancy to avoid investing in further brick-and-mortar locations, as well as maintain separation from its existing brand.

Conclusion

The pursuit of a low-cost strategy could be at odds with a strategy seeking to increase margins. Increasing organizational efficiency and cutting costs does not necessarily align with a commitment to quality and brand prestige, although there could be synergies associated with pursuing both. Brand prestige is likely more difficult to acquire, and Fancy's recent decisions to double-down on this approach with a flagship store and high-end giftware are not ill advised. However, the current lack of growth in the industry is cause for concern. The low-cost approach has stronger growth potential, but profitability may be eroded as more competitors enter the industry. There are drawbacks and benefits to singularly pursuing either strategy.

Given the unique opportunities inherent in the competing strategies, we recommend that Fancy pursue both strategies by creating multiple brands. Fancy appears capable of making the financial commitment necessary for pursuing such a strategy, and has demonstrated that it is well positioned to reap the benefits of its various aspects.

If Fancy uses this approach, it is important that its performance schemes align with the varying aspects of this strategy. At present, employees are incentivized based on the operating income at their respective locations. This may not be the most effective method of motivating and assessing the performance of employees, as operating profit at individual locations would not capture the specific skills and objectives of the multiple projects involved in the multiple-brand strategy. It may be more beneficial to align performance schemes with specific projects, rather than location. Further, given the interconnectedness of the various locations, as noted with the activities at the flagship store, it may be beneficial for a portion of such schemes to be based on the profitability of Fancy overall or the effort involved in the activities, rather than solely tied to the operating income of specific locations.

For Assessment Opportunity #13 (Performance Management), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to discuss how the decisions and initiatives mentioned fit into Fancy's existing strategy, or whether changes to the strategy are needed.

Competent – The candidate discusses how the decisions and initiatives mentioned fit into Fancy's existing strategy, whether changes to the strategy are needed, and proposes potential changes to the strategy going forward.

Competent with distinction – The candidate thoroughly discusses how the decisions and initiatives mentioned fit into Fancy's existing strategy, whether changes to the strategy are needed, and proposes potential changes to the strategy going forward.

DAY 2 ‑ MARKING GUIDE ‑ TAXATION ROLE
FANCY LUXURY JEWELLERY INC. (FANCY)

To: Steven Lundstrom, CFO
From: CPA
Subject: Items requested

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

Assessment Opportunity #7 (Depth Opportunity)

The candidate advises on Steven's residency for Canadian income tax purposes.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
6.3.1	Evaluates general tax issues for an individual	B	A
6.5.1	Analyzes residency of a taxpayer	C	B

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations
6.3.3 Applies decision criteria to choose among viable alternatives

Income Tax Residence of Steven

Steven has asked us to address whether he is considered a resident of Canada for income tax purposes, based on his move to Canada during 2023.

Residency is a question of fact (other than the potential deeming rules discussed below). Whether Steven is a resident of Canada is based on his residential ties, considering significant and secondary residential ties.

Significant residential ties

Significant residential ties relate to a dwelling available for occupation and the location of a spouse and dependants.

Steven has rented a townhouse in Canada, and this constitutes a significant residential tie. It is not necessary for him to own the townhouse for it to be relevant. The family maintains a vacation property in Australia, which could be considered a tie they have to Australia.

Steven's spouse and one of their two children joined him in Canada, which indicates strong residential ties to Canada. However, Steven's 16-year-old daughter has remained in Australia, which provides another tie to Australia.

Overall, Steven's significant residential ties lean in favour of Canada, given that the family's primary home is in Canada and his spouse and one of their children made the move with him. These likely outweigh the vacation home and his daughter in Australia.

Secondary residential ties

To evaluate their significance, we should look at secondary residential ties collectively rather than individually.

Steven has economic ties with Canada due to his employment with Fancy, the bank account he opened, and the credit cards he has obtained.

It appears that Steven has little personal property in Canada other than his clothing and perhaps some personal possessions, since the rented townhouse came furnished and the family does not own any automobiles in Canada. The family presumably retained some personal possessions at their vacation home in Australia.

Steven has formed some social ties in Canada by joining a social club in Toronto, although the family has also maintained their yacht club membership in Australia.

Steven is a Chartered Accountant in Australia and is continuing to fulfill his professional obligations for this designation. However, he intends to receive reciprocity in Canada.

The family's permanent resident status for immigration purposes indicates residential ties to Canada, although the status does not necessarily equate to residency for income tax purposes.

Lastly, the family has provincial health coverage in Ontario, which is indicative of a tie to Canada.

In assessing the above factors collectively, we can conclude that Steven has strong secondary residential ties to Canada.

Deemed resident

Steven was physically present in Canada for 192 days during 2023 (i.e., 12 days in March, 10 days in May, and 170 days from July 15 to December 31), and thereby eclipses the 183-day deeming rule. However, this rule only applies to an individual who is "sojourning" in Canada or, in other words, temporarily visiting. Steven's trips in March and May meet this definition; however, when he moved to Canada on July 15, he was no longer temporarily visiting because the move was more permanent in nature. Accordingly, he only sojourned in Canada for 22 days, and therefore cannot be deemed resident in Canada by way of Income Tax Act (ITA) subsection 250(1).

Conclusion

Steven has established factual residency in Canada, based on significant and secondary residential ties, both of which favour newly formed ties in Canada over the remaining ties in Australia.

Steven should be considered a part-year resident for 2023, and accordingly, taxable in Canada on his worldwide income earned on or after July 15, 2023, which is when the family permanently moved to Canada and Steven started work in Canada (and not earlier, as the previous trips were only temporary stays and Steven had not yet established any ties to Canada). For the period of January 1, 2023, to July 14, 2023, he will be considered a non-resident of Canada, and only taxable under Part I of the Income Tax Act on employment income earned in Canada (none), income from a business carried on in Canada (none), or the disposition of taxable Canadian property (none).

Steven should consult with an Australian tax practitioner to understand if he continues to be considered a resident of Australia for domestic tax purposes. If that is the case, he may need to rely on the income tax treaty between Canada and Australia to alleviate the risk of double taxation.

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

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

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

Reaching competence – The candidate attempts to discuss Steven's residency status.

Competent – The candidate discusses Steven's residency status.

Competent with distinction – The candidate thoroughly discusses Steven's residency status and identifies the tax consequences thereof.

Assessment Opportunity #8 (Depth Opportunity)

The candidate discusses the tax administration requests from Steven.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
6.1.1	Discusses general concepts and principles of income taxation	B	B
6.1.3	Explains implications of current trends, emerging issues and technologies in taxation	C	B
6.4.1	Evaluates adherence to compliance requirements	B	A

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations

Notice of Reassessment and Tax Administration Matters

Fancy has received a notice of reassessment (NOR), to which it intends to object. Steven has asked us about the process, and is also carrying some misconceptions that we should clarify for him.

Reassessment period

Steven was surprised that the Canada Revenue Agency (CRA) had the authority to reassess the 2021 income tax return on May 1, 2024.

The normal reassessment period for a Canadian-controlled private corporation (CCPC) is three years from the date of the initial notice of assessment (NOA) for a tax year. Although we were not provided with the exact date of the initial NOA, the earliest date that the December 31, 2021, corporate income tax return could have been filed would have been in 2022, which means that the CRA is entitled to reassess the 2021 corporate income tax return until, at the very least, the beginning of 2025.

The normal reassessment period may be extended in certain circumstances. Specifically, the CRA is entitled to reassess at any time if they suspect a tax return includes a misrepresentation or omission that is attributable to neglect, carelessness, wilful default, or fraud. There are additional scenarios where the normal reassessment period may be extended; however, they are not applicable to Fancy's situation.

Books and records

Fancy has already disposed of its corporate income tax records pertaining to the December 31, 2021, taxation year. It is important that Fancy retain its books and records pertaining to a taxation year for six years following the end of the taxation year to which those records relate. Therefore, any records relating to the December 31, 2021, taxation year should be retained until December 31, 2027.

Furthermore, if Fancy proceeds with filing a notice of objection (NOO), the books and records are required to be maintained until the matter is concluded, even if it is later than the normal six years. Therefore, Fancy should ensure that any such records relating to the December 31, 2021, taxation year are retained until at least December 31, 2027, and possibly longer, until the objection (and/or subsequent appeal, if required) is settled.

Objection and appeal process

As a corporate taxpayer, Fancy has until July 30, 2024 (i.e., 90 days from the date of the NOR) to file a NOO.

The NOO should outline the facts relevant to Fancy's entitlement to the $1.5 million limit in 2021. Furthermore, if Fancy was considered a large corporation (total taxable capital employed in Canada at the end of the tax year by the corporation and its related corporations is over $10 million) in 2021, it would be required to remit one-half of the assessed balance at the time of filing the NOO, and to reasonably describe the issue, specify the relief sought, and provide corresponding facts and reasoning. Given that Fancy greatly exceeds this threshold for 2023, it is likely that it did in 2021 as well, and would be subject to these requirements.

The NOO will be reviewed by CRA Appeals, a group independent of the one that issued the NOR. If the NOO is unsuccessful, Fancy would be entitled to appeal the matter to the Tax Court of Canada (TCC) within 90 days of the date of the NOO decision.

An appeal to the TCC is the beginning of the formal judicial process in litigating a tax matter. Following a TCC decision, matters may be further appealed to the Federal Court of Appeal. A taxpayer may also appeal to the Supreme Court of Canada (SCC), although the SCC only hears appeals that it deems to be a matter of public importance, or which raise an important issue of law that warrants its consideration.

<u>Legislative lifecycle</u>

Tax law in Canada is developed by the Department of Finance, headed by the finance minister, who is a member of parliament and a cabinet minister. The CRA is not responsible for the development of tax law; rather, they independently administer tax law, promote compliance with Canada's tax law, and provide their own interpretations of tax law. It is important to note that the CRA's interpretations are not binding and may be challenged in the judiciary.

The Department of Finance develops tax legislation following the mandates provided to the finance minister by Cabinet, and responding to critical tax issues as they arise. Unique to financial measures, to bring draft policy into enforceable law, a Notice of Ways and Means Motion (NWMM) must be tabled, which outlines the policy intended to be brought forward and is accompanied by (or subsequently followed by) draft legislation for public consultation.

Following the adoption of the NWMM and conclusion of public consultations (and any revised draft legislation), a tax bill may be brought to Parliament. It then follows the legislative steps, as with other bills. For a tax bill to become law, it must pass three readings in the House of Commons, including consideration in committee, followed by a similar process in the Senate, before Royal Assent is provided by the Governor General (the Crown's representative in Canada).

<u>Corporate income tax instalments</u>

Corporations are required to remit income tax instalments if they had prior-year taxes payable of at least $3,000, and will also have current-year taxes payable of at least $3,000. Based on Kenji's comment and the calculation of corporate taxes payable performed later, Fancy is required to make instalments for its 2024 taxation year.

Corporate income tax instalments are required to be made by the last day of each month unless they are considered a "small-CCPC" under ITA subsection 157(1.2), in which case they may be able to remit quarterly. The definition of small-CCPC requires that, in addition to the corporation being a CCPC, four conditions all be met:

a) Taxable income (for the corporation and all its associated corporations) for the current year or the preceding year is less than $500,000. This is not met for 2023, counting only Fancy's income, as calculated later, although we do not know if it will be met for 2024.
b) Taxable capital (for the corporation and all its associated corporations) for the current year or the preceding year is less than $10 million. Again, this is not met for 2023, as calculated later. It is unlikely to be met for 2024 either, unless both Fancy and Montaigne reduce greatly in size before the end of the year.
c) The corporation claims any amount for the small business deduction in the current or preceding year. This criterion is met for 2023.
d) The corporation has a perfect compliance record, including filing all returns and making all payments on time, for the year leading up to the final instalment payment for the year. We know that Fancy incurred late-filing penalties on GST/HST recently, so it is unlikely that this criterion is met.

Therefore, Fancy does not meet the criteria to be a small-CCPC. Accordingly, Fancy must make monthly instalments.

Monthly income tax instalments are determined as the least of the following three options:

i) 1/12 of the estimated tax liability for the current tax year (caution must be used with this method, as late-payment interest and penalties will be calculated using the actual amount of tax for the current tax year once it is determined, regardless of what the estimate was).
ii) 1/12 of the actual tax liability for the immediately preceding tax year.
iii) 1/12 of the actual tax liability for the second preceding tax year for the first two instalments, and then for the remaining ten months, 1/10 of the actual tax liability for the immediately preceding tax year, less the amounts paid for the first two months.

Failure to remit instalments may result in instalment interest and penalties, if Fancy has taxes payable for its December 31, 2024, tax year.

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

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

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

Reaching competence – The candidate discusses some of the tax administration issues.

Competent – The candidate discusses several of the tax administration issues.

Competent with distinction – The candidate discusses many of the tax administration issues.

Assessment Opportunity #9 (Depth Opportunity)

The candidate calculates Fancy's capital cost allowance and taxable income.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
6.2.2	Advises on taxes payable for a corporation	**B**	**A**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Capital Cost Allowance

Capital cost allowance has been determined as follows:

	20%	100%	S/L	55%		
	Class 8	**Class 12**	**Class 13**	**Class 50**	**Total**	**Note**
Opening UCC	$ 4,070,000	$ 0	$10,650,000	$ 486,000		
Additions	2,490,000	1,400,000	5,600,000	0		(a)
Disposals	(900,000)	0	(682,000)	0		(b)
AIIP adjustment	795,000	0	2,459,000	0		(c)
Immediate expensing	0	0	0	0		(d)
Basis for CCA	6,455,000	1,400,000	18,027,000	486,000		
CCA	(1,291,000)	(1,400,000)	(3,890,000)	(267,300)	(6,848,300)	(e)
Ending UCC	$ 4,369,000	$ 0	$11,678,000	$ 218,700		

Notes:

a. The current-year additions are classified as follows: leasehold improvements in Class 13, fixtures in Class 8, and computer software in Class 12.

b. The lesser of cost and proceeds of disposition have been determined as follows:

	Cost	**Proceeds**	**Lesser Amount**
Leasehold improvements	$6,250,000	682,000	682,000
Furniture and fixtures	$1,450,000	900,000	900,000
Computer equipment	$ 225,000	0	0

The proceeds of disposition received for the leasehold improvements and furniture and fixtures both represent the lesser of cost and proceeds for purposes of the adjustment to UCC. There is no adjustment required for the computer equipment because no proceeds were received, and there are still assets remaining in the class, so there is no terminal loss.

Further, proceeds are less than original cost in each case; therefore, no capital gain arises, and capital losses do not apply to depreciable property.

c. As the additions were made after November 20, 2018, and are available for use before 2024, they qualify for the accelerated investment incentive, which applies the CCA rate of 150% on the net additions. For Class 12, the accelerated investment incentive simply suspends the half-year rule, as the CCA rate is already 100%.

d. The $1.5 million limit for immediate expensing has been assigned to Montaigne for 2022 and 2023, and is therefore unavailable to Fancy.

e. The CCA for Class 13 was determined as follows:

CCA on pre-2023 improvements	$3,050,000
CCA on 2023 improvements	840,000
Total Class 13 CCA	$3,890,000

2023 additions	$5,600,000
Straight-line CCA over 10 years	560,000
AIIP adjustment	280,000
Total CCA on 2023 additions	$ 840,000

Calculation of Net Income for Income Tax Purposes and Taxable Income

		Note
Income before taxes, before revisions	$ 5,169,000	
Revisions from common assessment opportunities:		
Set-up of contract liability	(566,543)	AO #1
Recognition of warranty service revenue	9,442	AO #1
Reduction of restructuring costs	388,000	AO #2
Income before taxes, revised	4,999,899	
Book-to-tax adjustments:		
Depreciation	6,192,000	1
Amortization of ROU assets	3,360,000	2
Interest on lease liability	2,018,000	2
Cash payments on lease liability	(7,000,000)	2
Book loss on disposal of assets	1,120,000	3
Capital gains dividends included in investment income	(22,000)	4
Taxable capital gain	11,000	4
Capital cost allowance	(6,848,300)	1
Warranty reserve	557,101	5
Restructuring provision	710,000	6
Meals and entertainment	36,500	7
Green fees	7,000	7
Life insurance	80,000	8
Interest and penalties on GST/HST	5,000	9
Charitable contributions	50,000	10
Net income for income tax purposes	5,276,200	
Portfolio dividends	(60,000)	11
Charitable contributions	(50,000)	10
Taxable income	$ 5,166,200	

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

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

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

Reaching competence – The candidate attempts to calculate Fancy's capital cost allowance and taxable income.

Competent – The candidate calculates Fancy's capital cost allowance and taxable income.

Competent with distinction – The candidate thoroughly calculates Fancy's capital cost allowance and taxable income.

Assessment Opportunity #10 (Depth Opportunity)

The candidate discusses the adjustments required in the calculation of taxable income.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
6.2.2	Advises on taxes payable for a corporation	**B**	**A**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Notes:

1. Depreciation expense is not deductible because it is on account of capital. Capital cost allowance, calculated earlier, is allowed instead.

2. There are three components to the right-of-use assets and corresponding lease liability that must be considered:
   a) The amortization of right-of-use assets is not deductible because it is on account of capital.
   b) The interest expense on the lease obligations is not deductible because it is imputed interest and does not represent an actual cash outlay by Fancy.
   c) The actual cash payments made to service the lease obligations are deductible, and have been computed as follows:

Current portion of lease obligations, December 31, 2022		$ 4,833,000
Lease obligations, December 31, 2022		24,239,000
Total opening lease obligations		29,072,000
Add: Current-year interest expense		2,018,000
Expected ending lease obligations if no payments	A	31,090,000
Current portion of lease obligations, December 31, 2023		5,150,000
Lease obligations, December 31, 2023		18,940,000
Actual ending lease obligations	B	24,090,000
Cash payments	A - B	$ 7,000,000

3. The book losses on the disposal of assets are fully reversed because these are separately addressed for tax purposes as capital gains and adjustments to the capital cost allowance of the impacted classes (discussed earlier).

4. The capital gains dividend has been fully included in investment income; however, for tax purposes only, the taxable capital gain should be included. Accordingly, the amount recorded for book purposes should be fully reversed, and the taxable capital gain, calculated as $22,000 × 50% = $11,000, should be included.

5. For accounting purposes, a portion of revenue has been allocated to the lifetime warranty included on product sales. The total proceeds of these sales are included in income by way of ITA paragraph 12(1)(a). Taxpayers may be permitted to take a reserve under ITA paragraph 20(1)(m) for services to be rendered after the end of the year; however, ITA paragraph 20(7)(a) specifies that a reserve is not available in respect of warranties.

   Note that the warranty reserve under ITA paragraph 20(1)(m.1) would not be available to Fancy because the lifetime warranty program is not an extended warranty sold separately by Fancy (even though it is treated that way for financial reporting purposes).

   The total amount deferred after the adjustments is:
   $566,543 (AO#1, Adjustment #1) - $9,442 (AO#1, Adjustment #2) = $557,101

6. The restructuring provision is a contingency, as it represents forecasted costs that have not been incurred during the tax year. Therefore, this is not deductible and should be added back. The amount will be deductible when it is paid in 2024. The net adjustment to add back is $710,000 (balance sheet amount of $1,098,000 - AO#2 $388,000). *(An alternative approach to this item could consider the nature of the individual expenses, and make the case for deducting the severance in 2023 as it is unpaid remuneration that was paid within 179 days of the year end).*

7. A variety of items are included as meals and entertainment expenses. Generally, meals and entertainment expenses are limited by ITA subsection 67.1(1) to be 50% deductible for tax purposes. However, the following adjustments should be made:
   a) The green fees are fully denied by ITA subparagraph 18(1)(l)(i).
   b) The meals incurred in conjunction with rounds of golf are carved out of this limitation by CRA policy, so they are 50% deductible, similar to other meals.
   c) The holiday party is not subject to the limitation because it meets the exception in ITA paragraph 67.1(2)(f) as one of (up to) six special events open to all employees during the year.

   Accordingly, the meals and entertainment addback is ($100,000 - $7,000 - $20,000) × 50% = $36,500, and the addback for green fees is $7,000.

8. Life insurance is generally non-deductible because the costs are incurred for the shareholders. Premiums may be deductible if the criteria in ITA paragraph 20(1)(e.2) are met; however, Fancy does not have any external borrowings, so this paragraph does not apply.

   General property and casualty insurance is deductible as it is incurred for the purpose of earning business income.

9. Interest and penalties relating to a late-filed GST/HST return are not deductible for tax purposes.

   The interest charged on supplier invoices and bank charges (including overdraft fees) is incurred on debt used for earning business income, and is therefore not subject to restriction.

10. Charitable contributions are not deductible in computing net income for tax purposes but provide a Division C deduction in determining taxable income, provided the contributions do not exceed 75% of net income for tax purposes. Fancy easily meets this threshold, so the full amount of donations is deductible in Division C.

11. The eligible dividends earned from the money market funds are deductible under ITA subsection 112(1) in computing taxable income.

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

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

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

Reaching competence – The candidate discusses some of the adjustments to Fancy's taxable income.

Competent – The candidate discusses several of the adjustments to Fancy's taxable income, including some in-depth discussions.

Competent with distinction – The candidate discusses most of the adjustments to Fancy's taxable income, including several in-depth discussions.

Assessment Opportunity #11 (Depth Opportunity)

The candidate calculates Fancy's federal taxes payable for the December 31, 2023, tax year.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core	Elective
6.2.2	Advises on taxes payable for a corporation	B	A

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Calculation of Federal Taxes Payable

		Note
Taxable income	$5,166,200	
Basic federal tax (38%)	1,963,156	
Federal tax abatement (10%)	(516,620)	
Additional refundable tax	5,653	1
Small business deduction	(38,732)	2
General tax reduction	(638,216)	3
Part I tax payable	775,242	
Part IV tax payable	23,000	4
Dividend refund	(38,333)	5
Federal taxes payable, net of credits	**759,909**	
Instalments	(500,000)	
Balance owing	**$259,909**	

Notes:

1. Additional refundable tax is applied at 10 2/3% on the lesser of aggregate investment income (AII) and taxable income, less the amount on which the small business deduction was based. AII has been determined as follows:

Net taxable capital gains for the year	$ 11,000
Less: Net capital losses deducted under Division C	0
Plus: Income from property (dividends and interest)	102,000
Less: Dividends deducted under Division C	(60,000)
Less: Losses from property	0
Aggregate investment income	$ 53,000
Rate	10 2/3%
Additional refundable tax	$ 5,653

2. Fancy is a CCPC earning active business income, so it would be eligible for the small business deduction (SBD). The SBD is subject to the business limit of $500,000, which must be shared with associated corporations (Montaigne is the only associated corporation, and it has not been assigned any of the business limit), and which is reduced by two business limit reductions.

The first possible reduction is in respect of taxable capital, and is determined by the formula:
A × B ÷ $90,000

where
A is the corporation's assigned business limit before reductions (in this case, $500,000)
B is determined by the formula 0.225% × (C - $10,000,000), and
C is the *prior-year* taxable capital employed in Canada by the taxpayer and associated corporations

Taxable capital for 2022	
Capital	
Capital stock	$ 8,000,000
Retained earnings	20,492,000
Investment allowance	
GICs	(1,300,000)
Taxable capital employed in Canada by Fancy in 2022	27,192,000
Taxable capital employed in Canada by associated corporation (Montaigne)	6,500,000
Taxable capital employed in Canada by associated group	$33,692,000

Taxable capital business limit reduction:
$500,000 × {[0.225% × ($33,692,000 - $10,000,000)] ÷ $90,000} = $296,150

The second possible reduction is for adjusted aggregate investment income (AAII) in excess of $50,000 in the prior year, and is determined by the formula:
D ÷ $500,000 × 5 × (E - $50,000)

Where:
D is the amount determined for A (again, this is $500,000), and
E is the prior year AAII for the taxpayer and associated corporations (in this case, this is only the $67,000 of interest income)

Passive income business limit reduction:

$500,000 ÷ $500,000 × 5 ($67,000 - $50,000) = $85,000

The actual business limit reduction is the greater of the taxable capital and passive income reductions, and therefore is $296,150, resulting in a reduced business limit of $500,000 - $296,150 = $203,850.

The small business deduction is applied to the least of the reduced business limit, active business income, and taxable income. Therefore, for Fancy's December 31, 2023, tax year, it is applied on the reduced business limit of $203,850, as this is the least of the three amounts:

$203,850 × 19% = $38,732

3. The general tax reduction was determined as:

Taxable income	$5,166,200
Basis for small business deduction	(203,850)
Aggregate investment income	(53,000)
Basis for the general tax reduction	$4,909,350
Rate	13%
General tax reduction	$ 638,216

4. Fancy is subject to Part IV tax of 38 1/3% on the portfolio dividends received: $60,000 × 38 1/3% = $23,000

5. Fancy is entitled to a dividend refund on the other-than-eligible dividends of $100,000, paid to the extent that it has sufficient refundable dividend tax on hand.

	($)	**Note**
Opening NERDTOH, January 1, 2023	19,013	
Refundable portion of Part I tax	16,253	a
Closing NERDTOH, December 31, 2023	35,266	
Opening ERDTOH, January 1, 2023	0	
Part IV tax allocable to ERDTOH	23,000	b
Closing ERDTOH, December 31, 2023	23,000	

a. The refundable portion of Part I tax was determined as the *least* of the following three amounts:

30 2/3% of aggregate investment income*	$ 16,253
30 2/3% of taxable income less base for small business deduction**	1,521,787
Part I federal tax payable	775,242
Refundable portion of Part I tax	$ 16,253

* 30 2/3% of aggregate investment income:
30 2/3% × $53,000 = $16,253

** 30 2/3% of taxable income less base for small business deduction:
30 2/3% × ($5,166,200 - $203,850) = $1,521,787

b. The entire amount of Part IV tax payable is allocated to ERDTOH because the amount arose on eligible dividends paid by non-connected corporations.

The eligible dividend refund is $0, as no eligible dividends were paid during the year. The other-than-eligible dividend refund is the lesser of the following:

38 1/3% of non-eligible dividends paid during the year	$ 38,333
NERDTOH balance	35,266
Non-eligible dividend refund	$ 35,266

Fancy will also trigger an additional non-eligible dividend refund, which will reduce next year's ERDTOH balance. The additional non-eligible dividend refund is determined as the lesser of the following:

38 1/3% of other-than-eligible dividends paid during the year less ending NERDTOH*	$ 3,067
Ending ERDTOH less eligible dividend refund**	23,000
Additional other-than-eligible dividend refund	$ 3,067

* 38 1/3% of other-than-eligible dividends paid during the year less ending NERDTOH:
(38 1/3% × $100,000) - $35,266 = $3,067

** Ending ERDTOH less eligible dividend refund: $23,000 - $0 = $23,000

Therefore, the total dividend refund earned on the $100,000 of dividends paid is:
$35,266 + $3,067 = $38,333

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

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

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

Reaching competence – The candidate attempts to calculate Fancy's federal taxes payable.

Competent – The candidate calculates Fancy's federal taxes payable.

Competent with distinction – The candidate thoroughly calculates Fancy's federal taxes payable.

Assessment Opportunity #12 (Depth Opportunity)

The candidate calculates Daiki's taxable income for 2023.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
6.3.2	Evaluates income taxes payable for an individual	**B**	**A**
6.3.3	Analyzes specific tax-planning opportunities for individuals	**B**	**B**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Calculation of Net Income for Tax Purposes and Taxable Income – Daiki

	($)	Note
Income from an office or employment		
Salary	225,000	
Income from a business or property		1
Dividends other than eligible dividends	50,000	2
Gross-up	7,500	2
Eligible dividends	12,000	3
Gross-up	4,560	3
Foreign interest income	840	4
Interest income	4,200	
Partnership income	15,000	5
Net taxable capital gains		
House	230,000	6
Cottage	0	6
PUP	4,000	7
LPP	0	7
Investment portfolio	1,500	8
Other income/deductions		
RRSP contributions	(10,000)	9
Enhanced CPP	(631)	10
Net income for tax purposes	543,969	
Net capital loss carryover	(8,000)	11
Taxable income	535,969	

Notes:

1. Investment income earned in the TFSA and RRSP are tax-free (permanently for the TFSA, and until withdrawn for the RRSP); therefore, only the investment income earned in the non-registered account is taxable in 2023.

2. The gross-up of dividends other than eligible dividends is $50,000 × 15% = $7,500.

3. The gross-up of eligible dividends is $12,000 × 38% = $4,560.

4. Foreign interest income should be reported on a gross basis; therefore, the $40 of foreign taxes withheld are not deducted from net income for tax purposes, but may give rise to a foreign tax credit (calculated later). While a deduction under ITA subsections 20(11) or 20(12) may be available, since the foreign tax credit for the full amount of foreign tax paid is available, there is no benefit to deducting the foreign tax from income instead.

5. Partnership income flows through to the partners and is taxed in their hands, irrespective of the actual draws made by a partner during the year. Accordingly, $15,000 is included in income in respect of the slip received from the real estate limited partnership.

6. The principal residence exemption should be used to shelter a portion of the capital gains arising on the disposition of the family home and cottage. As the cottage is used each summer, it would be considered ordinarily inhabited, and therefore eligible for the exemption, in addition to Daiki's main home.

   To determine the maximum exemption, the capital gain per year should first be determined, which is $28,750 for the house and $30,625 for the cottage:

	House	**Cottage**
Proceeds of disposition	$1,200,000	$975,000
Adjusted cost base	450,000	375,000
Selling costs	60,000	48,750
Capital gain	690,000	551,250
Years owned	24	18
Capital gain per year	28,750	30,625

Although the cottage has the greatest gain per year, the first six years (2000 to 2005) must be assigned to the house because the cottage had not yet been acquired. Then, to benefit from the "1+" rule, the cottage should be designated for one less year (2006 or any other year) than it was owned. Therefore, the cottage is designated for 17 years, and the exemptions are calculated as follows:

(1 + 7) ÷ 24 × $690,000 = $230,000 for the house
(1 + 17) ÷ 18 × $551,250 = $551,250 for the cottage

The taxable capital gain is therefore calculated as follows:

	House ($)	**Cottage ($)**
Capital gain	690,000	551,250
Exemption	(230,000)	(551,250)
Revised capital gain	460,000	0
Taxable capital gain	230,000	0

7. Daiki disposed of certain personal-use property (PUP) and listed personal property (LPP). The taxable capital gain / allowable capital loss has been calculated below, as applicable:

   <u>Piano</u>

   The piano is classified as PUP, and the taxable capital gain is:
   ($40,000 - $32,000) × 50% = $4,000

   <u>Coins</u>

   The coin collection is classified as LPP, and the LPP gain is:
   ($2,300 - $2,000) = $300

   <u>Dining set</u>

   The dining set is classified as PUP; accordingly, proceeds are deemed to be the greater of $1,000 and actual proceeds, and cost deemed to be the greater of $1,000 and actual cost. Accordingly, no capital gain arises:
   ($1,000 - $1,000) × 50% = $0

Boat

The boat is classified as PUP. The calculation returns a capital loss, which is denied on PUP:
(\$12,500 - \$20,000) × 50% = (\$3,750), denied

Sculpture

The sculpture is classified as LPP, and the LPP loss is as follows:
(\$1,500 - \$2,700) = \$1,200

The \$1,200 LPP loss can be applied to reduce the LPP gain on the coin collection, but it may not be applied against the gain on the piano, because LPP losses may only be used against LPP gains.

Accordingly, the gain on the coin collection is reduced to \$0, and Daiki may carry forward the remaining LPP loss of \$900 for seven taxation years, or carry it back up to three taxation years if he had LPP gains in those years.

8. Capital gains of \$3,000 were incurred in the investment portfolio, and 50% of the capital gains are taxable (\$3,000 × 50%).

9. Daiki may deduct the full amount of his RRSP contributions of \$10,000 made during the year, as he had \$32,000 of contribution room for 2023. TFSA contributions are not deductible from income.

10. Daiki earned \$225,000 of employment income in 2023; his CPP contribution was \$3,754.45, of which \$631.00 is deductible enhanced contributions.

    CPP available as a non-refundable credit:
    (\$3,754.45 - \$631.00) = \$3,123.45

11. Daiki's capital loss carryover from 2020 may be applied against the capital gain arising on the disposition of the house: \$16,000 × 50% = \$8,000

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

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

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

Reaching competence – The candidate attempts to calculate Daiki's taxable income.

Competent – The candidate calculates Daiki's taxable income.

Competent with distinction – The candidate thoroughly calculates Daiki's taxable income.

Assessment Opportunity #13 (Depth Opportunity)

The candidate calculates Daiki's federal income taxes payable for the 2023 tax year.

The candidate demonstrates competence in the Taxation role.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**	**Elective**
6.3.2	Evaluates income taxes payable for an individual	**B**	**A**
6.4.1	Evaluates adherence to compliance requirements	**B**	**A**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Calculation of Federal Taxes Payable – Daiki

			Note
Taxable income		$ 535,969	
Tax on taxable income		$ 153,676	1
Non-refundable tax credits			
Basic personal amount	$ 13,521		
Spousal amount	13,521		
Canada employment amount	1,368		
CPP	3,123		
	31,533		
Credit rate	15%	(4,730)	2
Charitable donation tax credit		(624)	3
Tax otherwise payable		148,322	
Political contribution tax credit		(558)	4
Non-business foreign tax credit		(40)	5
Dividend tax credit		(7,680)	6
Net federal tax		140,044	
Source deductions		(53,000)	
Instalments		0	
Net taxes owing		87,044	
Instalment interest		2,707	7
Instalment penalty		854	7
Late-filing penalty		4,352	8
Estimated arrears interest		729	9
Final balance owing		$ 95,686	

Notes:

1. Tax on taxable income is calculated as follows:
   $54,579 + [($535,969 - $235,675) × 33%] = $153,676

2. Daiki's non-refundable tax credits were determined as follows:
   - $13,521 for the basic personal amount because Daiki's current-year income is greater than $235,675.
   - $13,521 for the spousal amount because Amil did not work in the year, and it is limited to $13,521 because of Daiki's income level.
   - $1,368 for the Canada employment amount because Daiki earned employment income from Fancy during the year.
   - $3,123 for CPP, based on the actual contributions Daiki would have been subject to, excluding enhanced contributions (calculated earlier).
   - Note that Daiki is not eligible for the EI premium tax credit because he is considered EI-exempt as he owns more than 40% of the shares of Fancy. We assumed that he has not voluntarily contributed to the special benefits program.

3. The charitable contribution tax credit is calculated as follows:

15% on the first $200		$ 0
33% on the lesser of:		
Total gifts over $200	$ 1,800	
Taxable income less the highest bracket*	$ 300,294	594
		$ 624

* $535,969 - $235,675 = $300,294

The $500 donation made to a Mexican charity is not eligible for a credit because it is not a registered Canadian charity.

4. The political contribution tax credit is calculated as follows:

Credit on first $400	75%	$ 300
Credit on next $350	50%	175
Credit on remainder ($1,000 - 400 - 350) = $250 remaining	33.33%	83
		$ 558

The $500 contribution made to Daiki's local city councillor is not eligible for a credit because the credit does not apply to municipal elections. Provincial income taxes are beyond the scope of this report.

5. Daiki is entitled to a non-business foreign income tax credit in respect of the foreign tax withheld on his foreign interest income. The credit is determined as the lesser of:
   (i) Non-business income tax paid to a foreign country ($40); or,
   (ii) Net non-business foreign income / adjusted net income for tax purposes × tax for the year otherwise payable

   Net income for tax purposes is adjusted to include the impact of net capital loss carryforwards applied, and tax otherwise payable was determined to be $148,322.

   Therefore, (ii) is calculated as:
   $840 ÷ ($543,969 - $8,000) × $148,322 = $232

   Therefore, the lesser amount is $40.

6. The dividend tax credits are calculated as follows:

Gross-up of eligible dividends	$ 4,560
Eligible dividend tax credit rate	6/11
Dividend tax credit	2,487
Gross-up of other-than-eligible dividends	7,500
Other-than-eligible dividend tax credit rate	9/13
Dividend tax credit	5,192
Total dividend tax credit	$ 7,680

7. Daiki is liable for instalment interest because he did not make the minimum required instalments of $40,000 for 2023, and his balance otherwise owing is greater than this ($87,044). Instalment interest is calculated from the original instalment due date until a taxpayer's balance owing date (i.e., April 30, 2024), and compounded daily.

Date	Instalment ($)	Cumulative Base ($)	Rate	Days	Interest ($)
15-Mar-23 (to 31-Mar)	7,500	7,500	8%	16	26
31-Mar-23 (to 15-Jun)		7,526	9%	93	142
15-Jun-23 (to 15-Sep)	7,500	15,168	9%	320	348
15-Sep-23 (to 15-Dec)	12,500	28,016	9%	228	636
15-Dec-23 (to 31-Dec)	12,500	41,152	9%	137	163
31-Dec-23 (to 30-Apr)		41,315	10%	121	1,392
Total					2,707

Since the instalment interest is greater than $1,000, Daiki is also subject to an instalment penalty. This is determined as 50% of actual interest less the greater of (a) $1,000, and (b) 25% of interest calculated as if no payments were made:

(a) Interest if no payments made × 25%	$ 677
(b) Flat rate	1,000
Actual interest	$ 2,707
Greater of (a) and (b) above	(1,000)
Difference	1,707
Penalty rate	50%
Instalment penalty	$ 854

8. Daiki is subject to a late-filing penalty because he is not self-employed; therefore, his tax return was due on April 30, 2024. Assuming that the return is filed by his requested date of May 28, 2024, and he is not a repeat late filer, his late-filing penalty will be as follows:
   $87,044 × 5% = $4,352

9. Daiki is subject to arrears interest on his balance outstanding that was not paid on or before April 30, 2024. Although we do not know when his balance owing will be paid, assuming that it is paid on May 28, 2024, his arrears interest will be as follows:

Federal tax payable	$ 87,044
Late-filing penalty	4,352
Instalment interest	2,707
Instalment penalty	854
Total amount owing	94,957
Arrears interest to May 28 (at 10% annual rate)	$ 729

For Assessment Opportunity #13 (Taxation), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to calculate Daiki's federal income taxes payable.

Competent – The candidate calculates Daiki's federal income taxes payable.

Competent with distinction – The candidate thoroughly calculates Daiki's federal income taxes payable.

APPENDIX D

MAY 30, 2024 – DAY 3
SIMULATIONS AND MARKING GUIDES

COMMON FINAL EXAMINATION
MAY 30, 2024 – DAY 3

Case #1 **(Suggested time: 85 minutes)**

Best Buddies Inc. (BB) is a store that sells premium products for children. The business currently consists of a single Canadian retail store. Jesse Dhaliwal launched BB in January 2023 and owns 100% of the 10,000 issued and outstanding common shares. BB completed its first year of operations on December 31, 2023, and reports under ASPE.

It is now January 2, 2024. BB had a good first year, and Jesse is excited about the progress the company has made. However, as this is Jesse's first business venture, he feels uncertain about the next steps for the business, and has therefore hired you, CPA, to help.

Jesse wants to sell seasonal boxes containing the newest children's products, and has asked for your advice (Appendix I).

Jesse has set goals for BB (Appendix II). He would like you to critique each goal to explain why he has had difficulty measuring BB's progress towards achievement. He would also like you to suggest metrics for measuring the company's performance against these goals.

In addition, Jesse plans to open a second store, and would like your advice on how to finance it (Appendix III).

If BB decides to externally finance the second store, the investor will require financial statements. Jesse would like you to explain the differences between a compilation engagement and a review engagement, and recommend one. He also wonders whether you could perform either of these engagements.

Also, Jesse needs help figuring out the accounting treatment of some inventory items (Appendix IV).

Finally, Jesse sent you an email about some expenses incurred in BB's first year of operations, and would like your tax advice on them (Appendix V).

APPENDIX I
SEASONAL BOXES

Each box, released quarterly, will be based on a seasonal theme. It will include various products and will be delivered directly to the customer.

Jesse thinks the total cost of all of the products included in each box would be around $35. In addition to product costs, Jesse expects to incur the following costs related to the project:

Cost	Amount
Annual packaging design costs	$ 3,700
Annual website costs	$ 8,600
Digital advertising, per click (estimated 48,000 clicks per year)	$ 0.50
Packaging, per box	$ 2.25
Shipping, per box	$ 16.00

Jesse plans to charge $140 per box, if sold individually, and would like to know how many boxes BB would need to sell in order to break even. Alternatively, he is considering requiring that customers sign up for a minimum one-year subscription. With the annual subscription, customers would get four boxes each year, one for each season. The subscriptions would be priced at $500 each, and would save BB $8,000 in digital advertising. Jesse wants to know how many subscriptions BB would need to sell in order to break even in the first year. He also wonders which option you would recommend, knowing that he estimates he could sell 500 individual boxes, or 115 annual subscriptions, depending on which option he chooses.

APPENDIX II
BB'S GOALS

Prior to launching the business, Jesse set the following goals for BB:

1. Become parents' number one choice for children's products in the area.
2. Be recognized as a community supporter by donating to special causes.
3. Minimize environmental waste from children's products and their packaging.
4. Each year, increase company profitability and generate positive cash flows.
5. Be a desirable employer.

APPENDIX III
SECOND STORE PROJECT

To open a second store, BB would need $500,000. Jesse has received two proposals from a potential investor, and is wondering if he should accept one of the proposals or use internally-generated funds instead. He asks that you first determine how long it would take BB to internally generate $500,000 from its existing store. He would then like you to analyze each of the investor's proposals. Lastly, he asks that you recommend the best course of action.

BB Financial Information

Jesse anticipates $185,000 in income before tax in 2024. However, he noted the following:

- Income before tax should grow by 3% in each of 2025 and 2026, and by 2% every year thereafter.
- The projections do not include the additional profit from the launch of the seasonal boxes, but they do include annual amortization expense of $40,000.
- Jesse anticipates spending $60,000 on store improvements in 2026; his projections include an increase in annual amortization expense to $46,000 following the renovations.
- Jesse plans to increase BB's investment in working capital by $25,000 each year from 2024 to 2026, and then keep working capital constant in future periods.
- The forecasted income before tax does not consider:
  - Jesse's plan to annually donate 2% of BB's income, before tax and owner's compensation, to special causes;
  - his annual salary of $50,000; and
  - the bonus that he plans to pay himself in January of each year, starting in January 2025, which will equal 10% of income before tax from the previous year.

APPENDIX III (CONTINUED)
SECOND STORE PROJECT

Investor's Proposals

Option 1 – Convertible preferred shares

An amount of $500,000, in exchange for 5,000 non-voting preferred shares, each featuring a $15 cumulative annual dividend. The preferred shares will be eligible for conversion into common shares any time after five years, at the investor's option. The conversion ratio will be two preferred shares for one common share.

Option 2 – Debt financing

A $500,000 loan, to be repaid over five years in annual payments of $100,000 plus interest on the outstanding balance, at the current market rate of 7%, on the last day of each year.

APPENDIX IV
INVENTORY

At the beginning of 2023, BB sold a lot of merchandise (sweaters, stuffed animals, and books) from a popular children's TV show called Blue Penguin. The TV show was cancelled in June 2023, and BB saw a drastic drop in sales of Blue Penguin items. These items are taking up a lot of shelf space, so Jesse is looking for opportunities to clear this inventory.

A reseller has offered to buy the sweaters at 50% of the original selling price. Jesse contacted a broker about selling the stuffed animals. The broker thinks they can sell the stuffed animals for $15 each but will charge BB a 30% commission on the sale. The books could be sold to a discount retailer for 15% of their cost, but instead, Jesse contacted a local children's organization and promised to donate the books.

The items are currently recorded at cost. Since the cost remains the same regardless of the selling price, Jesse doesn't think anything additional needs to be recorded for 2023. The details are below:

Item	Cost	Original Selling Price	Quantity in Inventory
Sweaters	$20	$52	178
Stuffed animals	$12	$24	144
Books	$18	$30	129

APPENDIX V
EMAIL FROM JESSE

To: CPA
From: Jesse Dhaliwal
Subject: Business expenses

Hi CPA,

I'm wondering whether the following costs incurred by BB in 2023 are tax deductible. I've heard that there are lots of rules about these things, but I'm not familiar with them.

- Product testing: Before I stock a new brand of products, I always test it out with my daughter Lisa. If she enjoys it, I know it's good enough to sell. I consider this to be product testing, and would like to deduct the cost of all of the products for tax purposes.
- Children's expo: This year, to learn more about the children's products industry, I travelled to the Global Children's Expo in Toronto. I visited the booths of many suppliers and discovered some new products that I am planning to stock at BB. I intend to deduct my registration fees, travel, meals, and hotel costs as business expenses.
- Consulting fees: Will your fees be deductible, and can they be deducted in 2023?

I'm also wondering if I can deduct the following costs on my personal tax return:
- Vehicle costs: My wife and I used to share a vehicle, but after I started operating BB, this became inconvenient. In July 2023, I bought my own vehicle, which I use for personal and business use. I use it to get to and from the store every day. I occasionally also use it to run errands for the business. I plan to deduct against my employment income all of my insurance, gas, and parking fees related to this second vehicle, since I wouldn't have bought it if I wasn't running BB. Can I also deduct the cost of the vehicle?
- Work from home: I usually work in the BB store during the day, and I catch up on a bit of work from my home office at night. I heard that home office expenses are deductible for tax purposes. Are there any home office costs I can deduct?

Thanks so much for your help. With a combined tax rate of 11% for BB, and an even higher rate for me personally, these things can make a difference!

Jesse

MARKING GUIDE 3-1
BEST BUDDIES INC. (BB)
ASSESSMENT OPPORTUNITIES

To: Jesse Dhaliwal
From: CPA
Subject: BB's plans for the future

Assessment Opportunity #1 (Depth and Breadth Opportunity)

The candidate calculates the break-even point for two options—to sell the seasonal boxes individually or by annual subscription—and recommends one of the two options.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core
3.5.1	Performs sensitivity analysis	A
3.5.2	Evaluates sustainable profit maximization and capacity management performance	A

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Break-Even Analysis

You are currently considering two options for selling seasonal boxes to your customers: selling individual boxes to customers for $140 per box, with no required ongoing commitment; or requiring customers to purchase a minimum one-year subscription for $500 that consists of four quarterly product boxes. I have calculated the number of boxes you would need to sell to break even in the first year if you only sold them individually, and the number of subscriptions you would need to sell to break even in the first year if you only sold subscriptions.

Individual Boxes

Annual fixed costs	Calculation	
Packaging design		3,700.00
Website costs		8,600.00
Digital advertising	(48,000 × $0.50)	24,000.00
Total fixed costs		36,300.00
Variable costs per unit		
Products included in the box		35.00
Packaging per box		2.25
Shipping per box		16.00
Total variable costs per unit		53.25
Contribution margin per unit	($140 - $53.25)	86.75
Break-even number of units	($36,300 ÷ $86.75)	418.44

If you decide to sell the boxes individually, you will need to sell a minimum of 419 units to break even in the first year.

Annual Subscriptions

Annual fixed costs	Calculation	
Packaging design		3,700.00
Website costs		8,600.00
Digital advertising	(48,000 × $0.50 - $8,000)	16,000.00
Total fixed costs		28,300.00
Variable costs per unit		
Products included in the four boxes	($35 × 4)	140.00
Packaging per year	($2.25 × 4)	9.00
Shipping per year	($16.00 × 4)	64.00
Total variable costs per subscription		213.00
Contribution margin per unit	($500 - $213)	287.00
Break-even number of units	($28,300 ÷ $287)	98.61

If you require customers to purchase an annual subscription, you will need to sell a minimum of 99 subscriptions to cover your fixed costs, or 396 boxes per year (99 subscriptions × 4 boxes).

Estimated Profits

You mentioned that you estimate you can sell 500 boxes if sold individually, and 115 subscriptions if sold as an annual subscription. I calculated the profit you could make under each option, using the estimates you provided.

Individual Boxes

Number of boxes sold		500
Contribution margin per unit	$	86.75
Contribution margin	$	43,375
Annual fixed costs	$	(36,300)
Estimated profit	$	7,075

Annual Subscriptions

Number of subscriptions sold		115
Contribution margin per unit	$	287.00
Contribution margin	$	33,005
Annual fixed costs	$	(28,300)
Estimated profit	$	4,705

Assumptions and Qualitative Factors

The above analyses rely on estimated costs, including, for example, the estimated cost of digital advertising, based on a projected number of clicks in the first year. The profitability analysis also relies on estimated volume of sales. Given that this will be the first time you are launching a product of this nature, actual costs and volume of sales may be higher or lower than estimated.

Customers may appreciate the flexibility of being able to purchase one seasonal product box at a time, but if they are not satisfied with their first box, they may not purchase any further boxes. This may make it more difficult to ensure that enough units are sold to cover your fixed costs, and the success of future seasonal product boxes will largely depend on the performance of the first box.

If you require customers to purchase an annual subscription, you will ensure that customers remain committed for the first four quarters of their subscription. Since they will become accustomed to regularly receiving products from BB, this could increase the likelihood that they will maintain their subscription in the future. Further, customers benefit from a discounted price per box by purchasing an annual subscription.

However, it might be less attractive for customers to have to commit to a full year of boxes, and they may prefer to try it first and purchase the boxes when convenient for them. Providing customers with the flexibility of purchasing only one box at a time might result in more customers being willing to try the seasonal box, thereby expanding your future reach.

Recommendation

According to my analysis, you would need to sell more boxes individually before you start making a profit (419 boxes) than you would need to sell under the annual subscription option (396 boxes). However, once break-even is met, each box sold provides a higher contribution margin under the individual boxes option ($86.75 per box when sold individually, compared to $71.75 ($287 ÷ 4) per box if sold by subscription). At the level of sales you are estimating, it would be more profitable to sell the boxes individually. Based on that, and the fact that you will potentially be able to reach more customers, I recommend that you sell the boxes individually rather than by annual subscription.

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

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

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

Reaching competence – The candidate attempts to calculate the break-even point for the individual seasonal boxes and the annual subscriptions.

Competent – The candidate calculates the break-even point for the individual seasonal boxes and the annual subscriptions, and recommends which option BB should choose.

Competent with distinction – The candidate calculates the break-even point and estimated profit for the individual boxes and the annual subscriptions, and recommends which option BB should choose.

Assessment Opportunity #2 (Breadth Opportunity)

The candidate critiques the goals, explaining why they have been difficult to measure, and suggests metrics for measuring BB's performance against its goals.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
2.3.1	Evaluates the entity's strategic objectives and related performance measures	**B**

CPA Map Enabling Competencies:
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
5.2.1 Uses existing knowledge in new or different ways
5.2.2 Uses brainstorming or other techniques to generate ideas
5.3.1 Assists in identifying opportunities for process, product and service improvements related to work functions
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

BB's Goals

You created several goals when you launched BB. You would like a critique of each goal, to understand why measuring its progress toward achievement has been challenging, so I have explained—for each goal—what may be causing the challenge. You are also seeking metrics, to be able to measure BB's performance against these goals.

<u>Goal 1: Become parents' number one choice for children's products in the area</u>

This goal is difficult to measure because you have not clearly defined the area in which you want to become parents' number one choice. Defining the geographical area would help determine where the information should be gathered, to see whether the goal has been achieved.

While it may be difficult to ascertain whether you are a parent's first choice for purchasing children's products, this could potentially be measured by calculating your market share relative to other children's product stores in your area, which should be defined. You may need to engage a market research firm to obtain this information. Another alternative would be to survey customers, in person or via email, and ask whether BB is their first choice for purchasing children's products, and how likely they are to recommend BB to other parents or to shop at BB again. Customers could rate their answers on a scale of 1 to 10, with 10 being the most likely. An average score greater than 7, for example, may indicate that you have reached your goal. However, it is important to note that this measure would not be as accurate as engaging a research firm, because only surveying existing customers will not accurately measure the preference of all parents within the area (parents who are current customers of BB and parents who are not). It is also more likely that BB would be their number one choice, since they are already a customer of the store. Finally, you may be able to sense BB's popularity with customers based on the volume of customers visiting your store in a given week, and assessing whether this is increasing on average.

<u>Goal 2: Be recognized as a community supporter by donating to special causes</u>

You are likely finding it difficult to measure this goal because it is difficult to determine whether BB is recognized as a community supporter without knowing who you want to be recognized by. You need to define whether it is customers, the local government, the Chamber of Commerce, the citizens, or another body. Once defined, it will then be easier to measure whether this goal has been met. It is also unclear what "special causes" means. To ensure that the donations made are related to community support, you may wish to focus only on local causes, which will likely have a more direct impact on your neighbourhood or town. BB may also want to consider identifying a specific need or cause within its community that requires donations.

If your aim is to achieve recognition, your first step is to consistently contribute meaningful amounts to community causes. To measure this goal, you should calculate the total amount of money BB has donated to special causes throughout the year. You may wish to compare the total dollar value of the donated amount to BB's total sales or income. Additionally, you could measure the number of times BB has donated to, supported, or held events in the local community. You mentioned 2% of income (before tax and owner's compensation) as a possible target. Defining a specific metric like this will make it much easier to determine if you have met your goal or not. To assess whether you are recognized for your support, you can measure the frequency with which you receive special recognition and awards from the causes you donate to, or the community in general, or you can survey customers to determine whether they are aware of BB's charitable focus.

Goal 3: Minimize environmental waste from children's products and their packaging

You are likely finding it difficult to measure this goal because "environmental waste" is quite vague. It would be helpful to define what you mean by this (i.e., is it only plastic waste or all types of waste?), and the types of product materials and packaging you view as acceptable (i.e., are biodegradable or recyclable materials and packaging acceptable?).

To measure this goal, you could calculate the percentage of products currently sold by BB that are made from recycled materials, are packaging-free, or have biodegradable packaging (or whichever package you will have pre-determined to be acceptable). To assess performance, you could compare this figure to an industry average. Being higher than the industry would mean that BB is minimizing environmental waste. You could also track the percentage for BB going forward, and aim to increase it each year. Alternatively, you could calculate the amount of waste BB diverted from the landfill each year by choosing environmentally-conscious suppliers for your products. Again, you could track this figure each year, to assess BB's progress and determine whether you are minimizing environmental waste.

Goal 4: Each year, increase company profitability and generate positive cash flows

This goal is relatively clear and likely would not be challenging to measure.

You can measure this goal by calculating net income, gross margin, profit margin, and/or net cash flows, and then comparing those figures to prior periods. To make the goal easier to measure, you may want to indicate a specific profit margin you aim to achieve, or a percentage increase in profit you expect to have, year over year. In terms of cash flows, you may wish to define whether you expect positive cash flows overall, or if instead, your aim is to have positive cash flows from operating activities. If desired, you could also measure these more specifically, such as for a particular stream of income.

Goal 5: Be a desirable employer

You are likely finding this goal difficult to measure because it is not clear what you mean by "desirable." You should be more explicit about what you mean by this. For example, it could simply mean adhering to basic labour laws, or it could mean going above and beyond to ensure that employees enjoy working at BB.

Generally speaking, employees will continue to work for employers when they are satisfied with their working conditions; therefore, you could measure your success on this goal based on the rate of employee turnover. Alternatively, you could survey your employees and ask them to assess their satisfaction with the workplace, allowing you to proactively identify any areas of concern. Consider using an online survey service, to preserve anonymity, since this will allow employees to be more objective and honest in their responses. Clearly defining the metric you will use for measuring your desirability as an employer, and setting a target you wish to reach (e.g., 95% of employees are "highly satisfied" with their work environment) will allow you to determine if you have hit your goal.

For Assessment Opportunity #2 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate critiques some of the goals, explaining why they have been difficult to measure, or suggests some metrics for measuring BB's performance against its goals.

Competent – The candidate critiques some of the goals, explaining why they have been difficult to measure, and suggests some metrics for measuring BB's performance against its goals.

Competent with distinction – The candidate critiques several of the goals, explaining why they have been difficult to measure, and suggests several metrics for measuring BB's performance against its goals.

Assessment Opportunity #3 (Breadth Opportunity)

The candidate analyzes how many years it will take BB to internally generate $500,000 to finance a potential expansion.

The candidate demonstrates competence in Finance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
5.2.1	Evaluates the entity's cash flow and working capital	A

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations

Cash Flow Projection

You are wondering how many years it would take BB to internally generate $500,000 if you continued to operate with one store.

I have projected BB's future cash flows, as shown below, and determined that you would exceed $500,000 in cumulative excess cash flows by the end of 2027.

	2024	2025	2026	2027	Note
Income before tax, owner's compensation, donations, and seasonal boxes	185,000	190,550	196,267	200,192	1
Add					
Seasonal boxes net profit	7,075	7,075	7,075	7,075	
Amortization	40,000	40,000	40,000	46,000	
Total additions	47,075	47,075	47,075	53,075	
Subtract					
Jesse's salary	50,000	50,000	50,000	50,000	
Donation	3,842	3,953	4,067	4,145	2
Bonus	0	13,823	12,985	13,629	3
Investment in working capital	25,000	25,000	25,000	0	
Store improvements	0	0	60,000	0	
Total subtractions	78,842	92,776	152,052	67,774	
Excess cash flows	153,233	144,849	91,290	185,493	
Estimated taxes – 2023	Unknown	0	0	0	4
Estimated taxes – current year	15,206	14,283	14,992	15,344	5
Excess cash flow after tax	138,027	130,566	76,298	170,149	
Cumulative excess cash flows	138,027	268,593	344,891	515,040	

Notes:

1. Income before tax is to increase by 3% in 2025 and 2026, and by 2% every year after.

2. Equal to 2% of income before tax and owner's compensation:
   a) 2024: ($185,000 + $7,075) × 2% = $3,842
   b) 2025: ($190,550 + $7,075) × 2% = $3,953
   c) 2026: ($196,267 + $7,075) × 2% = $4,067
   d) 2027: ($200,192 + $7,075) × 2% = $4,145

3. Equal to 10% of pre-tax income, paid in January of the next year:
   a) 2024: None; 2024's bonus paid in 2025
   b) 2025: ($185,000 + $7,075 - $3,842 - $50,000) × 10% = $13,823
   c) 2026: ($190,550 + $7,075 - $3,953 - $50,000 - $13,823) × 10% = $12,985
   d) 2027: ($196,267 + $7,075 - $4,067 - $50,000 - $12,985) × 10% = $13,629

4. Estimated using an 11% combined tax rate, as provided. Taxes for 2023 will be paid in 2024, based on BB's first year of operations (2023). I would need the information from 2023 to be able to calculate the correct amount. I left it as "unknown" for now.

5. In 2024, BB will have to pay tax in instalments (with any difference paid by March of the next year or refunded when the tax return is filed). For this purpose, I have assumed that instalments for the year will approximate the taxes for the year, such that the cash outflow for each year is 11% of the income before tax, which includes the seasonal boxes profit, owner's compensation (salary and bonus), and donations. For simplicity, the tax calculation assumes depreciation will approximate CCA (i.e., that the deduction for amortization is roughly equivalent to the CCA deduction that would be allowed), and that bonuses are both declared and paid in January (rather than being declared prior to year end, in which case they would be deductible in that prior year for tax purposes since they would be paid within 180 days of year end). This will give us a reasonable approximation of the cash outflows for taxes.

	2024	2025	2026	2027
Income before tax, owner's compensation, donations, and seasonal boxes	185,000	190,550	196,267	200,192
Add				
Seasonal boxes net profit	7,075	7,075	7,075	7,075
Subtract				
Jesse's salary	50,000	50,000	50,000	50,000
Donation	3,842	3,953	4,067	4,145
Bonus	0	13,823	12,985	13,629
Taxable income	138,233	129,849	136,290	139,493
Taxes payable at 11%	15,206	14,283	14,992	15,344

Based on my analysis, BB would be able to accumulate over $500,000 in excess cash flows by the end of 2027. This analysis is based on the projections you provided, which may vary from actuals, particularly given that you have limited experience running BB.

While waiting four years to accumulate the necessary cash flows to expand BB on your own may seem less desirable, this would give you an opportunity to see how your first store performs over the course of a few years before expanding to a second store.

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

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

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

Reaching competence – The candidate attempts to calculate how many years it would take BB to internally generate $500,000.

Competent – The candidate calculates how many years it would take BB to internally generate $500,000.

Competent with distinction – The candidate thoroughly calculates how many years it would take BB to internally generate $500,000.

Assessment Opportunity #4 (Breadth Opportunity) The candidate analyzes the financing proposals provided by the potential investor, and recommends the best option for BB. *The candidate demonstrates competence in Finance.*

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
5.2.3	Evaluates sources of financing	**B**

CPA Map Enabling Competencies: *6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems* *6.2.1 Maintains an objective and questioning mindset to avoid biased analyses* *6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives* *6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions*

Financing Alternatives

A potential investor has provided you with two financing options, if you wish to expand right away. I have analyzed both options to determine which would be most favourable for BB.

Option 1

Under this option, you will receive $500,000 up front; however, you will be responsible for paying a cumulative annual dividend of $75,000 ($15 × 5,000 shares) for at least five years, which is the equivalent of a 15% rate of interest ($75,000 ÷ $500,000). If you make the dividend payments annually, the present value of these payments alone, discounted at a rate of 7% (the market rate of the debt financing), is equal to $307,515 (= PV(RATE=7%, NPER=5, PMT=75000, FV=0, TYPE=0)) over a period of five years. This also only assumes that the dividends will be paid for five years, but if the conversion option is not exercised, they will be paid in perpetuity. Alternatively, if the conversion option is exercised, the value of the common shares issued will have to be considered. The cost of converting the preferred shares to common equity depends on the value of BB at the time of conversion. As this is at the option of the investor, conversion will most likely take place only if the value of the common shares is greater than the value of the preferred shares; put another way, conversion will only take place if the investor's price to acquire the common shares is advantageous relative to their value, which would be unfavourable to you, as you would be giving up the common shares for less than they are worth.

If the investor decides to convert their preferred shares into common shares after five years, your percentage of ownership in BB will decline and you will no longer hold 100% of the voting shares. Since the investor can convert to common shares at a ratio of 2:1, the investor would hold 2,500 common shares (5,000 preferred shares ÷ 2) in BB if all of the preferred shares were converted. If you continue to hold 10,000 shares, this would give the investor a 20% ownership interest in BB upon conversion (2,500 ÷ 12,500 shares). This represents a significant stake, but you would retain control of the business. While a 20% equity stake to a new investor does not grant control, it does create obligations that you would not have as the sole owner. We do not know at this time what rights would attach to the common shares, but such rights could include things such as regular reporting or a board seat, which may interfere with how you would like to operate the business. On the positive side, introducing a new investor could be beneficial to the business, for example, as a source of operating and financing advice or of future capital.

Note that, because the dividend on these preferred shares is cumulative, if you do not declare a dividend in a particular year, you will still be responsible for paying the annual dividend retrospectively when a dividend is declared in future years. Additionally, as these shares are preferred, you will be required to pay the cumulative dividend to the investor before you can pay a dividend to yourself. Finally, should the investor choose not to convert the preferred shares to common shares, you would become responsible for this dividend in perpetuity.

Option 2

The present value of future cash flows to be repaid under this option, including both principal and interest, assuming a market interest rate of 7%, is equal to the amount borrowed ($500,000). The 7% interest rate on the loan is less than the 15% equivalent rate of interest on the preferred shares. Further, interest paid on the loan is deductible for tax purposes, while preferred share dividends are not. This further reduces the financing cost associated with the loan versus the preferred shares.

Annual payments of principal plus interest will begin at $135,000 ($100,000 + (7% × $500,000)), and will decline over time as the principal balance of the loan falls. This option will place a higher demand on your cash flows than Option 1, since you will be obligated to make the capital and interest payments each year and will not have the option to delay them, as would be the case with a dividend.

However, with this option, you will not be required to give up a percentage of the ownership of your business, and you do not run the risk of having to continue to make payments in perpetuity (as in the case of the preferred shares).

Recommendation

Given that it will take until 2027 to generate the funds necessary for expanding BB internally, I recommend going with one of the financing options instead. I recommend going with Option 2 so that you maintain your 100% ownership of BB, and because Option 2 offers a lower cost of financing than Option 1. Under Option 2, the annual payments of principal and interest will be lower than the cash flow generated by the current store, so it should not be hard to cover these payments. Also, the profit generated by the second store will help cover the payments.

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

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

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

Reaching competence – The candidate attempts to analyze the financing options.

Competent – The candidate analyzes the financing options and provides a recommendation.

Competent with distinction – The candidate thoroughly analyzes the financing options and provides a recommendation.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate discusses the differences between a compilation and a review engagement, and recommends which would be more appropriate for BB.

The candidate demonstrates competence in Audit and Assurance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
4.2.1	Advises on an entity's assurance needs	**B**
4.3.1	Assesses issues related to the undertaking of the engagement or project	**B**

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

The investor has asked for financial statements if you wish to proceed with their offer. You have asked whether a compilation or review engagement would be more appropriate.

Applicable Standards

You have indicated that the financial statements will be prepared in accordance with ASPE. However, in a compilation engagement, the financial statements do not need to be in accordance with generally accepted accounting principles, although they can be. In a review engagement, financial statements must be in accordance with either ASPE or IFRS. In your case, although you plan to have your financial statements prepared in accordance with ASPE, if you were to get a compilation engagement done instead of a review engagement, you might benefit from having some flexibility regarding things such as note disclosure and how to account for certain transactions.

Degree of Assurance

According to CSRS 4200 *Compilation Engagements*, a compilation engagement involves the practitioner assisting management in the preparation of financial statements in accordance with the basis of accounting selected by management. In the case of BB, the basis for preparing the financial statements would be accounting standards for private enterprises (ASPE). However, it must be noted that a compilation engagement does not provide any assurance over the information included in the financial statements, and the practitioner does not express an opinion on the financial information compiled. While no opinion is provided, the practitioner does prepare a report that outlines the basis of preparation for the financial statements, along with management and the practitioner's responsibilities.

In a review engagement, the practitioner will obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement. This enables the practitioner to express a conclusion on whether anything has come to the practitioner's attention that causes the practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework. Review engagements provide a lower level of assurance (limited assurance) than an audit, which provides reasonable assurance. Given that a review does provide limited assurance, this is more than a compilation engagement, which provides no assurance.

Type of Work and Fees

Under a compilation engagement, the practitioner would assist you in the preparation of the compiled financial information in accordance with the basis of accounting selected by you (ASPE), based on information provided by you. Having obtained knowledge of your business, operations, accounting system, accounting records, and accounting policies, the practitioner would prepare the compiled financial information, including a note that describes the basis of accounting applied in the preparation of the compiled financial information. When the practitioner assists you with significant judgments used in the preparation of the compiled financial information, the practitioner would discuss those judgments with you so that you understand their impact on the compiled financial information and accept responsibility for them. After preparing the compiled financial information, the practitioner reads it and considers whether it appears misleading. If the practitioner becomes aware of matters that cause the compiled financial information to appear misleading, they will bring these matters to your attention and request additional or corrected information. The practitioner would be highly dependent on you to provide the information necessary for compiling the financial statements, as they are not required to verify the completeness or accuracy of the information you provide.

Given the nature of the engagement, this option will take the least amount of time and will be less costly than a review.

According to CSRE 2400, a review engagement requires the practitioner to perform inquiry and analytical procedures, to obtain limited assurance about whether the information contained in the financial statements is free from material misstatement.

Some of the key steps performed by the practitioner on a review engagement include:
- determining materiality for the financial statements as a whole.
- obtaining an understanding of your industry, operations, structure, investments, financing, accounting systems, accounting records, and accounting policies.
- identifying areas in the financial statements where material misstatements are likely to arise.
- making inquiries regarding: significant accounting estimates; related party transactions; significant, unusual, or complex transactions and events; actual, suspected, or alleged fraud and illegal acts; and whether there are events or conditions that appear to cast doubt on the entity's ability to continue as a going concern.
- performing inquiry and analytical procedures on all material items in the financial statements, and focusing on areas where material misstatements are likely to arise.

When the practitioner performs analytical procedures, this normally involves calculating the change from the prior period, to determine if possible material misstatements exist, based on their knowledge of the entity. However, since this is BB's first year of operations, the practitioner would likely aim to get a baseline understanding of the types of transactions that made up the financial statement balances. If the practitioner becomes aware of a matter that causes them to believe the financial statements may be materially misstated, they will design and perform sufficient additional procedures, to enable the practitioner to conclude on whether the financial statements are materially misstated. These additional procedures may involve additional inquiry or analytical procedures, or may be audit-type procedures such as substantive tests of detail or external confirmations.

Given the significant number of additional procedures performed in a review engagement, it is likely to take longer and cost more than a compilation engagement.

Independence

As I have provided you with advice in order to help your business succeed, including advice on how certain financial transactions should be reported, I am not likely to be considered independent from BB. Since an opinion is expressed at the completion of a review engagement, the practitioner is required to be independent of the reporting entity, and the work I have performed for you would present a self-review threat. Therefore, if you go with a review engagement, I recommend hiring a CPA who is licensed to perform these engagements and is independent of BB. However, since a compilation engagement does not involve expressing an opinion on the information presented, the practitioner is not required to be independent, and I could complete a compilation engagement for BB. My lack of independence should be disclosed in the compilation report.

Recommendation

If you decide to proceed with either option under the investor's offer, I recommend that you ask the investor if they require any assurance over the financial statements. If the investor indicates that they would be willing to accept a compilation, you should go with that option, to reduce your costs and save time. However, if the investor requires some assurance, a review engagement would be more appropriate.

For Assessment Opportunity #5 (Audit and Assurance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to discuss the differences between a compilation and a review engagement.

Competent – The candidate discusses the differences between a compilation and a review engagement, and provides a recommendation.

Competent with distinction – The candidate thoroughly discusses the differences between a compilation and a review engagement, provides a recommendation, and addresses the independence rules.

Assessment Opportunity #6 (Depth and Breadth Opportunity)

The candidate discusses the accounting treatment for the Blue Penguin inventory.

The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

Inventory

The Blue Penguin inventory will be sold at a reduced price in 2024 because the show was cancelled in June 2023. Although the inventory cost has not changed, the change in circumstances needs to be considered in the accounting for the Blue Penguin items for the year ended December 31, 2023, since it has a financial impact on the amount the inventories are expected to realize.

As per ASPE 3031 *Inventories*:

Measurement of Inventories

.10 Inventories shall be measured at the lower of cost and net realizable value.

Cost of inventories

.11 The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Net realizable value

.27 The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realizable value is consistent with the view that assets are not carried in excess of amounts expected to be realized from their sale or use.

.28 Inventories are usually written down to net realizable value item by item. However, in some circumstances, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on the basis of a classification of inventory (for example, finished goods, or all the inventories in a particular industry or geographical segment).

.29 Estimates of net realizable value are based on the most reliable evidence available, at the time the estimates are made, of the amount the inventories are expected to realize. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.

Discounted sweaters

The sweaters had an original selling price of $52, so they will be sold for $26 (50% of the original selling price). Since the selling price is still higher than the cost of $20, no write-down is needed for the sweaters that will be sold. The net realizable value (NRV) is still higher than the cost.

Discounted stuffed animals

The stuffed animals had a cost of $12. Per ASPE 3031.07, NRV is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The broker's commission is a cost "necessary to make the sale" and, as such, must be factored into the calculation of NRV. In this case, the NRV of the stuffed animals is $10.50 ($15 - ($15 × 30%)). Since the NRV is lower than the cost of $12, the stuffed animals will need to be written down. The total write-down will be $216 (($12.00 - $10.50) × 144 stuffed animals).

Donated books

The books could have been sold for 15% of the cost, but will instead be donated to a children's organization. As per paragraph 29 above: "*Estimates of net realizable value are based on the most reliable evidence available, at the time the estimates are made, of the amount the inventories are expected to realize*." Therefore, although the items could be sold, the decision has been made to donate them, and the amount the inventories are expected to realize is $0. The inventory that is expected to be donated will, therefore, need to be written down to $0, since no revenue will be generated from the sale of those items. Therefore, the books will need to be written down by $2,322 ($18 × 129 books).

Conclusion

In conclusion, a total write-down of $2,538 ($216 + $2,322) will need to be recorded in 2023.

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

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

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

Reaching competence – The candidate attempts to discuss the accounting treatment for the Blue Penguin inventory.

Competent – The candidate discusses the accounting treatment for the Blue Penguin inventory.

Competent with distinction – The candidate thoroughly discusses the accounting treatment for the Blue Penguin inventory.

Assessment Opportunity #7 (Breadth Opportunity)

The candidate discusses whether the expenses incurred are deductible for tax purposes.

The candidate demonstrates competence in Taxation.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
6.2.2	Advises on taxes payable for a corporation	**B**
6.3.2	Evaluates income taxes payable for an individual	**B**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

You have enquired about whether several business-related expenses are deductible for tax purposes.

Product Testing

Costs incurred to earn business income are generally deductible in calculating the corporation's net income for tax purposes; however, it may be difficult to argue that all the product costs incurred for your daughter Lisa are relevant to your business. While a limited amount of product testing may be appropriately deductible, this would only apply to products that are truly novel and unlike any of the products tested by your daughter previously. The types of products being tested by your daughter are not clear, but testing costs for ongoing purchases of similar products would likely be viewed as non-deductible personal expenses.

In addition, there may be some personal-use benefit, even for the testing phase of novel products, in that you received a benefit, as your daughter was able to keep the toy for no cost (presuming that the toys are not returned to the business or destroyed after use). Any personal benefit will not be deductible from the corporation's income.

Global Children's Expo

Subsection 20(10) of the Income Tax Act permits you to deduct the cost of attending up to two conventions per year, as long as the convention relates to your business and is held by a professional organization within the geographic area where you normally conduct your business. Assuming that the Global Children's Expo can be considered a convention, it meets these criteria. The nature of the expo clearly relates to your business, as evidenced by the fact that you identified some products you will now stock at BB. To be deductible, the convention must be held at a location that may reasonably be regarded as consistent with the territorial scope of the sponsoring organization. It is unclear who the sponsoring organization is in this case, but without information to the contrary, it is assumed that it is a Canadian organization, and that Toronto would be viewed as being within its territorial scope.

If the convention fee includes food, beverages, or entertainment, and these are not separately identified on your bill, the CRA requires you to deduct $50 per day from the convention fee. This amount is only 50% deductible, similar to other meals and entertainment. The 50% deduction will also apply to other meal costs incurred while on your visit to Toronto. Other hotel and travel costs, provided they all related to your business travel and are not for other family members who do not work for the business, are fully deductible.

Consulting Fees

The cost of my fees should be deducted in the period to which they pertain, as they are laid out for the purpose of earning business income. As I have primarily given you forward-looking advice, my fees will likely pertain mainly to your 2024 fiscal year, and should be deducted in that year.

Vehicle Costs

On your personal tax return, you may deduct motor vehicle costs such as gas, insurance, and capital cost allowance (depreciation) on the vehicle, to the extent that they were incurred to earn business income. However, if you use a vehicle for both business and personal use, you can only deduct the portion related to earning business income. Travel between your home and the store every day would be viewed as personal use, so those costs would not be deductible, but running errands for BB would be considered business use. To support the amount that you deduct, it is important to track the kilometres driven for business purposes so that you can prorate your vehicle costs, based on the number of kilometres driven for business relative to total kilometres driven. You should also keep receipts for parking and any supplementary insurance you purchased in order to be able to drive the vehicle for business purposes, as these costs can also be deducted in full.

Work from Home

As an employee of the corporation, you may deduct home office expenses for employment use only if one of the following conditions are met:

- Your home workspace is where you mainly (more than 50% of the time) work for a period of at least four consecutive weeks in the year; or,
- You use the space only to earn your employment income, and you use it on a regular and ongoing basis to meet your clients, customers, or patients.

In this case, I do not think your home office expenses would qualify for deduction, since you perform the majority of your work at the BB storefront, and that is the only place where you meet customers. Your home office expenses should not be deducted for tax purposes.

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

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

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

Reaching competence – The candidate discusses whether some of the expenses incurred are deductible for tax purposes.

Competent – The candidate discusses whether several of the expenses incurred are deductible for tax purposes.

Competent with distinction – The candidate discusses whether most of the expenses incurred are deductible for tax purposes.

COMMON FINAL EXAMINATION
MAY 30, 2024 – DAY 3

Case #2 **(Suggested time: 85 minutes)**

Good Read (GR) is a Canadian bookstore franchisor that has been successfully operating for 15 years. GR's success is largely based on building personal relationships with customers, focusing on being experts in literature, building on the franchisee's skills, and being known for giving back to the community. On January 1, 2023, Laura Saeed, a former teacher, incorporated her own GR franchise, Laura Saeed GR Inc. (LS), of which she is the sole shareholder. LS's year end is December 31.

It is currently January 15, 2024. You, CPA, were hired as a consultant to assist Laura with various matters, and today is your first meeting with Laura.

Laura: "As an avid reader, I'm so pleased with my decision to open LS. My vision is for LS to become a pillar in the community, where learning and creating are facilitated. I think we can do this in many different ways, not just through reading.

"I've prepared LS's draft 2023 financial statements and added my notes (Appendix I), but can you review the accounting treatment for the government assistance (Appendix II), and for the initial franchise fee (Appendix III)?

"Also, please calculate the federal corporate income taxes payable for the year ended December 31, 2023. Can you also prepare a budgeted before-tax income statement for 2024?

"I recently met with the auditors and, as this is my first audit, I was unclear on several of the topics discussed. Specifically, can you explain what the auditors' audit approach and materiality assessment will likely be. Please also tell me which accounts in the financial statements have a high risk of material misstatement, and explain why.

"In June 2023, I initiated a program for schools called "Book It". On the first school day of each month, the third-grade students at six different schools are provided with the same book, which I pick to ensure it provides a learning opportunity. On the last Thursday and Friday of each month, I go to each school and host a book club. This is a chance to provide students with increased access to books and thoughtful group discussions, which are important to me. So far, the program has been a big success. I love interacting with the children, and it has significantly impacted me, as I can see their love of books growing. The children get to know me through my visits with them, and it's so rewarding!

"Based on Book It's success, I am considering adding another program, and would like some guidance on which program would be the best from a strategic standpoint. The first option is to donate 5% of LS's gross profits to preschools and schools, to purchase books. The second option is to start a writing program, designed to teach creative writing to children for free. The classes would have a maximum of 15 children and occur every Saturday morning, and each session would last four weeks. I would teach several consecutive sessions."

APPENDIX I
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS AND NOTES

Laura Saeed GR Inc.
Balance Sheet
As at December 31, 2023

Assets	
Current assets:	
Cash	$ 215,780
Accounts receivable	7,000
Inventory	187,500
Total current assets	410,280
Property, plant, and equipment (Note 1)	116,767
Total assets	$ 527,047
Liabilities	
Current liabilities:	
Accounts payable	$ 70,000
Total current liabilities	70,000
Shareholder's equity	
Share capital	125,000
Retained earnings	332,047
Total shareholder's equity	457,047
Total liabilities and shareholder's equity	$ 527,047

APPENDIX I (CONTINUED)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS AND NOTES

Laura Saeed GR Inc.
Income Statement
For the year ended December 31, 2023

Revenue	
Book store revenue	$ 3,000,000
Government assistance (Note 2)	50,000
Total revenue	3,050,000
Expenses	
Cost of sales (Note 3)	2,250,000
Book It expenses (Note 4)	97,720
Franchise fee	120,000
Amortization	20,233
Salaries and wages (Note 5)	126,000
Advertising (Note 6)	10,000
Rent (Note 7)	84,000
General and administrative (Note 8)	10,000
Total expenses	2,717,953
Income before tax	$ 332,047

APPENDIX I (CONTINUED)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS AND NOTES

Notes:

1. Property, plant, and equipment (PP&E):

Asset	Cost ($)	Useful Life (years)	Amortization ($)
Vehicle	25,000	10	2,500
Bookshelves	30,000	10	3,000
Couches	25,000	5	5,000
Computers for customer use	12,000	5	2,400
Leasehold improvements	45,000	5	7,333
Total	137,000		20,233

   On November 1, 2023, we used part of the government assistance (Note 2) to convert a portion of the store's floor space into a storage and administrative centre for the Book It program. Included in leasehold improvements is $10,000 related to this conversion.

   On January 1, 2024, we started renovations to remove three walls that enclosed our biography section, at a projected cost of $8,000. Prior to this, biography sales seemed low, at 5% of total sales compared to 15% of total sales at other GR locations. I think sales were low because customers failed to notice the section, so the removal of the walls should fix that.

2. Due to the high cost of the Book It program, I was at risk of having to discontinue it. I contacted the provincial government in hopes of receiving assistance, and I received $50,000 on November 1, 2023 (Appendix II).

3. I expect the unit cost of books to increase by 2% in 2024.

4. There are 720 students in the Book It program. Each book costs $18, on average. There are also administrative costs, which average $1,000 per month.

APPENDIX I (CONTINUED)
EXCERPTS FROM DRAFT FINANCIAL STATEMENTS AND NOTES

Notes (continued):

5. LS's portion of payroll deductions is included in salaries and wages expense. I only took a salary of $50,000 in 2023; I'm hoping to increase this to the average annual franchisee owner's salary of $100,000 for 2024. Throughout 2023, I did not have enough employees to be open for the standard 12-hour days, like other GR locations. I work approximately 60 hours per week on the sales floor. During 2023, the hours of operation were as follows:

Monday to Friday	9:00 am – 6:00 pm
Saturday and Sunday	9:00 am – 9:00 pm

   I have hired an additional employee, who started on January 1, 2024, at $17 per hour and will work 40 hours per week, 50 weeks per year. This will enable the store to be open from 9:00 am to 9:00 pm, 7 days a week, which will increase sales (Appendix IV).

   Due to limited staff, we have very few processes in place for our operations.

6. I'm expecting advertising costs to increase by 5% in 2024.

7. Rent is $7,000 per month.

8. This amount includes $2,000 for meals and entertainment, $4,000 for annual memberships to the local recreation centre for me and all employees, and $1,500 for our year-end staff party.

APPENDIX II
EXCERPT FROM GOVERNMENT ASSISTANCE AGREEMENT

1. The assistance is to be used to help fund the “Book It” program from November 1, 2023, to October 31, 2024 (“Grant Period”).

2. A maximum of $10,000 can be allocated to capital expenditures.

3. The use of funds for non-capital expenditures must be spread evenly across the Grant Period.

4. If the “Book It” program is discontinued by the recipient before October 31, 2024, any unspent portion must be returned to the government.

APPENDIX III
EXCERPT FROM FRANCHISE AGREEMENT

The Franchisee is required to:

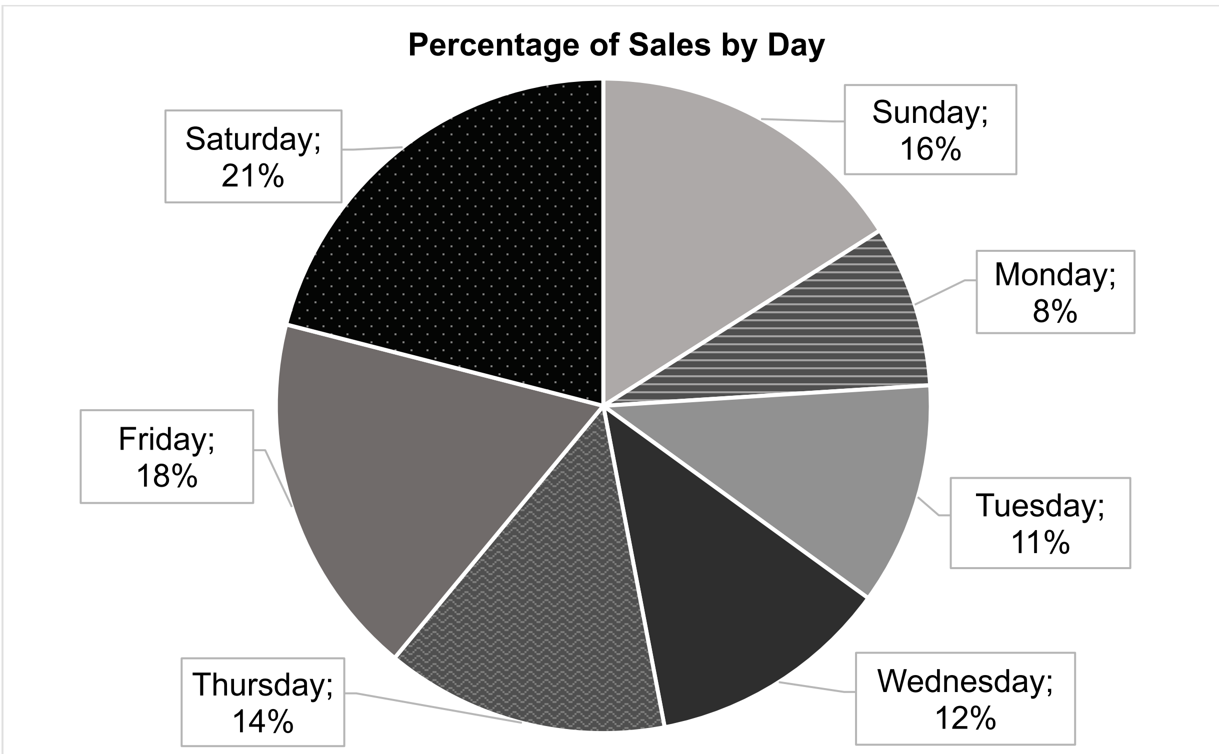
- remit the initial franchise fee of $120,000 upon signing of the Agreement. The initial fee includes the following: $107,000 for the right of the Franchisee to operate indefinitely under the Good Read name; and $13,000 for the hardware required for the point-of-sale system.
- remit the annual franchise royalty of 10% to the Franchisor by March 31 of the following year. The royalty fee is based on the annual income before corporate income taxes.
- remit the annual audited ASPE financial statements to the Franchisor by March 31 of the following year.
- remit a budgeted before-tax income statement to the Franchisor by March 31 of each year, for the current year.

APPENDIX IV
SALES INFORMATION FROM ANNUAL FRANCHISOR REPORT

Sales Increases

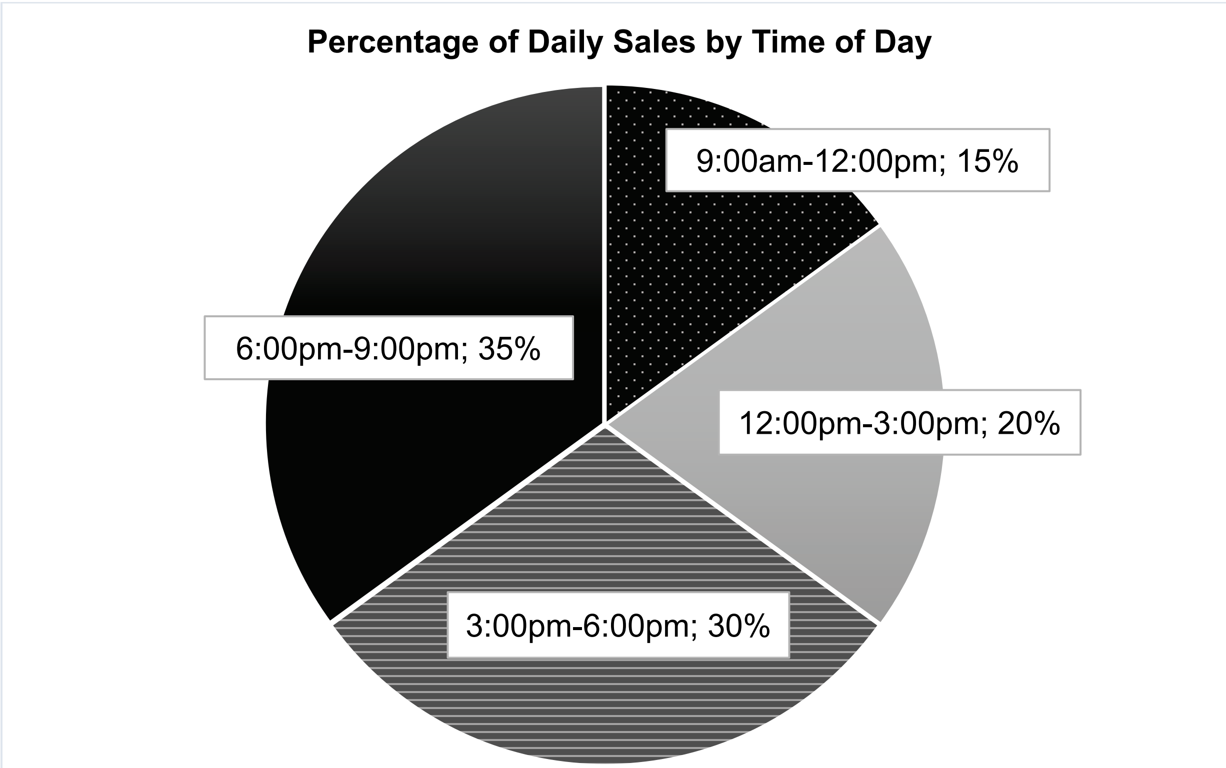
The historical sales average across all GR locations shows that the new locations usually see a 3% increase in annual sales during their second year of operation.

Sales Information



APPENDIX IV (CONTINUED)
SALES INFORMATION FROM ANNUAL FRANCHISOR REPORT

Sales Information (continued)



MARKING GUIDE 3-2
GOOD READ (GR)
ASSESSMENT OPPORTUNITIES

To: Laura Saeed
From: CPA
Subject: Various matters

Assessment Opportunity #1 (Depth and Breadth Opportunity)
The candidate discusses the accounting treatment for the government assistance.
The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
1.2.1	Develops or evaluates appropriate accounting policies and procedures	A
1.2.2	Evaluates treatment for routine transactions	A

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

During the year, LS received $50,000 from the government to assist with the Book It program, for a period of 12 months beginning on November 1, 2023 (the Grant Period). Currently, the full amount is recorded as revenue in the year ended December 31, 2023. Based on ASPE, we need to consider if that is the appropriate accounting treatment. The specific standard to consult is ASPE 3800 *Government Assistance.*

Capital Expenditures

LS used $10,000 of the assistance toward leasehold improvements. Accordingly, there is a capital component to the usage of the assistance. Per the guidance in the *Handbook*, assistance related to the acquisition of capital assets is accounted for as follows:

.21 Some government programs provide for assistance toward the acquisition of fixed assets. The net outlay is charged to income over the useful life of the related fixed assets.

.22 Government assistance towards the acquisition of fixed assets shall be either:
- *(a) deducted from the related fixed assets with any depreciation calculated on the net amount; or*
- *(b) deferred and amortized to income on the same basis as the related depreciable fixed assets are depreciated.*

Non-Capital Expenditures

The remaining $40,000 from the government assistance will likely be used toward the purchase of books, which, per the government assistance agreement, must be spread evenly across the Grant Period. According to guidance provided in the *Handbook*, assistance related to non-capital items is accounted for as follows:

.17 Government assistance toward current expenses or revenues shall be included in the determination of net income for the period.

.18 The presentation of government assistance in the income statement will depend on circumstances. The alternatives available are to show expenses net of assistance or to show the assistance as a deduction from aggregate expenses or as revenue.

Expenses of future periods

.19 Some types of government assistance are received or receivable in a period but relate to expenses that will be incurred in future periods. It would not be appropriate to apply all of the assistance to the expenses in the current period if subsequent accounting periods will continue to bear relevant expenses.

.20 When government assistance relates to expenses of future accounting periods, the appropriate amounts shall be deferred and amortized to income as related expenses are incurred.

Based on the above, the following adjustments are required.

Initial Recording

Recording the full $50,000 as revenue in the year ended December 31, 2023, is incorrect. The full amount of the assistance cannot be recorded in revenue upon receipt as it does not match the nature of the usage or the period in which it was used. A few adjustments must be made.

The first journal entry is to reverse the entry that was made, to credit government assistance revenue and to record the funds received into a deferred government assistance account:

Dr. Government assistance revenue	$50,000	
Cr. Deferred government assistance		$50,000

Acquisition of fixed assets

The second entry is to properly record the portion of the government assistance used for the leasehold improvements. As per the above, LS has two options for recording the leasehold improvements. The first option is to deduct the amount of the assistance from the related fixed assets, with any amortization calculated on the net amount. Under this option, the following entry is required:

Dr. Deferred government assistance	$10,000	
Cr. Leasehold improvements		$10,000

If this option is chosen, we need to adjust the current-year amortization, and reduce amortization by the amount related to the leasehold improvements specific to the Book It program (($10,000 ÷ 5 years) × (2 months ÷ 12 months)):

Dr. Accumulated amortization	$333	
Cr. Amortization expense		$333

The second option is to defer and amortize the amount of the assistance to income on the same basis that the related depreciable fixed assets are depreciated. As the expected life of the leasehold improvements is five years, and the leasehold improvements occurred in November (therefore, two months of amortization), under this option the following entry is required for 2023:

Dr. Deferred government assistance	$333	
Cr. Government assistance revenue		$333

The subsequent four years will require the same entry but with the full year of amortization ($10,000 ÷ 5 years):

Dr. Deferred government assistance	$2,000	
Cr. Government assistance revenue		$2,000

The fifth year will require an entry to amortize the rest of the deferred government assistance.

For ease of tracking, I have chosen the first option. Under this option, LS can do all of the adjustments now, without having to remember to recognize the capital portion of the assistance into revenue each year.

Current and future expenses

Per the government assistance agreement, any amount not used for capital expenditures must be spread evenly across the grant period. As $10,000 was used for leasehold improvements, the remaining $40,000 must be allocated monthly from November 1, 2023, to October 31, 2024, for a monthly amount of $3,333 ($40,000 ÷ 12). The following entry is required as of December 31, 2023, to account for the portion of the assistance that was used in November and December 2023 ($3,333 × 2 months):

Dr. Deferred government assistance	$6,666	
Cr. Book It expenses (or Government assistance revenue)		$6,666

The remaining $33,334 ($40,000 - $6,666) will remain as deferred government assistance and will be netted against the monthly expenses during 2024 (i.e., monthly administrative costs of $1,000, and the cost of books purchased each month for the Book It program), or shown as government assistance revenue.

Per the government assistance agreement, if the program is discontinued before October 31, 2024, any unspent portion must be returned to the government. Therefore, if you choose to end the program, any amounts remaining as deferred government assistance must be debited, with the offsetting credit to cash:

Dr. Deferred government assistance	$XX	
Cr. Cash		$XX

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

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

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

Reaching competence – The candidate attempts to discuss the accounting treatment for the government assistance.

Competent – The candidate discusses the accounting treatment for the government assistance.

Competent with distinction – The candidate thoroughly discusses the accounting treatment for the government assistance.

Assessment Opportunity #2 (Depth and Breadth Opportunity)
The candidate discusses the accounting treatment for the initial franchise fee.
The candidate demonstrates competence in Financial Reporting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
1.2.2	Evaluates treatment for routine transactions	**A**

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

The $120,000 franchise fee has been recorded as an expense in 2023. The franchise fee covers two components: $13,000 for the hardware required for the point-of-sale system, and $107,000 for the indefinite use of the name, Good Read. The components of the franchise fee suggest that there are different accounting treatments for the different costs, since the costs are of different natures.

Use of the Good Read Name – $107,000

ASPE 3064 *Goodwill and Intangible Assets* needs to be consulted, to determine the correct accounting treatment for the use of the Good Read name. Per ASPE 3064.18, both the definition and recognition criteria must be met, to recognize an intangible asset:

> *The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:*
>
> *(a) the definition of an intangible asset (see paragraphs* 3064.08-*.17); and*
>
> *(b) the recognition criteria (see paragraphs* 3064.21-*.23).*

To meet the definition of an intangible asset, the asset must be identifiable, the entity must have control over the asset, and future economic benefits must exist.

Identifiability

Per ASPE 3064.12:

An asset meets the identifiability criterion in the definition of an intangible asset when it:

(a) is separable (i.e., is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability); or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The use of the Good Read name is included in the franchise agreement terms, which gives you the legal right to use the Good Read name. Therefore, it meets the identifiability criterion.

Control

Per ASPE 3064.13*:*

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

LS has the right to future economic benefits that result from the use of the Good Read name. This is supported by the legal right to the aforementioned. Therefore, it meets the control criterion.

Existence of future economic benefits

Per ASPE 3064.17*:*

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

The use of the Good Read name will result in future economic benefits for your franchise location. The broader Good Read name has been operating successfully for 15 years. Part of the economic benefits expected to be realized result from the name recognition, as it will attract customers, thereby generating revenue. Therefore, it meets the future economic benefits criterion.

Recognition

As per ASPE 3064.21:

An intangible asset shall be recognized if, and only if:

(a) *it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and*

(b) *the cost of the asset can be measured reliably.*

As per the above, it is probable that the expected future economic benefits will flow to LS. In addition, the cost of the asset can be reliably measured because it is stated within the agreement. Therefore, the recognition criteria are met.

Subsequent measurement

We also need to consider the subsequent measurement of the intangible assets acquired. Per ASPE 3064.56, "*A recognized intangible asset shall be amortized over its useful life to an enterprise, unless the life is determined to be indefinite. When an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its life is determined to be no longer indefinite.*"

Per the franchise agreement, the initial fee gives the franchisee the right to operate indefinitely under the Good Read name. We have also determined that $107,000 of the total franchise fee relates to the use of the name. Therefore, this portion of the franchise fee is not amortized until it is determined to no longer be indefinite. As per ASPE 3064.57, "*The amortization method and estimate of the useful life of an intangible asset shall be reviewed annually.*" In addition, the intangible asset will need to be tested for impairment whenever events or changes in circumstances indicate that its carrying amount may exceed its fair value, as per ASPE 3064.65.

Conclusion

Based on the above analysis, the following adjustments are required:

Dr. Intangible asset (franchise fee)	$107,000	
Cr. Franchise fee expense		$107,000

To correctly account for the portion of the franchise fee related to the use of the Good Read name.

Point-of-Sale Hardware – $13,000

ASPE 3061 *Property, Plant and Equipment* needs to be consulted, to determine the correct accounting for the point-of-sale hardware. Per ASPE 3061.03:

(a) Property, plant and equipment are identifiable tangible assets that meet all of the following criteria:

(i) are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other property, plant and equipment;

This criterion is met because the point-of-sale system will be used within the store.

(ii) have been acquired, constructed or developed with the intention of being used on a continuing basis; and

This criterion is met because it will be used on a continuing basis to complete each sales transaction.

(iii) are not intended for sale in the ordinary course of business.

This criterion is met because the point-of-sale system is not intended to be sold. It will be used on a continuing basis for the daily operation of LS.

Conclusion

Based on the above, as the point-of-sale hardware meets the definition of property, plant, and equipment, this portion of the franchise fee ($13,000) should be capitalized and depreciated over the useful life of the system. Per ASPE 3061.16:

Amortization shall be recognized in a rational and systematic manner appropriate to the nature of an item of property, plant and equipment with a limited life and its use by the enterprise. The amount of amortization that shall be charged to income is the greater of:

(a) the cost less salvage value over the life of the asset; and

(b) the cost less residual value over the useful life of the asset.

The life of the point-of-sale system needs to be considered. It may be necessary to inquire with the franchisor as to the typical life of the asset. For example, after how many years does the system need to be either upgraded or completely changed? In the meantime, five years appears reasonable, as this is what we have estimated for the useful life of our other computer hardware.

Based on the above, the following adjusting entries are required:

Dr. Property, plant, and equipment	$13,000	
Cr. Franchise fee expense		$13,000

To capitalize the point-of-sale system to property, plant, and equipment.

Dr. Amortization	$2,600	
Cr. Accumulated amortization		$2,600

To amortize the point-of-sale system for the use in 2023 ($13,000 ÷ 5 years).

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

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

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

Reaching competence – The candidate attempts to discuss the accounting treatment for the initial franchise fee.

Competent – The candidate discusses the accounting treatment for the initial franchise fee.

Competent with distinction – The candidate thoroughly discusses the accounting treatment for the initial franchise fee.

Assessment Opportunity #3 (Breadth Opportunity) The candidate calculates LS's federal corporate income taxes payable. *The candidate demonstrates competence in Taxation.*

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
6.2.2	Advises on taxes payable for a corporation	**B**

CPA Map Enabling Competencies: *6.1.1 Identifies and articulates issues within areas of work responsibility* *6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems* *6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives* *6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions*

The following is the calculation of LS's corporate federal income taxes payable:

		Note
Adjusted income before tax for accounting purposes	$365,801	1
Add back:		
Amortization per financial statements	20,233	
Adjustment to amortization	2,267	2
Government assistance	40,000	3
Meals and entertainment	1,000	4
Recreation centre fees	4,000	4
Deduct:		
Capital cost allowance	(148,025)	5
Offset of government assistance to current year – Book It expenses	(6,666)	3
Net income for tax purposes	278,610	
9% federal small business rate (first $500,000)	25,075	6
15% federal general rate (remainder)	0	
Federal income taxes payable	$25,075	

Notes:

1. The accounting income before tax needs to be adjusted for accounting adjustments as follows:

Original accounting income before tax:		**$332,047**
Less: Government assistance revenue	(50,000)	
Add: Income statement impact – capital expenditures	333	
Add: Income statement impact – non-capital expenditures	6,666	(43,001)
Add: Franchise fee expense	120,000	
Less: Amortization of point-of-sale system	(2,600)	117,400
Less: Royalty fee ($406,446 × 10%)		(40,645)
Adjusted income before tax for accounting purposes		$365,801

2. $333 (reversal of amortization booked on the leasehold improvements related to Book It) - $2,600 (amortization of the point-of-sale system) = $2,267.

3. Government assistance needs to be reported as income or as a reduction of an expense in the period in which it was received for tax purposes. An election can be made to reduce the capital cost of a capital item (the leasehold improvements), similar to the adjustment made for accounting purposes, so only $40,000 is added back into income here.

   In calculating net income for accounting purposes, we offset the Book It expenses during 2023 by $6,666, which the government assistance allocated to the costs incurred for the program during 2023, thus increasing accounting net income. For tax purposes, we added back the full $40,000 of government assistance going toward non-capital expenditures received during 2023. To equate for this, we need to deduct the $6,666 (which is part of the actual cash LS spent on the program in 2023) from net income for tax purposes.

4. Per paragraph 67.1(1), meals and entertainment expenses are only deductible up to 50% of the total cost incurred. There is an exception to this limitation in paragraph 67.1(2)(f), which states that the company can hold up to six special events per year, provided to all employees, where the amounts paid to hold the event(s) are 100% deductible. Therefore, $1,000 for meals and entertainment must be added back ($2,000 × 50%), and the $1,500 for the year-end staff party can be deducted.

   Per paragraph 18(1)(l), recreation centre fees provided to employees are not deductible to the company. The $4,000 incurred for recreation centre memberships must be added back to net income.

5. The CCA calculation is as follows. LS is a CCPC with no associated corporations, so it would be allowed to deduct up to $1.5 million of these costs annually.

Class	**Asset**	**Additions**	**Rate**	**CCA (Note A)**	**Ending UCC Balance ($)**
8	Bookshelves and couches	55,000	20%	55,000	0
10	Vehicle	25,000	30%	25,000	0
14.1	Eligible capital property (franchise fee) (Note B)	107,000	5%	8,025	98,975
50	Customer-use computers and point-of-sale system (Note C)	25,000	55%	25,000	0
13	Leasehold improvements (Note D)	35,000	20%	35,000	0
				148,025	

Note A: For all classes except Class 14.1, the immediate expensing provisions allow the full cost to be deducted in the year of acquisition. As LS is a CCPC with no associated corporations, it would be allowed to deduct up to $1.5 million of these costs annually. For Class 14.1, the immediate expensing provisions do not apply, but the accelerated investment incentive (which allows for 1.5 times the normal CCA in the year) does ($107,000 × 1.5 × 5%).

Note B: As the franchise fee is for an indefinite period, it belongs in Class 14.1, not Class 14.

Note C: This includes the $13,000 related to the hardware for the point-of-sale system allocated from the initial franchise fee, and the $12,000 related to computers for customer use.

Note D: This is net of the $10,000 government assistance allocation.

6. The 9% federal small business rate was calculated as 38% basic corporate - 10% federal tax abatement - 19% small business deduction. As LS's net income for tax purposes was less than $500,000, this rate was used.

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

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

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

Reaching competence – The candidate attempts to calculate LS's federal corporate income taxes payable.

Competent – The candidate calculates LS's federal corporate income taxes payable.

Competent with distinction – The candidate thoroughly calculates LS's federal corporate income taxes payable.

Assessment Opportunity #4 (Depth and Breadth Opportunity)

The candidate prepares a budgeted before-tax income statement for 2024.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
3.2.1	Develops or evaluates data and information inputs for operational plans, budgets, and forecasts	A
3.2.2	Prepares, analyzes, or evaluates operational plans, budgets, and forecasts	A

CPA Map Enabling Competencies:
5.1.1 Applies general business knowledge to enhance work performed
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

I have prepared a budgeted before-tax income statement for 2024, using historical information and assumptions, which I have explained below.

		Note
Sales	$ 4,625,073	1
Cost of sales	(3,538,181)	2
Book It expenses	(108,858)	3
Amortization	(24,500)	4
Salaries and wages	(210,000)	5
Advertising	(10,500)	6
Rent	(84,000)	
General and administrative	(10,000)	7
Income before tax and royalties	639,034	
Royalty fee	(63,903)	8
Income before tax	$ 575,131	

Notes:

1. Sales

Biography genre sales

The sales of the biography genre were only 5% compared to 15% for the average of all GR locations. The decrease in the sales rate has been attributed to the placement of the biography section within the store, which was segregated from the rest of the store. Upon removal of the walls, sales are expected to be 15% of total sales.

Total current sales	$3,000,000
Current biography sales ($3,000,000 × 5%)	(150,000)
Total other sales	$2,850,000

If biography sales were 15% of total sales, total sales would be $3,352,941 ($2,850,000 ÷ 85%), for an increase in sales of $352,941 ($3,352,941 - $3,000,000).

Store hours

Sales are expected to increase in 2024, based on the increase in store hours. The increase in sales is based on the data from the annual franchise report excerpt. During 2023, due to lack of staff, your GR location was unable to open for the standard 12 hours per day. As you will have a new full-time employee starting in January, the store can remain open during these hours and generate additional revenue.

Day	% of Weekly Sales (Note A)	Sales ($) (Note B)	Daily Hours	Additional Sales (%) (Note C)	Additional Sales ($) (Note D)
Monday to Friday	63%	2,112,353	9:00 am – 6:00 pm	35%	1,137,421
Saturday and Sunday	37%	1,240,588	9:00 am – 9:00 pm	0	0
Total	100%	3,352,941			1,137,421

Note A: The Monday to Friday sales represent 63% of total sales (8% + 11% + 12% + 14% + 18%), and the Saturday and Sunday sales represent 37% of total sales (21% + 16%).

Note B: Total yearly sales on each day, including the increased biography sales:
Monday to Friday: 63% × $3,352,941 = $2,112,353
Saturday and Sunday: 37% × $3,352,941 = $1,240,588

Note C: With the new opening hours, the store will now be open Monday to Friday between 6:00 pm and 9:00 pm. Per the annual franchise report, 35% of the daily sales happen from 6:00 pm to 9:00 pm.

Note D: Additional sales are calculated as follows:
Monday to Friday: $2,112,353 ÷ (1 - 35%) × 35% = $1,137,421

Second-year sales increase

Per the Annual Franchisor Report, during the second year of operations, franchise locations saw an average increase of 3% in sales.

The total sales forecasted is ($3,352,941 + $1,137,421) × 1.03 = $4,625,073.

2. Cost of Sales (COS)

A 2% increase in the costs of books is expected for 2024. Here is my calculation of the 2024 COS:

Total sales	$4,625,073	
COS in % from 2023	75%	($2,250,000 ÷ $3,000,000)
COS prior to increase	$3,468,805	
% of increase	2%	
Total COS	$3,538,181	

3. Book It Expenses

LS will incur a monthly expense for the Book It program until October 31, 2024. I have not forecasted additional government assistance or additional monthly costs beyond October 31, 2024. At this point, there is not enough information to assess whether the program will continue, if government assistance will be received, or what it will cost to continue the program.

Total current monthly cost of books (Note A)	$12,960
Expected 2% cost increase	2%
Total book cost	$13,219
Monthly administrative cost	$1,000
Total monthly cost	$14,219
January to October cost ($14,219 × 10 months)	$142,192
Total remaining government assistance (Note B)	$33,334
Net expense	$108,858

Note A: 720 students × $18 per book = $12,960

Note B: $40,000 operating portion of assistance - ($3,333 × 2 months already used) = $33,334

4. Amortization

You forecasted that you will spend $8,000 to remove three walls, to assist in additional sales of the biography genre. Renovations began on January 1, 2024. This will increase the amortization expense for the year, due to the amount required to be capitalized. This will likely be amortized on the remaining duration of the lease, which is four years as of January 1, 2024. The original leasehold improvements total $35,000 ($45,000 leasehold improvements - $10,000 assistance), which is amortized over the five-year lease. I also added the $13,000 spent on hardware required for the point-of-sale system to the computers for customer use ($12,000 + $13,000 = $25,000). The amortization for the year should be as presented in the following table:

Asset	Cost ($)	Useful Life (Years)	Amortization ($)
Vehicle	25,000	10	2,500
Bookshelves	30,000	10	3,000
Couches	25,000	5	5,000
Computers for customer use and point-of-sale system	25,000	5	5,000
Original leasehold improvements	35,000	5	7,000
New leasehold improvements	8,000	4	2,000
Total			24,500

5. Salaries

Current salaries	$126,000
New employee (Note A)	34,000
Laura's anticipated salary increase	50,000
Total 2024 salary	$210,000

Note A: $17 × 40 hours × 50 weeks = $34,000. The employer portion of the related payroll deductions should be included; however, there is not enough information to calculate it.

6. Advertising

A 5% increase in advertising expenses is expected in 2024:

2023 expense	$10,000
Increase of 5%	5%
Total	$10,500

7. General and administrative

Assumed the same as 2023.

8. Royalties

Calculated as 10% × $639,034 = $63,903.

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

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

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

Reaching competence – The candidate attempts to prepare a budgeted before-tax income statement for 2024.

Competent – The candidate prepares a budgeted before-tax income statement for 2024.

Competent with distinction – The candidate prepares a thorough budgeted before-tax income statement for 2024.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate prepares a report that explains what the auditors' audit approach and materiality assessment will likely be and identifies which accounts in the financial statements have higher risk of material misstatement, and why.

The candidate demonstrates competence in Audit and Assurance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		Core
4.3.4	Assesses materiality for the assurance engagement or project	B
4.3.5	Assesses the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures	B
4.3.6	Develops appropriate procedures, including Audit Data Analytics (ADA), based on the identified risk of material misstatement	B

CPA Map Enabling Competencies:
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Approach

There are two main audit approaches that auditors can use to plan and perform an audit:

1. Substantive approach: This approach involves performing substantive testing (analytical procedures and tests of details) on account balances and transactions, to obtain sufficient appropriate audit evidence that the amounts are free of material misstatement.
2. Combined approach: This approach relies on the internal control of the business to reduce the amount of substantive testing required. The auditors will evaluate the design and effectiveness of the internal controls, to assess whether they are effective at reducing the risk of material misstatement in the financial statements. If the controls are determined to be effective, the auditors may reduce the amount of substantive testing required in some financial statement areas.

The audit approach selected depends on the nature and complexity of the business. Due to limited staff, it is not possible for you to implement adequate segregation of duties. In addition, you mentioned that you have very few processes in place, which likely means there are limited internal controls designed to reduce the risk of error and fraud. Therefore, the auditors will likely take a substantive approach, as your controls cannot be relied upon.

Materiality

Materiality is the concept that "*misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements*" (CAS 320). The primary user of the audited financial statements will be the franchisor, so that is the user the auditors will consider when determining the amount that could influence their decisions.

CAS outlines financial statement materiality and performance materiality as the basis used by the auditors when planning and performing an audit. Materiality is generally calculated as a percentage of the financial statement benchmark, such as total assets, net income, or total revenue, that is relevant to the users of the financial statements. CAS 320 provides the following guidance:

A5. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

CAS does not prescribe specific percentages to be used for materiality. Rather, professional judgment should be used, as per CAS 320:

A8. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

Overall financial statement materiality

As indicated, the primary user of the financial statements is the franchisor, to ensure that the annual franchise royalty is correct. The franchise royalty is calculated as 10% of income before tax, so an appropriate basis upon which to determine materiality would be income before tax. Given that this is the first year of operations, the franchisor will likely be sensitive to misstatements, to ensure that they are receiving the appropriate royalty amount. Therefore, the auditors may set materiality at 3% of income before tax (the low point of the typical range of 3%–7%).

Adjusted income before tax	$365,801
Materiality – 3%	$10,974 (rounded to $10,900)

Performance materiality

The auditors will also calculate a performance materiality, which is used when conducting their audit procedures. Per CAS 320.A13, performance materiality is "*set at less than materiality for the financial statements as a whole to reduce aggregation risk to an appropriately low level*." Although professional judgment needs to be applied, the acceptable range for performance materiality is 50% to 90% of overall materiality. Given that there is a bias for management to understate net income, thereby increasing the risk of material misstatement, the auditors will likely select the lower part of the range, perhaps 60%.

Overall financial statement materiality	$10,900
Performance materiality – 60%	$6,540

High-risk accounts

There are a number of financial statement accounts that could contain potential material misstatements arising from new, unusual, or complex transactions, as discussed below. In addition, the auditor will want to consider whether there are opportunities and motivations for management to misstate the financial statements in order to meet conditions in the government assistance agreement and/or the franchise agreement. Finally, the auditor will also consider whether management may fraudulently misstate the financial statements for other reasons, particularly given the lack of segregation of duties, due to there being limited staff during 2023. For example, to minimize the franchise royalty fee, management may be motivated to understate revenue and overstate expenses. It would be typical for the auditor to look into this in an engagement of this nature.

Revenue

The method used to recognize revenue is important in determining the amount of net income. Improper or incorrect revenue recognition can result in a misstatement of net income, which can impact the calculation of the franchise royalty. In addition, CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 27, states that there is a presumption that there are risks of fraud in revenue recognition. A risk of fraud is associated with cash sales in the store because management could take the cash and not record the sales. Since there will be a bias to reduce revenue in order to reduce the royalty fees, the key assertions the auditors will focus on are completeness (that all revenue earned during the period has been recorded), accuracy (that the revenue reported reflects the actual amounts earned), and cut-off (that the revenue earned is recorded in the correct period).

Inventory/ cost of sales

Inventory is LS's second largest asset, after cash. The high volume of low-value inventory leads to a high risk of theft. The auditors will be concerned with existence as well as completeness. They will want to ensure that the inventory recorded exists and that all of the inventory has been accounted for.

In addition, as cost of sales is LS's primary expense, it is a significant factor in determining the net income. Any errors or inaccuracies in the calculation of cost of sales can significantly impact the franchise royalty calculation. Cost of sales is also directly linked to inventory, and given that LS has a high volume of low-value inventory, as mentioned above, there is a high risk of theft. LS is biased to inflate expenses in order to reduce the royalty fees. The key assertions are occurrence (ensuring that only costs associated with the books sold during the period have been included in cost of sales), accuracy (that the cost of sales reports reflect the actual costs incurred), and cut-off (that the costs incurred are recorded in the correct period).

Salaries and wages

This is an important account due its size, as it is the largest expense after the cost of sales. Also, salaries and wages require a number of calculations for taxes and benefits, which can be susceptible to errors if proper controls are not in place. Since there will be a bias to inflate expenses in order to reduce the royalty fees, the key assertions are occurrence (ensuring that only costs associated with salaries and wages for LS have been included), accuracy (that the costs reported reflect the actual costs incurred), and cut-off (that the costs incurred are recorded in the correct period).

Government assistance revenue / deferred revenue

Given that the period covered by the government assistance agreement spans the year end, with only 2/12ths falling in the 2023 fiscal year, the allocation between revenue and deferred revenue could be materially misstated. Also, the accounting rules for recognizing government assistance are complex, with different options available, as discussed earlier. Therefore, government assistance revenue / deferred revenue is a high-risk account to be addressed during the audit. The auditor will be primarily concerned with the cut-off assertion (that the revenue is recorded in the correct period), the accuracy assertion (that it is accurately allocated between capital and non-capital expenditures), and the occurrence assertion (that the government assistance revenue has been earned by being spent on qualifying expenditures related to the Book It program).

Initial franchise fee

Given the significance of the amount of the initial franchise fee ($120,000), the fact that the accounting rules are complex, because it relates to future periods as well as the current year and it serves more than one purpose (use of the Good Read name and point-of-sale hardware), the accounting for the initial franchise fee is high risk. Since the entire amount will be capitalized (split between an indefinite life intangible and PPE), in addition to the accuracy assertion, the auditors will be concerned with the valuation assertion (whether a write-down of these assets is needed).

For Assessment Opportunity #5 (Audit and Assurance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to explain what the audit approach and materiality assessment will likely be, and discusses a few of the accounts with a higher risk of material misstatement.

Competent – The candidate explains what the audit approach and materiality assessment will likely be, and discusses some of the accounts with a higher risk of material misstatement.

Competent with distinction – The candidate thoroughly explains what the audit approach and materiality assessment will likely be, and discusses several of the accounts with a higher risk of material misstatement.

Assessment Opportunity #6 (Breadth Opportunity)

The candidate assesses the two program options, and recommends which program would be the best from a strategic standpoint.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
2.3.3	Evaluates strategic alternatives	**B**

CPA Map Enabling Competencies:
2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
5.1.1 Applies general business knowledge to enhance work performed
5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

You indicated that, based on Book It's success, you want to add another program, and need some guidance on which of the two programs you are considering is the best strategic fit for LS.

We should first note that your vision for LS is slightly different than the factors that have made GR's franchises successful. While your focus to become a pillar in the community, where learning and creating are facilitated, can help with certain aspects of GR's success factors (e.g., helping with learning provides the opportunity to build personal relationships and is a form of giving back to the community), GR has also built its success on being experts in literature. You have noted that you think you can foster learning and creating in many different ways, not just through reading. You should be careful when adding programs to ensure that you do not veer too far from literature, as this may cause you to lose focus on what makes the franchise successful.

Below is my analysis of the strategic fit of the two proposed programs.

Fit with Laura's Vision

<u>Become a pillar in the community</u>

With the donation program, donations will go to preschools and schools. Accordingly, you will have a wide reach within the community, and your bookstore will potentially become known in the community as a socially-responsible business, due to its donations.

Although the writing program will also reach out to children from the community, the reach is much more limited than with the donation program. You would only be able to reach 15 children for each four-week session.

<u>Facilitate learning</u>

The big reach of the donation program will help facilitate learning for the children who will access the books that will be bought with the donations. However, with the donation program, you will not get to choose which books the preschools and schools will purchase. With the current Book It program, you like to select the books so that they present learning opportunities. The donation program will not allow you to do that.

On the other hand, the writing program will be a good opportunity for children to learn, through your teaching of writing techniques and the stories they will be creating. Although the reach won't be as wide, you will have a direct influence on their learning journey.

<u>Facilitate creation</u>

The writing program introduces writing and creating to children, and your vision includes facilitating creating, so hosting a class of this nature would fulfill this portion of your vision. The children will develop writing skills that will serve them throughout their academic and professional careers.

The donation program will be more of a learning opportunity for the children, but not so much of a creation exercise. The donation program does not really achieve that part of your vision for LS.

Fit with GR's Key Success Factors

<u>Building personal relationships with customers</u>

With the writing program, you will meet several children through the course of the program. The children will receive one-on-one time with you, which will build personal relationships, and the children and their parents are likely to come back to the bookstore later.

The donation program, however, will not allow you to have any direct interaction with the children.

<u>Focusing on being experts in literature</u>

It is debatable whether the writing program fits with this key success factor. Being an expert in literature likely means having a good understanding of what types of books are available, and is not necessarily focused on building writing skills in children.

However, the donation program could be more in line with this key success factor, if you were to also recommend what books to purchase for the schools, as this would show the schools that you are an expert in the area.

<u>Building on the franchisee's skills</u>

As you were previously a teacher, you are already familiar with teaching children, and you understand optimal teaching techniques and how to successfully engage children. The writing program will definitely put that skill to use, as you will be directly teaching children about writing techniques.

The donation program will not be putting your teaching experience to use as there will be no direct interaction with children.

Other Considerations

You are currently working 60 hours per week and running the Book It program. Your time available for another program is likely very limited. You need to ensure that this additional program would not be at the expense of the continued growth and success of your GR location.

There is an administrative burden with implementing a donation program. You will need to ensure that there is a process to track the donation amounts. You may also want to follow up with the schools, to ensure that the funds are being used appropriately, and/or have oversight of what books are selected.

Organizing and managing a creative writing program could be even more time-consuming and require a lot of coordination. You will need to develop a curriculum, teach the sessions, and perhaps find a suitable location. This could be challenging, considering all the commitments you already have.

Recommendation

Based on the fit with LS, I recommend the writing program. Your vision for LS is to become a pillar in the community, where learning and creating are facilitated. The writing program fulfills the creating aspect of the vision as well as the learning aspect. Although the reach is smaller than with the donation program, it will likely have a greater impact on the children, resulting in better relationships, and contributing ultimately to LS's success. Finally, you will have more control over the administration of the writing program. The time commitment required might be a lot, but the hiring of a new employee for the bookstore will hopefully free up time you can reallocate to the writing program.

For Assessment Opportunity #6 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate discusses a few of the factors to consider in the programs from a strategic standpoint.

Competent – The candidate discusses some of the factors to consider in the programs from a strategic standpoint.

Competent with distinction – The candidate discusses several of the factors to consider in the programs from a strategic standpoint.

COMMON FINAL EXAMINATION
MAY 30, 2024 – DAY 3

<u>Case #3</u> **(Suggested time: 70 minutes)**

Lotoski is a Canadian law firm that specializes in corporate and real estate law. Lotoski's strategic objectives are to provide timely, effective, and confidential legal services, increase profits, build long-term relationships with existing clients, and grow the law firm's real estate customer base.

It is January 15, 2024, and Rosie Lotoski, one of the two partners at Lotoski, has hired you, CPA, as a consultant.

Lotoski was approached for two potential engagements, which would both start in March (Appendix I). Rosie has provided you with information on Lotoski's resources (Appendix II). She would like you to analyze this information, to determine whether Lotoski currently has the capacity to accept both engagements. She would also like to know which engagement is the most attractive from a quantitative perspective.

Rosie would also like to know how each of the two potential engagements aligns with Lotoski's strategic objectives. She would like you to recommend which engagement to accept, based on your analyses.

Lotoski has recently started using a new cloud platform (JH-Cloud) for storing its engagement files and client information (Appendix III). Previously, this information was stored on paper in locked filing cabinets within Lotoski's office. Rosie would like you to discuss the risks and related implications of using JH-Cloud, and recommend controls to mitigate those risks.

Also, Rosie asks for your help in providing tax advice to one of Lotoski's clients (Appendix IV).

Lotoski is doing really well and the business has extra funds available to invest. Rosie has provided you with information on potential investment opportunities and would like you to analyze them and recommend one (Appendix V). Rosie asks you to ignore any tax considerations for the purpose of this analysis.

APPENDIX I
POTENTIAL ENGAGEMENTS DETAILS

Engagement 1 – Rader Technologies Inc. (Rader)

Rader is an existing client of Lotoski, who always promptly provides documents and information needed to complete the engagements. They would like to engage Lotoski to complete legal services related to a corporate merger. The legal services must be completed within six months as this is when the merger is set to close. The engagement is estimated to take 800 hours and generate a contribution margin of $53 per hour.

Engagement 2 – Jet Incorporated (Jet)

Jet would like to engage Lotoski to complete legal services related to real estate, specifically purchasing a new condo building and selling individual units. This would be Jet's first time using Lotoski's legal services. Jordan, the owner of Jet and long-time friend of Rosie, would like the engagement completed within six months. Given Jet's rapid growth, Jordan is often busy with multiple ongoing projects. Depending on his workload, he can be hard to reach. Jet constantly has new real estate projects that require legal services, and if all goes well, plans to engage Lotoski for future services. The engagement is estimated to take 1,000 hours and generate a contribution margin of $38 per hour.

APPENDIX II
INFORMATION ON LOTOSKI'S RESOURCES

For the period of six months starting in March, Rosie estimates that, aside from the two potential new engagements, 330 direct labour hours per week will need to be allocated for work on existing client engagements. The breakdown of direct labour hours per existing engagement, by position, is below, and is expected to remain the same for the two potential engagements.

Position	Breakdown of Direct Labour Hours
Partner	15%
Associate	65%
Paralegal	20%

The partners, the associates, and the paralegals work directly on legal engagements and each work 40 hours per week. The number of people in each position is detailed below.

Position	Number of People
Partner	2
Associate	6
Paralegal	2

APPENDIX III
JH-CLOUD PLATFORM

Lotoski's engagement files and client information were scanned and transferred to JH-Cloud. JH-Cloud is accessible through a web portal from anywhere with a reliable internet connection, or through JH-Cloud's secure downloadable application. For simplicity, Lotoski accesses JH-Cloud through the web portal.

JH-Cloud has a function that gives specific access permissions to each user, based on their unique username and associated password. Lotoski currently has three unique login usernames: one shared by the two partners, one that is shared by the six associates, and one that is shared by the two paralegals. In addition, JH-Cloud is also able to track which files have been accessed, downloaded, modified, and printed by username.

Maintenance is performed on JH-Cloud when an issue arises. When maintenance occurs, the platform is inaccessible for a few hours, usually during working hours. Currently, JH-Cloud is backed up weekly.

APPENDIX IV
INFORMATION PROVIDED BY THE CLIENT

The client, Ming Lessard, bought a house as a rental property in 2013 for $325,000 ($75,000 for the land and $250,000 for the building), and rented it out for 10 years. In December 2023, Ming moved into the house. At the time of the move, the property was valued at $800,000 ($200,000 for the land and $600,000 for the building). Ming has never claimed CCA on the property.

Prior to moving into the house, Ming had been living in a cottage since 2008, when she purchased it for $150,000 ($80,000 for the land and $70,000 for the building). The cottage is now valued at $500,000 ($400,000 for the land and $100,000 for the building), and she will keep it to use on summer holidays.

Ming has never owned any homes other than these two properties. She is wondering what the tax implications of these changes are for the 2023 tax year, and for the future.

APPENDIX V
POTENTIAL INVESTMENT OPPORTUNITIES

Lotoski would like to invest $400,000 for four to five years. Lotoski has a low-to-moderate risk tolerance and expects an annual rate of return of 5% or greater.

Option 1 – Mutual Fund

Purchase units of a known mutual fund that invests mostly in shares of well-established companies. The mutual fund is rebalanced on a regular basis. The broker anticipates a value of $540,000 in five years with an initial investment of $400,000. No cash distributions are expected.

Option 2 – Guaranteed Investment Certificate (GIC)

Purchase a $400,000 three-year, non-redeemable GIC from a local bank with annual interest of $16,000, paid at the end of each year.

Option 3 – Mandatorily Redeemable Preferred Shares

Rosie's husband, Rob, owns a construction company. He incorporated it five years ago and started earning profit after two years. Rob wants to grow his company and needs financing. He is offering 40,000 preferred shares for $10 per share. The preferred shares will be bought back by Rob's company in four years for a value of $11 per share. Cumulative dividends of 2% of the initial investment will also be paid annually.

MARKING GUIDE 3-3
LOTOSKI
ASSESSMENT OPPORTUNITIES

To: Rosie Lotoski
From: CPA
Subject: Advice regarding Lotoski

Assessment Opportunity #1 (Depth and Breadth Opportunity)

The candidate assesses whether Lotoski has the capacity to accept both potential engagements, and which one is quantitatively more attractive.

The candidate demonstrates competence in Management Accounting.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
3.5.1	Performs sensitivity analysis	A
3.5.2	Evaluates sustainable profit maximization and capacity management performance	A

CPA Map Enabling Competencies:
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Capacity Calculation

In considering whether to accept both engagements, we must determine whether direct labour hours could be a constrained resource. First, I calculated the number of hours available with the current staff for each position for the period of six months over which the engagements would last, so we know Lotoski's capacity:

Position	Hours/Week	Number of Positions	Number of Weeks	Hourly Capacity for 6 Months
Partner	40	2	26	2,080
Associate	40	6	26	6,240
Paralegal	40	2	26	2,080
Total				10,400

I then calculated the number of hours needed for our current engagements, per position, for the six-month period, and compared it to the total capacity. This shows how many hours are available to take on additional work:

Position	Number of Weeks	Number of Hours per Week	% of Involvement	Hourly Requirement for Current Engagements
Partner	26	330	15%	1,287
Associate	26	330	65%	5,577
Paralegal	26	330	20%	1,716
Total				8,580

Position	Hourly Capacity for 6 Months	Hourly Requirement for Current Engagements	Hourly Capacity Available
Partner	2,080	1,287	793
Associate	6,240	5,577	663
Paralegal	2,080	1,716	364
Total	10,400	8,580	1,820

We can now calculate how many labour hours are required for each position for the two potential engagements:

Rader

Position	Total Number of Hours	% of Involvement	Hourly Requirement
Partner	800	15%	120
Associate	800	65%	520
Paralegal	800	20%	160
Total			800

Jet

Position	Total Number of Hours	% of Involvement	Hourly Requirement
Partner	1,000	15%	150
Associate	1,000	65%	650
Paralegal	1,000	20%	200
Total			1,000

Lastly, we can calculate whether Lotoski has enough capacity for the two engagements:

Position	Hourly Capacity Available	Rader Hourly Requirement	Jet Hourly Requirement	Hourly Capacity Remaining (Deficit)
Partner	793	120	150	523
Associate	663	520	650	(507)
Paralegal	364	160	200	4
Total	1,820	800	1,000	20

Lotoski does not have enough associate labour hours to accept both engagements, but it does have enough to accept either engagement on its own. However, it might be worth looking into the possibility of having the associates work overtime, as 507 hours would represent a little over three hours of overtime for each associate per week (507 hours ÷ 26 weeks ÷ 6 associates). If the associates are willing to work overtime, Lotoski could take on both engagements.

Total Contribution Margin Calculation

You also asked me which engagement is the most attractive from a quantitative perspective. I calculated the total contribution margin of each engagement to assess, quantitatively, which one is more attractive:
Rader: $53 per hour × 800 hours = $42,400
Jet: $38 per hour × 1,000 hours = $38,000

Assumption

I assumed that the workload is spread equally over the six months. However, if the workload is front heavy or back heavy, this would change the overall capacity available, and might require overtime.

Recommendation

From a purely quantitative standpoint, the Rader engagement is more attractive because it is more profitable, providing a higher hourly rate and a higher contribution margin by $4,400, compared to the Jet engagement.

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

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

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

Reaching competence – The candidate attempts to assess whether Lotoski has the capacity to accept both potential engagements, and which one is quantitatively more attractive.

Competent – The candidate assesses whether Lotoski has the capacity to accept both potential engagements, and which one is quantitatively more attractive.

Competent with distinction – The candidate thoroughly assesses whether Lotoski has the capacity to accept both potential engagements, and which one is quantitatively more attractive.

Assessment Opportunity #2 (Breadth Opportunity)

The candidate discusses the strategic fit of the two potential engagements, and recommends which one to accept.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
2.2.1	Assesses whether management decisions align with the entity's mission, vision, and values	**B**
2.3.3	Evaluates strategic alternatives	**B**

CPA Map Enabling Competencies:
2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
5.1.1 Applies general business knowledge to enhance work performed
5.1.2 Recognizes the interrelationships among departmental and functional areas within the organization
5.1.3 Develops and uses knowledge of the organization, industry and stakeholders

You asked me to discuss the alignment of the two potential engagements with Lotoski's strategic objectives.

Provide Timely, Effective, and Confidential Legal Services

Rader

Rader is an existing client and has a proven history of providing prompt responses, documents, and information needed to complete the engagements. If we accept this engagement, Lotoski can likely provide timely and effective legal services due to Rader's continuous, prompt responses.

Jet

Jet has grown rapidly; therefore, Jordan is often busy with multiple ongoing projects and can sometimes be hard to reach. If this engagement is accepted, Lotoski may struggle to provide timely and effective legal services because the firm will need to cater to Jordan's availability, which may be limited, depending on his workload.

Increase Profits

Rader

Rader is a six-month engagement with a contribution margin of $42,400, which would increase profits.

Rader is a returning client, which means they have been satisfied with Lotoski's legal services in the past. Therefore, it is likely that Rader will engage Lotoski for legal services in the future, which will in turn increase profits. If we decline this engagement, there is a chance that Rader might not be as loyal to Lotoski in the future, which will decrease expected profits.

Jet

Jet is also a six-month engagement, with a slightly lower contribution margin of $38,000. Although this contribution margin is lower than with Rader, the engagement would still increase overall profits.

Jet has experienced rapid growth and often works on multiple projects. It was noted that, if all goes well, the corporation will engage Lotoski for future legal services, which would increase profits.

Build Long-Term Relationships with Existing Clients

Rader

As noted, Rader is an existing client of Lotoski. If this engagement is accepted, Lotoski would continue to build its relationship and trust with Rader, which could lead to potential future engagements and a long-term relationship with this client.

Jet

If this engagement is accepted, this would be Lotoski's first time performing legal services for Jet, which means this engagement would not help build a long-term relationship with an existing client. However, although Lotoski has never completed work for Jet, Rosie and Jordan are long-time friends, so a foundation of trust may already be established. There is a risk, however, that the personal relationship overlaps with the professional relationship, and if things don't go as planned professionally, the personal relationship could be negatively affected.

Grow the Law Firm's Real Estate Customer Base

Rader

Rader requires legal services related to a corporate merger. Although Lotoski specializes in corporate and real estate law, this engagement would fall under corporate law, and would therefore not contribute to the growth of the law firm's real estate customer base.

Jet

Jet requires legal services related to real estate, specifically purchasing a condo building and selling individual units. This engagement would fall under real estate law, and would therefore contribute to the growth of the law firm's real estate customer base.

In addition, Jet has grown rapidly, and constantly has new real estate projects that require legal services. Assuming that all goes well, Jet is willing to engage Lotoski for these services. This provides an opportunity for many potential real estate engagements and would contribute to the growth of the law firm's real estate customer base.

Analysis and Recommendation

Per the qualitative analysis above, Lotoski should choose to accept the Rader engagement. Based on Lotoski's strategic objectives, the Rader engagement is a better strategic fit than the Jet engagement. With the Jet engagement, the firm will need to cater to Jordan's potentially limited availability, which may affect its ability to provide timely and effective legal services, whereas Rader has always provided prompt information that should allow Lotoski to provide timely and effective services to them. The contribution margin earned from the Rader engagement would increase profits slightly more than the Jet engagement, and there is strong potential for profits to be further increased by other future engagements as well. The Rader engagement would also contribute to building a long-term relationship with this existing client. Lastly, the Rader engagement may not grow the law firm's real estate customer base, but it still falls under Lotoski's expertise in corporate law, so Lotoski will likely be able to provide effective legal services.

That said, turning down one engagement over the other goes against Lotoski's strategic objective to increase profits. Although the Rader engagement aligns better with the firm's strategic objectives, the Jet engagement is also somewhat aligned, especially in terms of the type of legal services to be provided. The Jet engagement involves legal services related to real estate, and might also bring in future real-estate related engagements, which is an area that the firm wants to grow.

To be able to take on both engagements, Lotoski could consider hiring another associate, since the firm has excess capacity in terms of partner hours. These might not be full-time positions for now, as you are only a few hours short of being able to accept both engagements, but since you want to grow the real estate side of the business, they may quickly become full-time positions. This would help the overall growth of the firm and would create the opportunity for Lotoski to accept both engagements. As mentioned above, both engagements align with some of Lotoski's strategic objectives. Most importantly, accepting both engagements would increase profits further, as well as grow the firm's real estate customer base.

For Assessment Opportunity #2 (Strategy and Governance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate attempts to discuss the strategic fit of the two potential engagements.

Competent – The candidate discusses the strategic fit of the two potential engagements, and provides a recommendation.

Competent with distinction – The candidate thoroughly discusses the strategic fit of the two potential engagements, and provides a recommendation.

Assessment Opportunity #3 (Breadth Opportunity)

The candidate discusses the risks and related implications of using JH-Cloud, and recommends controls to mitigate those risks.

The candidate demonstrates competence in Audit and Assurance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
4.1.1	Assesses the entity's risk assessment processes	**A**
4.1.2	Evaluates the information system, including the related processes, using knowledge of data requirements and risk exposures	**B**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions

Security

Risk: JH-Cloud is accessible through a web portal. There is a risk that hackers, identity thieves, competitors, or people with business or social relations with your clients could access Lotoski's records using the web portal.

Implication: Unauthorized third parties may be able to access information and data that they are not entitled to, or could modify data without permission. Because one of Lotoski's strategic objectives is to provide confidential legal services, this could damage the firm's reputation and potentially lead to lawsuits against Lotoski, if confidential information is accessed by unauthorized parties. This could also damage client relationships.

Recommendation: Lotoski should have physical and logical controls in place, such as firewalls, multi-factor identification, strong passwords, and access logs that are regularly reviewed. In addition, the web portal should only be accessed through a secure virtual private network (VPN). Lotoski should also consider using the JH-Cloud downloadable application, which would be more secure than the web portal.

Confidentiality

Risk: Only one username and password is used for the two partners, one username and password is shared by all associates, and one username and password is shared by all of the paralegals. As specific access permissions are based off the shared usernames for each position, there is a risk that an unauthorized employee could access confidential information stored in JH-Cloud.

Implication: Confidential information and data could be accessed by employees who do not need access to it, and it could be leaked. Lotoski would be liable if this information was accessed without the clients' consent. In addition, although JH-Cloud is able to track which files have been accessed, downloaded, modified, and printed, this information is tracked by the shared usernames. Therefore, you would not be able to determine which associate accessed which files. This would damage Lotoski's reputation of providing legal services with guaranteed confidentiality, and could damage client relationships.

Recommendation: Lotoski should have controls to prevent unauthorized access by employees. Each employee should be provided with a separate username and password that grants specific access permissions, based on the individual employee. This will ensure that employees can only access information they have been given permission to, which will limit the risk of breached confidentiality. It would also allow Lotoski to identify who accessed the information, in case of a leak.

Availability During Maintenance

Risk: Maintenance requires the platform to be inaccessible for a few hours. This typically takes place during working hours; therefore, there is a risk that JH-Cloud (file engagements data, client information, etc.) will not be available for a few hours during the work week.

Implication: Being unable to access file engagement data and client information during standard working hours would create inefficiencies with engagements, and may cause Lotoski to struggle to meet deadlines. Employees may not be able to access information needed or requested during calls or meetings with clients, which could potentially damage Lotoski's reputation for timely and effective service, and would undermine the trust clients have in Lotoski.

Recommendation: Lotoski should ensure that maintenance is scheduled overnight (not during business hours). This would prevent, or at least reduce, inefficient time spent without access to JH-Cloud during standard working hours.

Frequency of Maintenance

Risk: Maintenance on the platform is performed only when an issue arises and not on a regular basis.

Implication: If maintenance is not performed proactively and regularly, there could be issues with the platform creating bugs and errors. The platform could also be more vulnerable to intrusions and hacking and stealing of confidential information. This could also impact Lotoski's operations and the effectiveness of the legal services, for example, with the platform being inaccessible for employees until maintenance is performed.

Recommendation: Lotoski should create a maintenance schedule (for example, every two weeks). Performing maintenance proactively instead of reacting to issues as they occur would reduce the number of issues occurring, as maintenance would be performed regularly and should detect any bugs or errors, thereby ensuring that Lotoski provides timely and effective legal services.

Backup

Risk: The information is only backed up once a week. There is a risk that the platform may crash, and Lotoski might lose data and information because it cannot be recovered if JH-Cloud had not been backed up recently.

Implication: This would create inefficiencies, as lost work would need to be completed again. Documents may need to be requested from clients again, which could irritate the client and damage the relationship. This could also create issues with meeting deadlines.

Recommendation: If possible, Lotoski should update the preferences of JH-Cloud so that the file engagement data and client information are being backed up daily, or when the data or information is changed. This will ensure that the information could always be recovered if the platform were to crash, and reduces the risk of having to complete the work again.

Internet Connection

Risk: A reliable internet connection is required for the platform to be used. There is a risk that you may not be able to access the JH-Cloud if your internet connection is unreliable. As Lotoski's file engagement data and client information is accessed through JH-Cloud, there may be problems accessing the information during working hours.

Implication: Being unable to access file engagement data and client information during standard working hours would create inefficiencies with engagements, and Lotoski may struggle to meet deadlines or obtain information when needed. In the past, Lotoski kept local copies of engagement data and client information, so staff had access regardless of the internet connection status. Therefore, clients have never experienced delays due to lack of internet connection, which could potentially damage Lotoski's reputation for timely service.

Recommendation: It is necessary to have a reliable internet connection when using the cloud platform to store data and information. To mitigate the risk of an unreliable internet connection, you could investigate replacing your modem, router, or internet provider, to ensure a more reliable connection.

Conversion from Paper Files to JH-Cloud

Risk: Lotoski has recently started using the JH-Cloud platform, and the engagement file data and client information were recently scanned and transferred to JH-Cloud. There is a risk that data was not completely or accurately scanned and transferred, either due to human error or issues with the electronic scanning and/or transfer processes.

Implication: If some data was missed during the scanning process, was not accurately scanned (e.g., the scan was blurry or only included partial pages), or was lost or corrupted during transmission, the engagement file data and client information in JH-Cloud could be incomplete or inaccurate. If the original paper copies are not retained for a period of time, it is possible that such information may be lost forever. This could seriously damage Lotoski's reputation for providing timely and effective legal services, and could hamper the firm's ability to actually perform those services.

Recommendation: After each file is transferred to JH-Cloud, a different employee should verify that all data was completely and accurately transferred by comparing the paper version with the electronic version in JH-Cloud. Any issues with scanning or transmission could then be rectified immediately while the paper version is still available. It is also recommended that the paper version be retained for a period of time (at least one year) so that, if missing data is identified, it can still be retrieved from the paper copy.

For Assessment Opportunity #3 (Audit and Assurance), the candidate must be ranked in one of the following five categories:

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

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

Reaching competence – The candidate discusses some of the risks and implications of using JH-Cloud or recommends some controls to mitigate those risks.

Competent – The candidate discusses some of the risks and implications of using JH-Cloud and recommends some controls to mitigate those risks.

Competent with distinction – The candidate discusses several of the risks and implications of using JH-Cloud and recommends several controls to mitigate those risks.

Assessment Opportunity #4 (Breadth Opportunity)

The candidate explains the tax implications of the changes in Ming's situation for 2023, and for the future.

The candidate demonstrates competence in Taxation.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
6.3.2	Evaluates income taxes payable for an individual	**B**

CPA Map Enabling Competencies:
6.1.1 Identifies and articulates issues within areas of work responsibility
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.3 Applies decision criteria to choose among viable alternatives

You asked me to explain the tax implications of your client Ming's real estate transactions. There are implications due to the change of use of both the rental property, which became a principal residence, and of the previous principal residence, which will now become a secondary residence.

Tax Implications for 2023

Because the property was used as a rental property and is now a principal residence, Ming has changed the use of her property, and this triggers tax consequences. Ming will be considered to have sold the property at its fair market value and immediately reacquired it for the same amount. This will trigger a capital gain in the year the change of use occurred, which is 2023. I have calculated the capital gain below:

<u>Building</u>

Proceeds of disposition (fair market value)	$ 600,000
Capital cost	$(250,000)
Capital gain	$ 350,000

<u>Land</u>

Proceeds of disposition	$ 200,000
Capital cost	$ (75,000)
Capital gain	$ 125,000

Therefore, a total taxable capital gain of $237,500 (($350,000 + 125,000) × 50%) will need to be included in her income. The new cost basis for Ming will be the fair values, being $600,000 for the building and $200,000 for the land.

Alternatively, since she is converting the property from income-producing to principal residence use and has never claimed CCA, Ming can elect under ss. 45(3) of the Income Tax Act to defer the deemed disposition. Under that election, which must be filed by the due date of her tax return for the year in which the property is actually sold, she can choose to treat the deemed disposition as not taking place. If she makes this election, when she eventually sells the property, she will calculate the gain using the original cost basis, and will be able to claim the principal residence exemption for any years that she actually resided there plus up to four additional years (i.e., 2019 through 2022) before she resided there (even though it was rented during that time).

Future Tax Implications

Regardless of whether a ss. 45(3) election is made, when Ming does sell one of her two properties, she will have some decisions to make that will have consequences on the taxes she pays. First, she will have to designate which one of her residences is her principal residence, on a year-by-year basis. For 2008 through 2018, the cottage will be her principal residence, as no other property would qualify. However, for each year after 2018, she will get to decide which one of her residences is her principal residence. Even though she only lives part-time at the cottage, this is sufficient for meeting the definition of principal residence, as long as the property is "ordinarily inhabited" by her.

It will make the most sense to use the principal residence exemption on the property with the highest capital gain per year. Assuming that the properties will continue to grow in value at a similar pace to what they have in the past, this is likely to be the house. The gain per year on the house was ($800,000 - $325,000) ÷ 11 years = $43,182, and on the cottage was ($500,000 - $150,000) ÷ 16 = $21,875. However, Ming will not have to make this decision until the first of the two properties is sold. In all cases, at least one year should be allocated to each property, as the formula for the principal residence exemption adds one to the number of years claimed, meaning that Ming can designate one year less than the total years owned and still receive a full exemption.

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

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

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

Reaching competence – The candidate explains a few of the tax implications from the changes in Ming's situation.

Competent – The candidate explains some of the tax implications from the changes in Ming's situation.

Competent with distinction – The candidate explains several of the tax implications from the changes in Ming's situation.

Assessment Opportunity #5 (Breadth Opportunity)

The candidate quantitatively and qualitatively assesses the investment options.

The candidate demonstrates competence in Finance.

CPA Map Technical Competencies (based on the 2022 CPA Competency Map)		**Core**
5.2.2	Evaluates the entity's investment portfolio	**B**

CPA Map Enabling Competencies:
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives
7.1.2 Communicates non-complex financial information logically, clearly, concisely

Lotoski would like to invest $400,000 of extra funds for four to five years. I have calculated the rate of return for the three investment options. I have also discussed the risks and any other considerations for the investment options. Please note that any tax considerations have been ignored for the purpose of this analysis, as requested.

Option 1: Mutual Fund

<u>Rate of return</u>

Initial Investment	$400,000.00	
Term	5 years	
Future value	$540,000.00	
Rate of return	6.19%	= RATE(NPER=5, PMT=0, PV=$400,000, FV=($540,000), TYPE=0)
Annual return	$24,743.50	

The annual rate of return is 6.19%, which is greater than the 5% that Lotoski is expecting.

Risks and other considerations

This investment appears to align with Lotoski's low-to-moderate risk tolerance. A mutual fund invests in a multitude of companies, which diversifies the risk. This specific mutual fund invests mostly in established companies, which would have profits and cash flow available to distribute. Although the broker anticipates a value of $540,000 in five years, the stock market tends to fluctuate; therefore, there is no guarantee on the value in five years. For example, companies' equity value can decline in times of economic downturn or uncertainty. However, the mutual fund is also rebalanced regularly. When the stock portfolio is rebalanced, the portfolio is adjusted to match the level of return and amount of risk targeted by the mutual fund. Therefore, the overall risk related to the mutual fund option would be considered low to moderate.

The invested funds, plus any related proceeds, can be accessed at any time. That said, the value of proceeds may differ depending on the withdrawal date. Lotoski is looking to invest the funds for four to five years. The term of this investment is five years; therefore, it is within the timeline.

Option 2: GIC

Rate of return

Initial Investment	$400,000.00	
Rate of return	4.00%	= RATE(NPER=3, PMT=($16,000), PV=$400,000, FV=($400,000), TYPE=0)
Annual return	$16,000.00	

The annual rate of return is 4%, which is less than the 5% that Lotoski is expecting.

Risks and other considerations

This investment has low risk involved, as the interest of 4% annually is promised by the local bank and the principal is guaranteed by CDIC (Canadian Deposit Insurance Corporation), as is the case for all GICs. Non-redeemable GICs cannot be cashed in before the maturity date. Therefore, the original investment cannot be accessed for three years. That said, Lotoski wishes to invest the funds for four to five years, so this option is well within the timeline. However, this option would only produce returns for three of the four to five years that Lotoski wants to invest for. To help reduce the gap between the GIC timeline and the desired timeline, the annual interest and the capital available at the end of the three-year term could be invested in a short-term GIC of a year or two, to produce some interest. Short-term GICs tend to offer a lower rate of return, so it would likely not be high enough to make up for the 4% return of the first three years, to meet the 5% required return.

Option 3: Mandatorily-Redeemable Preferred Shares

Rate of return

Initial Investment	$400,000.00	
Term	4 years	
Future value	$440,000.00	
Annual dividend	$8,000.00	
Rate of return	4.34%	= RATE(NPER=4, PMT=($8,000), PV=$400,000, FV=($440,000), TYPE=0)
Annual return	$17,371.63	

The annual rate of return is 4.34%, which is less than the 5% that Lotoski is expecting.

Risks and other considerations

This investment has moderate risk involved. The mandatorily-redeemable preferred shares include a legal obligation for Rob's company to buy back the shares after four years, at the indicated value. However, his company is only five years old, and although it has earned profits in the last three years, it would still be considered a new business and may not be successful in the future. In other words, there is no guarantee that the new business will have the funds available to buy back the shares in four years at the indicated value.

Lotoski would receive cash dividends of $8,000 annually, but the remaining funds plus other profits would be inaccessible until the shares are redeemed. Lotoski wants to invest the funds for four to five years, so this option is within the timeline.

Recommendation

Based on the above analysis, I recommend that Lotoski invest the $400,000 in units held within a known mutual fund (Option 1). The anticipated rate of return of the investment is 6.19%, which is greater than the expected 5%. In addition, it matches the risk tolerance of low to moderate. Although the stock market tends to fluctuate, the mutual fund invests in established companies, which means the stock investment is more likely to earn returns, and the stock portfolio is rebalanced on a regular basis.

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

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

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

Reaching competence – The candidate attempts to analyze the investment options.

Competent – The candidate analyzes the investment options and provides a recommendation.

Competent with distinction – The candidate thoroughly analyzes the investment options and provides a recommendation.

APPENDIX E

RESULTS BY ASSESSMENT OPPORTUNITIES FOR DAY 2 AND DAY 3
(FOR ALL WRITERS)

THE LEVEL 2 DEPTH TEST
(DAY 2 AND DAY 3–ALL WRITERS)

Financial Reporting:		**NA**	**NC**	**RC**	**C**	**CD**	**C+CD**
Day 2 Common							
AO1	**Warranty**	1%	16%	49%	32%	2%	**34%**
AO2	**Restructuring costs**	3%	19%	36%	38%	4%	**42%**
AO3	**Cash and cash equivalents**	2%	24%	32%	40%	2%	**42%**
Day 3 – Q1 BB							
AO6	**Inventory**	2%	10%	21%	65%	2%	**67%**
Day 3 – Q2 GR							
AO1	**Government assistance**	1%	17%	42%	35%	5%	**40%**
AO2	**Franchise fee**	7%	22%	37%	30%	4%	**34%**

Management Accounting:		**NA**	**NC**	**RC**	**C**	**CD**	**C+CD**
Day 2 Common							
AO4	**Giftware line**	3%	9%	41%	43%	4%	**47%**
AO5	**Privacy and data security**	3%	10%	31%	52%	4%	**56%**
AO6	**Victoria store**	6%	11%	25%	55%	3%	**58%**
Day 3 – Q1 BB							
AO1	**Breakeven**	1%	4%	22%	67%	6%	**73%**
Day 3 – Q2 GR							
AO4	**Budget**	7%	7%	37%	38%	11%	**49%**
Day 3 – Q3 Lotoski							
AO1	**Capacity for engagements**	1%	22%	55%	17%	5%	**22%**

THE LEVEL 3 DEPTH TEST – ROLE
(DAY 2-ALL WRITERS)

Audit and Assurance		Papers	NA	NC	RC	C	CD	C+CD
AO7	**Bond investments**	1080	6%	36%	30%	25%	3%	**28%**
AO8	**Audit plan**	1080	1%	18%	35%	44%	2%	**46%**
AO9	**Procedures - financial reporting issues**	1080	2%	33%	25%	38%	2%	**40%**
AO10	**Data analytics procedures – benefits and application**	1080	4%	37%	33%	25%	1%	**26%**
AO11	**Internal controls**	1080	1%	32%	30%	36%	1%	**37%**
AO12	**Use of an expert**	1080	1%	25%	31%	40%	3%	**43%**
AO13	**Procedures - compliance**	1080	2%	31%	25%	39%	3%	**42%**

Finance		Papers	NA	NC	RC	C	CD	C+CD
AO7	**NPV analysis**	181	1%	9%	29%	59%	2%	**61%**
AO8	**Distribution centre offer price**	181	2%	6%	55%	31%	6%	**37%**
AO9	**Financing options**	181	2%	8%	16%	56%	18%	**74%**
AO10	**YNJ asset-based valuation**	181	2%	11%	44%	34%	9%	**43%**
AO11	**Hedging alternatives**	181	4%	14%	41%	40%	1%	**41%**
AO12	**Gold order quantity**	181	14%	21%	34%	30%	1%	**31%**
AO13	**Investable funds**	181	16%	13%	35%	33%	3%	**36%**

THE LEVEL 3 DEPTH TEST – ROLE (DAY 2–ALL WRITERS)

Performance Management		Papers	NA	NC	RC	C	CD	C+CD
AO7	**Lab-grown diamonds - pricing**	696	0%	7%	38%	54%	1%	**55%**
AO8	**Lab-grown diamonds - qualitative**	696	2%	5%	19%	73%	1%	**74%**
AO9	**Virtual store**	696	0%	10%	39%	49%	2%	**51%**
AO10	**Flagship store allocations**	696	3%	27%	33%	36%	1%	**37%**
AO11	**Salespeople KPI**	696	1%	7%	57%	34%	1%	**35%**
AO12	**Diamond-tracking technology**	696	2%	6%	34%	58%	0%	**58%**
AO13	**Strategy vs initiatives**	696	5%	15%	16%	62%	2%	**64%**

Taxation		Papers	NA	NC	RC	C	CD	C+CD
AO7	**Residence**	94	0%	7%	29%	62%	2%	**64%**
AO8	**Tax administration**	94	3%	19%	40%	35%	3%	**38%**
AO9	**Corporate taxable income (quantitative)**	94	2%	7%	28%	59%	4%	**63%**
AO10	**Corporate taxable income (qualitative)**	94	3%	26%	34%	32%	5%	**37%**
AO11	**Corporate taxes payable**	94	4%	21%	36%	37%	2%	**39%**
AO12	**Personal taxable income**	94	4%	11%	31%	53%	1%	**54%**
AO13	**Personal taxes payable**	94	10%	18%	36%	33%	3%	**36%**

THE LEVEL 4 BREADTH TEST
(DAY 2 AND DAY 3, BY COMPETENCY AREA, ALL WRITERS)

Financial Reporting:		NA	NC	RC	C	CD	RC+C+CD
Day 2 Common							
AO1	**Warranty**	1%	16%	49%	32%	2%	**83%**
AO2	**Restructuring costs**	3%	19%	36%	38%	4%	**78%**
AO3	**Cash and cash equivalents**	2%	24%	32%	40%	2%	**74%**
Day 3 – Q1 BB							
AO6	**Inventory**	2%	10%	21%	65%	2%	**88%**
Day 3 – Q2 GR							
AO1	**Government assistance**	1%	17%	42%	35%	5%	**82%**
AO2	**Franchise fee**	7%	22%	37%	30%	4%	**71%**

Management Accounting:		NA	NC	RC	C	CD	RC+C+CD
Day 2 Common							
AO4	**Giftware line**	3%	9%	41%	43%	4%	**88%**
AO5	**Privacy and data security**	3%	10%	31%	52%	4%	**87%**
AO6	**Victoria store**	6%	11%	25%	55%	3%	**83%**
Day 3 – Q1 BB							
AO1	**Breakeven**	1%	4%	22%	67%	6%	**95%**
Day 3 – Q2 GR							
AO4	**Budget**	7%	7%	37%	38%	11%	**86%**
Day 3 – Q3 Lotoski							
AO1	**Capacity for engagements**	1%	22%	55%	17%	5%	**77%**

THE LEVEL 4 BREADTH TEST
(DAY 2 AND DAY 3, BY COMPETENCY AREA, ALL WRITERS)

Strategy and Governance		NA	NC	RC	C	CD	RC+C+CD
III-1 AO2	**Critique goals / metrics**	2%	10%	37%	46%	5%	**88%**
III-2 AO6	**Strategic fit of options**	9%	13%	28%	41%	9%	**78%**
III-3 AO2	**Strategic fit of engagements**	2%	9%	31%	51%	7%	**89%**

Audit and Assurance		NA	NC	RC	C	CD	RC+C+CD
III-1 AO5	**Compilation vs review**	3%	12%	36%	46%	3%	**85%**
III-2 AO5	**Materiality, approach, and risk on accounts**	2%	18%	27%	43%	10%	**80%**
III-3 AO3	**Risk and controls JH-Cloud**	2%	5%	27%	53%	13%	**93%**

Finance		NA	NC	RC	C	CD	RC+C+CD
III-1 AO3	**Cash flow**	6%	5%	41%	44%	4%	**89%**
III-1 AO4	**Financing options**	3%	17%	35%	43%	2%	**80%**
III-3 AO5	**Investment options**	3%	18%	36%	36%	7%	**79%**

Taxation		NA	NC	RC	C	CD	RC+C+CD
III-1 AO7	**Expense deductibility**	3%	19%	37%	39%	2%	**78%**
III-2 AO3	**Corporate taxes payable**	3%	5%	35%	44%	13%	**92%**
III-3 AO4	**Change of use**	5%	33%	40%	17%	5%	**62%**

APPENDIX F

BOARD OF EXAMINERS' COMMENTS ON DAY 2 AND DAY 3 SIMULATIONS

BOARD OF EXAMINERS' COMMENTS ON DAY 2 SIMULATION

Paper/Simulation: **Day 2, Common Role (Fancy)**

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Management Accounting (3); Financial Reporting (3)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (Warranty)

Candidates were asked to discuss the financial reporting treatment of Fancy's warranty program. Candidates were given specific information regarding Fancy's warranty program in Appendix III (Common). Candidates were also given industry information regarding warranties, such as the market price of a lifetime warranty and common claim periods, in Appendix I (Common). To demonstrate competence, candidates were expected to provide a reasonable analysis of the accounting treatment, using Handbook guidance and case facts to support their discussion. Candidates were expected to use case facts to determine that Fancy's warranty would constitute a service warranty. Candidates were then expected to conclude that there were two performance obligations present in each sale under the program, and to appropriately record the portion of the sale relating to the warranty as deferred revenue.

Candidates struggled with this AO. Many candidates did not recognize that there are different types of warranties under *IFRS 15 Revenue from contracts with customers*, and thus did not recognize that a warranty's financial reporting treatment is dependent on its type. Other candidates, who identified the different types of warranties, had difficulty applying case facts to the specific Handbook section that dealt with warranties, or incorrectly assumed that Fancy's customers had the option to purchase the warranty separately; since a lifetime product guarantee was included in every sale, this was not the case. Of the candidates who identified that customers did not have an option to purchase the warranties separately, many analyzed the issue under *IAS 37 Provisions, Contingent Liabilities, and Contingent Assets*, despite the guidance in IFRS 15, Appendix B, paragraph B30, stating that it was first necessary to determine if the warranty provided the customer with a service, which was the case for Fancy, given the time frame of the warranty offered and types of services included. Despite their unfamiliarity with the types of warranties described under IFRS 15, candidates were generally able to correctly conclude that there would be two distinct performance obligations present in each sale, and that a portion of the sale should be deferred. These candidates were able to provide a reasonable calculation of how to allocate the revenue, using the market price of 7% for extended lifetime warranties.

Strong candidates recognized that different types of warranties exist, and included case facts, such as the length of the warranty coverage and the types of services Fancy provides under its warranty program, to support which type of warranty the new warranty program would represent. Strong candidates typically recognized that, since the warranty contained service elements and Fancy's customers did not have the option to purchase the warranty separately, the warranty should be recognized as a separate single performance obligation. These candidates were also more likely to recognize that the warranty program was started in October 2023, and pro-rated their adjustments to revenue as a result.

Weak candidates were more likely to perform their analysis using IAS 37, which limited their discussions, as they did not recognize that there were two performance obligations in each sale of diamond jewellery. As a result, these candidates were more likely to incorrectly conclude that the entire diamond jewellery sales of $8,660,000 should be recorded as revenue, with a separate amount being recorded as a provision, or that the entire sales should be deferred as a provision, despite the fact that the performance of one of the obligations (i.e., the initial sale of the jewellery) was clearly satisfied. Weak candidates were also less likely to integrate case facts from other parts of the simulation, such as the typical 7% cost for lifetime warranties that could be used to perform the allocation of the performance obligations. Many weak candidates incorrectly assumed that all criteria used to assess whether a warranty would be a service-type or assurance-type needed to be met, when in fact only one of the criteria needed to be met in order for a warranty to be considered a service-type warranty.

AO#2 (Restructuring costs)

Candidates were asked to discuss the financial reporting treatment for Fancy's management terminations. Candidates were given specific information regarding the management terminations in Appendix III (Common). To demonstrate competence, candidates were expected to provide a reasonable analysis of the accounting treatment, using Handbook guidance and case facts to support their discussion. Candidates were expected to analyze the various termination costs, using specific guidance in *IAS 37 Provisions, Contingent Liabilities and Contingent Assets,* and conclude on which of the costs should be included in the restructuring provision previously recorded.

Candidate performance on this AO was mixed. Candidates were generally comfortable assessing the need for a provision, using the general IAS 37 criteria, but were less comfortable using the specific criteria related to restructuring, to discuss the different costs. While most candidates were able to find the appropriate Handbook section with which to analyze the issue, some candidates attempted to use *IAS 19 Employee Benefits,* to analyze the issue. While IAS 19 can be applicable for some costs in this AO (e.g., severance costs), for the other restructuring costs, IAS 19 references back to IAS 37 for analysis. Candidates who used IAS 19 for their analysis typically did not use IAS 37, and as a result, could not analyze some of the costs appropriately.

Strong candidates were more likely to assess the individual costs comprising the previously recorded restructuring provision, and question whether each of the costs should be included, using IAS 37, paragraphs 80 and 81. Strong candidates were more likely to support their rationale for certain costs being included by discussing whether these costs are directly related to the restructuring of the entity via the elimination of the assistant manager positions. These candidates were also more likely to bring in multiple case facts, to support their conclusion that the management terminations would constitute a constructive obligation under IAS 37, paragraph 72.

Weak candidates were more likely to conclude on whether the initial accounting treatment of the management terminations as a restructuring provision liability was correct, and did not recognize that some of the costs included in the provision would not qualify for inclusion. These candidates were less likely to assess whether the costs would constitute a constructive obligation under IAS 37, paragraph 72, and instead used the general IAS 37 recognition criteria in their analysis, or focused their use of case facts on the timing of the costs rather than on their nature. Weak candidates who attempted to discuss some of the specific costs were more likely to try to apply general provision criteria to the costs, limiting the usefulness of their discussion, or to simply conclude that certain costs should, or should not, be included without linking case facts to the appropriate Handbook section.

AO#3 (Cash and cash equivalents)

Candidates were asked to discuss the financial reporting treatment of Fancy's cash and cash equivalents account. Candidates were given specific information regarding the various items currently recorded in cash and cash equivalents in Appendix III (Common). To demonstrate competence, candidates were expected to provide a reasonable analysis of the accounting treatment of the various items recorded in cash and cash equivalents, using Handbook guidance and case facts to support their discussion. Candidates were expected to analyze several of the items, using specific guidance from *IAS 7 Statement of Cash Flows*, and conclude on the appropriate treatment for each.

Candidate performance on this AO was mixed. While most candidates were able to find the appropriate guidance in IAS 7, many struggled to apply the criteria to case facts, to assess the various items recorded in cash and cash equivalents. For example, while most candidates were comfortable applying case facts to the guidance around length of maturity, they were less comfortable applying case facts to concepts such as liquidity or risk of changes in value. Candidates often used the same criteria to assess multiple accounts, even if those criteria were not the most relevant. For example, candidates often used only the period of maturity to assess the treatment of the money market funds, which contained features that needed to be assessed in addition to its maturity date, such as the redeemable-on-demand feature, or the risk of changes in value as a result of the 2% to 7% range in annual returns.

Strong candidates discussed several of the items recorded in cash and cash equivalents in depth by applying case facts to various Handbook criteria. For example, strong candidates were more likely to discuss whether the expected returns on the money market funds would constitute an insignificant change in value, or to discuss the contractual requirements of maintaining a certain balance when discussing restricted cash. Strong candidates were also more likely to use the guidance found in IAS 7, paragraph 8, to support their discussions of why the bank overdraft should be classified as cash. Strong candidates were also more likely to provide valid conclusions on their treatment of the items, such as recommending that restricted cash be disclosed separately.

Weak candidates were more likely to use an inappropriate Handbook section to assess the items recorded in cash and cash equivalents, such as *IFRS 9 Financial Instruments,* or the Handbook's conceptual framework. Weak candidates who did identify the correct Handbook section often struggled to explain their conclusions, for example, by stating that the overdraft should be classified as cash because it was a cash account. Other weak candidates demonstrated confusion regarding the maturity threshold for cash equivalents, assuming that the threshold was three months from year end instead of three months from the date of acquisition, or stating that the threshold is one year from the date of acquisition. Weak candidates were also less likely to conclude appropriately after discussing an item.

AO#4 (Giftware line)

Candidates were asked to critique and revise a quantitative analysis for a new line of giftware items, and to provide a qualitative analysis and recommendation on whether to proceed with this proposal. Candidates were given specific information regarding the giftware line proposal in Appendix IV (Common). To demonstrate competence, candidates were expected to propose several adjustments to the quantitative analysis, provide a reasonable discussion of valid qualitative considerations, and recommend whether Fancy should move forward with the giftware line.

Candidate performance on this AO was mixed. While most candidates proposed some adjustments to Taylor's calculation, such as travel and marketing costs, many candidates struggled with how to treat less obvious adjustments, such as the leasehold improvement costs or Taylor's non-incremental salary. Very few candidates integrated case facts from elsewhere in the simulation in their quantitative analysis, such as including sales commission or recognizing that Fancy would experience different margins on sales of the other in-store products. Most candidates provided a reasonably thorough qualitative analysis, often commenting on the capacity of Fancy's stores to offer these new products, or the proposed outsourcing of giftware distribution and warehousing. Most candidates provided a supported recommendation of whether Fancy should move forward with the giftware line.

Strong candidates included a number of adjustments in their revision of Taylor's quantitative analysis, such as adding the costs of the leasehold improvements, and understanding that, since Taylor's salary would be incurred regardless of whether Fancy offered the line, it should not be included. While strong candidates were more likely to adjust for sales commission or the different variable costs of distribution, very few candidates did this overall, especially not for the adjustment to the cost of goods sold. Strong candidates were more likely to provide a complete and balanced discussion of the qualitative considerations, often using case facts that demonstrated integration with other parts of the simulation, such as commenting on the giftware line's alignment with Fancy's strategy, or the competition present in the industry.

Weak candidates struggled to make adjustments to Taylor's quantitative analysis, and often only adjusted for the travel or marketing costs, despite there being a number of other adjustments that could have been made. Other weak candidates had errors in their adjustments, such as including the entire cost of the leasehold improvements in their one-year analysis, which suggested the costs would occur annually despite the fact that these costs would be incurred once and the improvements would last for five years. Weak candidates often prepared their analysis for what appeared to be the four stores in total, but then brought in costs for only one store, or included costs that were not incremental to the giftware line, such as the total annual marketing costs and Taylor's salary. The qualitative discussions of weak candidates were also more likely to focus on explanations of their assumptions in their quantitative analysis, or did not include explanations of the implications of the points raised, and as a result, had less depth.

AO#5 (Privacy and data security)

Candidates were asked to analyze Fancy's privacy and data security practices, and describe what changes are necessary. Candidates were given specific information regarding Fancy's customer data collection practices in Appendix IV (Common). To demonstrate competence, candidates were expected to identify several issues related to Fancy's existing privacy and data security practices, discuss the implications to Fancy of the issues identified, and provide recommendations that would address each of the issues.

Candidates performed well on this AO. Most candidates discussed a number of the privacy and data security issues presented, and provided good depth in their responses as they were able to discuss the implications and solutions for each of the issues identified. Candidates were most comfortable discussing the length of time data was stored on local hard drives, various employees' access to Fancy's customer records and central database, and Fancy's practice of printing and retaining hard copies of customer transactions.

Strong candidates used a structured approach when responding to Daiki's request, clearly explaining the weakness and implication of each issue identified, and proposing an action to resolve each issue. Strong candidates discussed a greater number of issues, and were more likely to tailor their recommendations to the specific implications noted. In addition to the issues discussed by most candidates, strong candidates were more likely to comment on the necessity of the data collected by Fancy, and whether customers had consented to its collection.

Weak candidates were less specific when discussing the privacy and data security issues they identified, often making generic statements such as "data could be hacked" when attempting to discuss the implications of a weakness, or providing recommendations that simply incorporated jargon such as "firewall" and "cyber security" and did not resolve the weaknesses identified. Other weak candidates recommended actions already performed by Fancy, or recommended unreasonable actions, such as proposing that salespeople not be allowed to enter customer information. Some weak candidates focused their discussions on operational concerns rather than on privacy and data security issues, for example, by noting the cost of printing hard copies or commenting on the internal controls surrounding the accuracy of the data collected. Many candidates appeared confused about certain aspects of Fancy's technology infrastructure, such as how data was uploaded and stored on the cloud.

AO#6 (Victoria store)

Candidates were asked to perform a quantitative and qualitative analysis, to determine whether Fancy should close its Victoria store. Candidates were given information regarding the financial results for the Victoria store in Appendix IV (Common), as well as additional information relevant to its continued operation or closure. To demonstrate competence, candidates were expected to calculate the incremental cost savings of closing the store, provide a discussion of valid qualitative considerations, and recommend whether to close the store.

Candidates performed reasonably well on this AO. Most candidates were able to identify several areas of incremental cost savings if the Victoria store was closed, such as the in-store wages, maintenance, and IT support costs. In addition, candidates generally included in their calculations the costs that would remain if the store was closed, including those relating to head office, the store manager, and a portion of the marketing costs. While most candidates were able to correctly identify the portion of sales expected to transfer to Fancy's Vancouver store, many candidates did not factor in the associated cost of goods sold, rendering such adjustments incomplete. Most candidates incorporated the incremental revenue that would arise from subleasing the location; however, most did not comment on the one-time nature of the moving and severance costs. Most candidates provided a reasonable discussion of qualitative considerations, often commenting on the impact to employee morale, the validity of the assumption of sales driven to the Vancouver store, or the impact on Fancy's reputation. In addition, most candidates provided a recommendation of whether Fancy should close the store, although not all candidates supported their recommendations.

Strong candidates typically used an incremental approach to calculating the cost savings if the Victoria store closed, often by using the 2023 financial results as a starting point, and adjusting each line item for costs that would either be saved or would remain. This helped strong candidates perform a greater number of adjustments, and reduced the likelihood that they would become confused about whether the cost would be saved or would remain. The qualitative discussions of strong candidates were more likely to integrate case facts from elsewhere in the simulation, such as the fact that Fancy has remained profitable by closing underperforming stores, or noting the opportunity for competitors to expand into the area.

Weak candidates were more likely to use an unstructured approach to the calculations, often starting with operating income and adding and subtracting adjustments identified. While not incorrect, this approach often led to conceptual errors, since candidates often appeared confused about whether a cost would be a savings to Fancy or would continue to be incurred. Other weak candidates attempted to normalize the Victoria store's operating income, which did not respond to the request by Daiki, as this approach assumed the store would remain open. Weak candidates were less likely to support the qualitative considerations identified with full thoughts, and were more likely to provide an implied recommendation rather than a supported one.

Paper/Simulation: **Day 2, Assurance Role (Fancy)**

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Audit and Assurance (7)

Evaluators' comments by Assessment Opportunity (AO)

AO#7 (Bond investments)

Candidates were informed that Steven is looking at investing in one of two bond issues by Karat Co., and candidates were asked to advise on the appropriate financial reporting treatment for each bond alternative, including the financial statement impact. Additional details on the two bonds were provided in Appendix V (Assurance). To demonstrate competence, candidates were expected to discuss the financial reporting treatment of the two different bonds, using Handbook guidance and case facts to support their discussion. Candidates were expected to analyze the two bonds, using specific guidance in *IFRS 9 Financial Instruments,* and conclude on the appropriate treatment for each.

Candidates struggled with this AO. Many candidates demonstrated technical weaknesses in their analysis by not identifying the relevant Handbook guidance, or not identifying that there is specific guidance for the classification and measurement of financial assets within the Handbook section. Many candidates described the financial statement impact of the bond with fixed interest; however, candidates were often unable to identify and discuss the key difference between the two bonds: the nature of the interest received, and the related impact on the financial reporting treatment.

Strong candidates demonstrated the technical knowledge required to assess this issue by identifying relevant Handbook criteria for classification of financial assets, and attempting to apply the case facts specific to the fixed-interest bond. Strong candidates typically concluded that the fixed-interest bond would be measured at amortized cost, and were able to explain or demonstrate how that treatment would impact the financial statements.

Weak candidates did not identify the relevant Handbook section, and were therefore limited in the depth of their analysis. They either provided very poor analysis for only one of the bonds (for example, with limited use of case facts or technical guidance), or attempted to apply Handbook guidance that was not applicable, such as *IAS 40 – Investment property,* or the definition of an asset from the *Conceptual framework.* Some weak candidates did not follow the required, instead discussing the issue from a strategy or finance perspective, and simply recommending which bond investment to choose without discussing the financial reporting treatment.

AO#8 (Audit plan)

Candidates were asked to revise the draft preliminary audit plan that was completed in September 2023. The draft preliminary audit plan was provided in Appendix V (Assurance), and other information relevant to the audit plan, such as risk factors and financial statement users, was provided throughout the case, both in the Common and Assurance sections. To demonstrate competence, candidates were expected to provide a revised audit planning memo that included a reasonable discussion of risks of material misstatement at the financial statement level, materiality, and the audit approach. Candidates were expected to use specific case facts regarding Fancy's operations and interested parties in their discussion of the audit plan, and were expected to focus on items that were new since September 2023, or errors/omissions in the draft preliminary audit plan.

Candidates underperformed on this AO, which was expected to be straightforward. Most candidates attempted to provide a discussion of risks, materiality, and audit approach, but struggled to provide complete discussions that were supported with case facts. In their risk discussions, the most commonly discussed risk factors were the lack of a CFO for four months, and the fact that there were already several accounting errors noted; however, candidates often struggled to explain how each risk factor impacted the risk of material misstatement at the overall financial statement level. Most candidates provided a reasonable materiality analysis by discussing the users of the financial statements and choosing an appropriate basis that would address their needs, adjusting the basis for the accounting errors identified and/or normalizing events, and calculating a planning materiality using an appropriate percentage, given their selected basis. Most candidates also provided a discussion of the audit approach; however, their analysis was not always supported by relevant case facts. For example, candidates would conclude that a substantive approach would be required due to a weak control environment, without using a specific case fact to support this conclusion.

Strong candidates provided more risk factors in their risk assessment and often provided better explanations for the impact each of those factors would have on the risk of material misstatement. Strong candidates also provided a more in-depth discussion of the users of the financial statements, and justified the basis they chose according to the users' needs. Some strong candidates also provided a good discussion and calculation of performance materiality. Regarding the audit approach, strong candidates were able to discuss multiple case facts that supported their overall conclusion, such as the lack of a CFO for four months, or the weaknesses identified in the inventory processes and systems.

Weak candidates generally did not provide an adequate risk assessment, and often listed risk factors without explaining how they would impact the overall financial statement risk. Some weak candidates also provided business risk factors instead of focusing on the risks of material misstatement at the overall financial statement level, and therefore had difficulty providing a useful analysis. Weak candidates also often had materiality discussions that lacked depth. For example, weak candidates would identify users of the financial statements, but struggled to discuss the needs and interests of the users. Some weak candidates had materiality discussions that contained technical errors, such as attempting to justify their choice of percentage based on the overall financial statement risk, instead of basing it on the sensitivity of the users, making it difficult to demonstrate their competence in this area. Some weak candidates also demonstrated technical weaknesses in their discussion of the audit approach, such as concluding on a controls-based approach (which was not a valid option), or suggesting performing substantive procedures (which are performed in both a combined and substantive approach).

AO#9 (Procedures – financial reporting issues)

Candidates were asked to provide audit procedures for the warranty program, management terminations, and the various components currently recorded in cash and cash equivalents. Information on these financial reporting issues was provided throughout the Common section of the case. To demonstrate competence, candidates were expected to discuss several procedures that would address the specific risks related to the financial reporting issues.

Given that this AO was on the easier end of the range of historical audit procedure AOs, candidates' performance was below expectation. Most candidates demonstrated sufficient breadth by providing one or two procedures for each of the financial reporting issues; however, candidates often struggled to provide reasonable procedures, including what audit evidence they would obtain, and what they would do with that audit evidence. The procedures that were most often adequately explained were related to the bank overdraft account and the management terminations, as these areas are more straightforward to audit.

Strong candidates clearly demonstrated that they understood the significant audit risks of each financial reporting issue. For example, for the warranty program, instead of simply verifying the sales amount to related invoices, strong candidates focused their audit procedures on whether the assumptions provided were appropriate (allocating 7% of the sale price to the warranty and using 15 years as representative of a lifetime warranty). Strong candidates also provided precise and well-described procedures, clearly noting what external evidence would be obtained and what the auditor should do with that evidence.

Weak candidates tended to provide vague procedures without suggesting what specific audit evidence needed to be obtained and what information needed to be verified, which made it difficult to determine exactly what they were proposing, and what risk they were trying to address. In addition, some weak candidates provided generic audit procedures for the relevant financial statement accounts. For example, some weak candidates provided generic sales procedures to verify the existence and accuracy of sales, instead of focusing their procedures on the new warranty program. Some weak candidates also demonstrated technical weaknesses in their discussion, as the procedures they provided were review-level procedures, such as inquiry and recalculation, instead of audit procedures, as requested.

AO#10 (Data analytics procedures – benefits and application)

Candidates were asked to discuss the benefits of applying data analytics procedures within the audit, and to explain which expense accounts QLW should consider performing data analytics procedures on for this year. The expense accounts and substantive procedures performed in the prior year were provided in Appendix V (Assurance). To demonstrate competence, candidates were expected to provide a reasonable discussion of the benefits of applying data analytics procedures, and to discuss which expense accounts to perform data analytics procedures on in the current audit.

Candidates struggled with this AO, which was disappointing, given the prominence of data analytics in assurance. Most candidates identified the two elements of the required, but struggled to provide discussions that were clearly in the context of data analytics procedures. For example, candidates would discuss the four expense accounts provided; however, they would provide additional substantive testing (increasing sample size, etc.) or a substantive analytic procedure at the overall account level, such as a year-over-year variance analysis. These discussions did not leverage the data sources that were provided in the case, and therefore made it difficult to assess whether candidates understood the concept of data analytics.

Strong candidates demonstrated an understanding of data analytics and described the possible use of data analytics procedures for at least one of the identified expense accounts. The accounts that were most often adequately discussed were the employee wages and sales commissions. Strong candidates also discussed the overall benefits of data analytics in more detail, explaining how data analytics could lead to improved efficiency or audit quality.

Weak candidates were often not focused in the context of data analytics. Some of these candidates were focused on critiquing the work that was completed last year, and provided recommendations for additional non-data-analytics procedures that should be performed (additional vouching, extending sample sizes, etc.). In addition, weak candidates often identified the benefits of data analytics, such as saving time and cost in the audit, but did not explain how data analytics provided those benefits.

AO#11 (Internal controls)

Candidates were asked to discuss any control weaknesses identified in Fancy's inventory processes and systems, and provide recommendations for improvement. A process description was provided in Appendix V (Assurance). To demonstrate competence, candidates were expected to identify several internal control weaknesses, explain the implication of each weakness, and provide a reasonable recommendation for addressing each weakness.

Candidates did not perform as expected on this AO, which was supposed to be relatively easy. Most candidates identified many of the weaknesses and provided relevant recommendations; however, many candidates struggled to explain the implications of the internal control weaknesses identified. For example, candidates often identified that the accounts payable clerk processing the invoice and printing, signing, and mailing the cheque could result in fraud, but did not explain how the accounts payable clerk would be able to commit fraud. In addition, many candidates identified that Fancy does not have an inventory system for managing internally-designed custom jewellery, but struggled to explain how this impacted Fancy's financial statements. For example, they could have discussed how inventory would be understated, as the balance would not include the labour and overhead that would be involved in creating the individual pieces of internally-designed custom jewellery.

Strong candidates better explained the implications of each weakness identified. For example, instead of simply stating that the accounts payable clerk could commit fraud, strong candidates explained that the accounts payable clerk could create fictitious suppliers, and process invoices and sign cheques to deposit to themselves. Strong candidates also often provided clearer and more practical recommendations. For example, relating to shipments mistakenly being sent to the buyer directly or to the wrong store, strong candidates recommended that Fancy implement an ordering system whereby retail stores can submit orders to the warehouse directly, noting the items requested and the address for delivery.

Weak candidates often did not explain how the internal control weakness could cause fraud or errors to occur. For example, weak candidates often stated that the control weaknesses could result in inventory being lost or stolen, but did not explain how Fancy's processes increased the risk of inventory being lost or stolen. Regarding the fact that a warehouse clerk only updates the DC inventory weekly for inventory received, weak candidates would state that inventory was at a higher risk of being stolen; however, they did not explain why this timing delay increased the risk of theft. A better response would have noted that Fancy would not be able to detect whether inventory had been stolen because its inventory records were not updated in a timely manner for shipments received. Weak candidates also provided recommendations that were not always sufficiently specific. For example, weak candidates often stated that the buyers' purchases should be reviewed, but did not identify who the appropriate reviewer would be (the inventory manager). Some weak candidates also appear to have misunderstood the case facts, and interpreted the "buyer" described in the process as Fancy's customer rather than an internal position. As a result, candidates provided discussions that were not consistent with the process description provided.

AO#12 (Use of the work of an expert)

Candidates were asked to explain why using the work of an expert is appropriate for determining the valuation of Fancy's raw materials inventory as at December 31, 2023, and to provide additional procedures that QLW must perform in order to rely on the expert's report. Excerpts from the expert's report were provided in Appendix V (Assurance). To demonstrate competence, candidates were expected to provide a reasonable discussion of the appropriateness of relying on the expert, and to provide additional procedures to be performed on the report.

Candidates performed adequately on this AO. Most candidates provided a reasonable analysis of the appropriateness of relying on the expert's work by discussing the expert's competency and objectivity, using specific case facts. Candidates were also generally able to attempt some procedures that would be performed, such as procedures to audit calculations in the report and the competence of the expert. However, these procedures were not always well explained. For example, many candidates simply recommended verifying the assumptions of the report without specifying what evidence to obtain, to support the procedure.

Strong candidates considered, in their discussion of the appropriateness of relying on the expert's work, the need for an expert, in addition to the analysis of the expert's competency and objectivity. They often referred to the relevant Handbook sections to frame their analysis, and tended to apply specific case facts to the relevant Handbook criteria. They were also able to better describe procedures.

Weak candidates tended to not clearly identify the guidance from the Handbook related to reliance on an auditor's expert. Therefore, they would reference the relevant case facts, but would not clearly be in the context of the guidance (competency, objectivity, etc.). In addition, weak candidates would often provide insufficient or inappropriate procedures, such as suggesting that an inventory count be performed without recognizing that one was performed at year end, providing procedures that were only inquiry, or suggesting that another expert be hired to evaluate the work of the expert.

AO#13 (Procedures – compliance)

Candidates were informed that Daiki wants to source diamonds from a new supplier, Symmetry Diamond Co. (Symmetry). Candidates were asked to explain 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. The mine-to-market process was provided in Appendix V (Assurance), outlining the five criteria that must be met. To demonstrate competence, candidates were expected to discuss several procedures that would verify the criteria in the mine-to-market process.

Candidates performed adequately on this AO. Most candidates demonstrated sufficient breadth by providing procedures for four or five of the criteria in the mine-to-market process. Many candidates were also able to adequately explain some of their procedures by discussing what evidence they would obtain, and what they would do with the evidence. The procedures that were most often adequately explained were related to the official coordinator, the licences for diamond mines and the individual miners, and the digital certificates for each diamond mined, as these statements are more straightforward to audit.

Strong candidates clearly demonstrated that they understood the risks of each statement. For example, instead of simply obtaining the certificate of the official coordinator, strong candidates further validated the official coordinator's certification by contacting the Institute of Mining directly. Strong candidates also provided precise and well-described procedures, clearly noting what external evidence would be obtained and what the auditor should do with that evidence.

Weak candidates tended to provide vague procedures without suggesting what specific evidence needed to be obtained, and what information needed to be verified in order to do so. Some weak candidates provided procedures that did not address the key risk associated with the criterion. For example, related to the criterion that a digital certificate must be created for each diamond mined, some weak candidates would recommend obtaining Symmetry's digital certificates and verifying that the required information was included. This was not a sufficient audit procedure as it did not verify that a digital certificate was created for each diamond mined. A better procedure would have been to select a sample of diamonds mined and request the digital certificates specific to those diamonds, to ensure that the certificate exists and contains the required information.

Paper/Simulation: **Day 2, Finance Role (Fancy)**

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Finance (7)

Evaluators' comments by Assessment Opportunity (AO)

AO#7 (Net present value analysis)

Candidates were asked to assess a potential new spokesperson deal by considering whether it meets Fancy's return requirements, calculate the maximum upfront payment Fancy can make, discuss qualitative considerations, and provide a recommendation. Details on the potential spokesperson deal and Fancy's hurdle and tax rate were provided in Appendix V (Finance). To demonstrate competence, candidates were expected to prepare a net present value analysis using an appropriate discount rate, taking into consideration incremental gross margins from the potential spokesperson deal and relevant costs, attempt to calculate the maximum upfront payment, discuss some relevant qualitative considerations, and provide a recommendation.

Candidates performed well on this AO. Most candidates seemed comfortable with preparing a net present value analysis, incorporating an incremental analysis. Candidates considered incremental gross margins from the contract (taking into consideration the increase in revenues and/or the improvement in gross margins), some relevant costs (typically, the payments under the agreement, bridal magazine ads, and social media clicks), and applied the provided discount rate. Most candidates discussed some relevant qualitative considerations (typically, Justine's popularity, lack of recent movie success, and her husband's legal issues), and provided a supported recommendation.

Strong candidates incorporated more complex items such as the social media clawback/bonus and income taxes, and correctly calculated the maximum upfront payment, based on their net present value analysis. Strong candidates also discussed more relevant qualitative considerations, and provided more depth for each discussion.

Weak candidates sometimes did not consider a net present value analysis, instead providing an analysis of cash flows only, applied the net present value analysis incorrectly (for example, by incorrectly discounting future cash flows), or did not consider the incremental gross margins (incorporating total revenues or incremental revenues only). Most weak candidates provided a qualitative analysis that lacked depth, restating case facts without explaining how they are relevant to the decision, for example, stating that Justine is considering a move to Italy without explaining how this could negatively impact the incremental revenues from the proposed deal.

AO#8 (Distribution centre offer price)

Candidates were asked to recommend a price that Fancy could offer for the building in which its distribution centre is located. Information on the building and market comparables was provided in Appendix V (Finance). To demonstrate competence, candidates were expected to attempt to value the distribution centre, using both the income-based and market-based comparable approaches, and using at least one as a primary approach (i.e., demonstrating more depth in the analysis).

Candidates struggled with this AO. Most candidates attempted to value the building using an income-based approach, taking into consideration the lease revenues and some relevant expenses (such as property taxes and energy costs, although some candidates erroneously incorporated the mortgage interest), applying the appropriate capitalization multiple, and attempting to adjust for either the renovation costs or the excess land. Many candidates struggled with the market-based comparable approach, with candidates taking a number of different approaches, using the data provided. Some candidates attempted to calculate the value per square foot (sometimes without regard for assessing the land and building components separately), some focused on the excess land (calculating the land-to-building ratio for the comparable properties), and some focused on a qualitative discussion of the two comparables but did not attempt any calculations. Most candidates provided a conclusion on the price, based on the approaches they applied.

Strong candidates, in addition to providing a reasonable income-based valuation, provided a better market-based comparable valuation by calculating the per-square-foot value of the comparable properties, taking into consideration the value per square foot for the building and land separately, as well as the impact of excess land in the comparable properties, and applying these metrics to the distribution centre. Strong candidates also attempted to adjust the valuations for the renovation costs (as a single adjustment rather than attempting to incorporate it into the income under the income-based approach), and the value of the excess land, taking into consideration the optimal land-to-building ratio and sale price of excess land.

Weak candidates focused on the income-based approach but incorporated irrelevant items, such as mortgage interest or annual renovation cost, in calculating the operating income of the distribution centre. Weak candidates did not attempt the market-based comparable approach, discussed the comparable buildings without any quantitative analysis, or only compared the total value of the comparable properties against the distribution centre without taking into consideration the value per square foot.

AO#9 (Financing options)

Candidates were asked to discuss the financing options (commercial mortgage and unsecured debenture) available for Fancy to acquire the distribution centre, and provide a recommendation. Information on the financing options was provided in Appendix V (Finance), and information on Fancy's current financial position (which could be used to calculate covenants) was provided in Appendix II (Common). To demonstrate competence, candidates were expected to discuss both financing options (taking into consideration elements such as the borrowing costs, covenants, interest rate, and flexibility), and provide a recommendation.

Candidates performed well on this AO. Most candidates provided a discussion of both financing options, focusing on various qualitative and quantitative considerations (typically the interest rate or borrowing cost, collateral, flexibility, and covenants), and provided a supported recommendation. Most candidates attempted to quantify some of their considerations, most commonly the borrowing cost.

Strong candidates attempted to calculate the borrowing cost and/or the debt-to-equity ratio, using the financial information presented in the case, and discussed more relevant qualitative considerations, such as the amount of financing available and the repayment terms, and discussed them in more depth.

Weak candidates included a fewer number of considerations. In addition, their discussions were often superficial, repeating case facts without explaining why they are important to the decision, for example, stating that the commercial mortgage required the distribution centre to be pledged as collateral without explaining why this might be less beneficial for Fancy.

AO#10 (YNJ Asset-based valuation)

Candidates were asked to determine an appropriate offer price for Your Neighbourhood Jewellery Inc. (YNJ), using an asset-based approach. Information on YNJ's assets and liabilities was presented in Appendix V (Finance). To demonstrate competence, candidates were expected to apply an asset-based approach to valuing YNJ, taking into consideration the fair market value of the company's assets and liabilities (including the accounts receivables, inventory, lease terms, and tax losses).

Candidates performed adequately on this AO. Most candidates identified the appropriate assets and/or liabilities to include in their asset-based valuation, and correctly calculated the fair market value of the accounts receivable and inventory, based on the case facts provided. Most candidates also recognized that the lease and tax losses represented additional assets for the company, but many struggled to understand how to determine the fair market value of the favourable lease terms, instead calculating the fair market value of the total lease payments. Many also struggled to appropriately value the tax losses, instead including the full amount of tax losses as an asset.

Strong candidates recognized that the favourable lease terms represented an asset, and attempted to quantify the fair market value of this asset, based on the difference between YNJ's lease payments and the fair market value. Strong candidates considered the tax rate in determining the value of the tax losses.

Weak candidates excluded relevant components of the asset-based valuation, such as the liabilities. Weak candidates incorrectly calculated the fair market value of the accounts receivable and/or inventory, misinterpreting case facts or making calculation mistakes. Weak candidates did not consider the lease, or incorporated it only as an obligation, and often did not consider the tax losses in their analysis.

AO#11 (Hedging alternatives)

Candidates were asked to discuss two hedging alternatives (gold-backed zero-coupon bonds, and gold futures contracts) for securing the price of gold, and provide a recommendation. Information on the hedging alternatives was provided in Appendix V (Finance). To demonstrate competence, candidates were expected to discuss relevant considerations in assessing the hedging alternatives (such as the cost and cost savings, hedge effectiveness, and default risk), and make a recommendation.

Candidates performed adequately on this AO. Most candidates attempted a quantitative analysis of the cost, most frequently calculating the initial cost of the futures, or the cost savings on the zero-coupon bonds. Most candidates attempted a qualitative analysis (typically focusing on the default risk on the zero-coupon bond and the effectiveness of the futures), and provided a supported conclusion.

Strong candidates calculated the cost and cost savings of each of the hedging options, and in the case of the zero-coupon bonds, sometimes considered the costs if Purity did not succeed in developing the mine. Strong candidates also demonstrated more depth in their qualitative discussions, explaining why each case fact would impact the effectiveness of the hedge. Strong candidates were also better able to link their quantitative analysis to their qualitative discussion (for example, recognizing that the zero-coupon bond is not a fully effective hedge due to the risk associated with the mine becoming operational, and quantifying the resultant cost to Fancy).

Weak candidates did not incorporate any quantitative analysis, and often discussed the qualitative considerations superficially, for example, stating that Purity does not have experience with operating mines without explaining the impact on Purity's operations, and Fancy's ability to receive gold at maturity of the bond.

AO#12 (Gold order quantity)

Candidates were asked to assess the option of Fancy reducing its gold order quantity from 500 ounces to 250 ounces at a time, using a quantitative and qualitative analysis, and to provide a recommendation. Information on the gold order quantity options was provided in Appendix V (Finance). To demonstrate competence, candidates were expected to calculate the cost of each alternative (incorporating relevant items such as the shipping, warehousing, and insurance costs), discuss some relevant qualitative considerations and provide a conclusion.

Candidates struggled with this AO. Most candidates attempted a quantitative analysis, typically incorporating the shipping, warehousing, and insurance costs, but sometimes made errors in their calculations (for example, not recognizing that the insurance cost for the 250-ounce order option is additional and per shipment). Most candidates discussed some qualitative considerations (typically the risk of theft and supplier reliability), and provided a supported conclusion, but often did not discuss enough qualitative considerations, particularly if a significant amount of time was spent on the quantitative analysis.

Strong candidates correctly included the shipping, warehousing, and insurance costs in their quantitative analysis. Strong candidates also demonstrated more depth in their qualitative analysis, explaining why each case fact would impact their recommendation on the gold order quantity.

Weak candidates did not include relevant cost components (such as not recognizing that the insurance cost on the 250-ounce order option is not included in the transportation cost), or did not consider the differences between costs that are per shipment rather than per ounce. Weak candidates repeated case facts in their qualitative analysis without explaining how it would impact their recommendation, for example, referencing the increased thefts without explaining how it would impact their recommendation.

AO#13 (Investable funds)

Candidates were asked to determine the total amount of investable funds Fancy has, taking into consideration Fancy's minimum cash requirements and the impact of proposed projects, and discuss the investment options presented. Information on Fancy's excess cash, and the investment options being considered, was provided in Appendix V (Finance). Candidates could also have incorporated Fancy's financial position, provided in Appendix II (Common), in their analysis of Fancy's excess cash. To demonstrate competence, candidates were expected to calculate the investable funds, taking into account the target working capital ratio / current assets, impact of the proposed projects, investment from Daiki/Kenji, minimum cash requirement and other adjustments, and discuss the investment options, taking into consideration their returns, volatility, and qualitative aspects.

Candidates struggled with this AO. Candidates took a variety of approaches for the quantitative component. Some calculated the target working capital and/or target current assets, often without connecting that to the rest of their analysis. Other candidates started with Daiki/Kenji's proposed cash contribution and made adjustments to it, without considering Fancy's existing cash on hand. Candidates often provided a brief assessment of the investment options; although various case facts were presented, along with returns/volatility data, many candidates only identified a difference in the returns of the investment options and discussed some qualitative factors (typically, the political instability and build quality).

Strong candidates provided a reasonable calculation of total investable funds, linking Fancy's current working capital situation to the amount of cash available for investment, and taking into consideration Fancy's target working capital in determining the total investable funds. Strong candidates also integrated other AOs into their analysis, incorporating the cost of other projects in the cash available to invest. Strong candidates demonstrated depth in their qualitative analysis, analyzing the returns and volatility of the investments, based on the information provided.

Weak candidates did not assess Fancy's current situation by calculating its current working capital, or provided unclear calculations that were difficult to follow through to a conclusion on Fancy's excess cash. Weak candidates sometimes considered only the cash on hand, without taking into account Fancy's current situation or the minimum cash requirement. Weak candidates repeated case facts in their qualitative analysis without comparing the investments, or explaining why that would make one investment more appropriate for Fancy.

Paper/Simulation: **Day 2, Performance Management Role (Fancy)**

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Performance Management (7)

Evaluators' comments by Assessment Opportunity (AO)

AO#7 (Lab-grown diamond pricing)

Candidates were asked to develop a price for lab-grown diamonds (a new potential product line) under two proposed pricing strategies: a cost-based approach, and a demand-based approach. They were also asked to perform a qualitative analysis, to determine which pricing strategy should be used. Information related to the lab-grown diamonds and on the two strategies considered, as well as information on the rating, pricing, and mining of diamonds was presented in Appendix V (Performance Management). To demonstrate competence, candidates were expected to provide a reasonable calculation of a potential selling price under each proposed pricing strategy, as well as a reasonable qualitative analysis of the two strategies.

Candidates performed well on this AO. The demand-based price calculation was challenging, because the information was presented in an unstructured way, and because numerous variables interacted with each other in the determination of the selling price. Despite this added difficulty, most candidates provided both a reasonable quantitative and qualitative analysis of the two proposed pricing strategies. For the quantitative component, most candidates were able to correctly calculate the selling price of the lab-grown diamonds under the cost-based strategy, which was the easier calculation of the two. They were also able to provide a reasonable calculation of the selling price under the more challenging, demand-based strategy, but the calculation often contained some errors or omissions. For example, candidates often forgot to adjust the selling price for the fact that the benchmark price given in the case was for a diamond rated by the more reputable grader (GSI), whereas Fancy's lab-grown diamond would be graded by the less reputable grader (GIA). They also often forgot to adjust for the high supply of diamonds that would impact global diamond prices, as DeWine, a major mined-diamond supplier, is projecting to release 36 million carats in the coming year. For the qualitative analysis, most candidates were generally able to provide a few valid discussion points, such as the link between the pricing and Fancy as a reputable brand, the low price-sensitivity of diamond buyers, the volatility of demand-based prices, or the increasing competition in the lab-diamond industry.

Strong candidates were able to provide a perfect calculation of the cost-based price, and a near-perfect calculation of the demand-based price. Their calculation of the cost-based price took both cost components into account (the diamond and the rest of the costs associated with the ring), and their demand-based price calculation took the benchmark price given for a D1-type diamond, and adjusted for the E2 nature of the lab-grown diamond proposed, the high-supply environment, the GIA grading, and the lab-grown nature of the diamond. Some strong candidates also realized that the diamond ring required components other than just the diamond, and adjusted the selling price to ensure that Fancy would at least recuperate the cost of those components. Similar to most candidates, strong candidates provided a few valid discussion points for their qualitative analysis.

Weak candidates calculated the cost-based price based on the cost of the diamond alone, forgetting the other costs associated with the ring. They also provided demand-based price calculations that often only incorporated the 40% adjustment for the lab-grown nature of the product, and omitted the adjustments linked to the type of diamond, the grading company, and the supply environment. Many weak candidates seemed unable to understand how to structure the demand-based price calculation, often marking up the benchmark price in the same way they had marked up the cost in the cost-based approach calculation. Weak candidates often provided a qualitative analysis of the introduction of lab-grown diamonds (see AO#8), rather than a qualitative analysis of the pricing strategy of these diamonds, even though it was explicitly requested. Some weak candidates discussed both within the same qualitative analysis, and it was difficult to determine whether they were discussing the idea of introducing the lab-grown diamonds (AO#8), or the pricing of the lab-grown diamonds (AO#7).

AO#8 (Lab-grown diamonds – qualitative)

Candidates were asked to analyze whether Fancy should offer lab-grown diamonds. Information related to the grading and pricing of diamonds, as well as more specific information related to lab-grown diamonds, was presented in Appendix V (Performance Management). To demonstrate competence, candidates were expected to present a balanced qualitative analysis of the advantages and disadvantages of the proposal to introduce lab-grown diamonds, linked with the numerous case facts presented (including Fancy's strategic statement presented in the requireds of the Performance Management role).

Candidates performed very well on this relatively easy AO. Most candidates provided a qualitative analysis that included several relevant discussions that were linked to the case facts, displaying a good understanding of the issue. Most candidates were able to address numerous elements, such as the impact on Fancy's brand reputation, the ability to attract a different demographic, the smaller environmental footprint, the fact that they would not be mined in conflicted areas, the increased competition in the lab-grown diamond market, and that the lab-grown diamonds are chemically identical to mined ones.

Strong candidates discussed more valid elements, and in more depth. They were not only able to raise several of the elements mentioned above (as well as additional ones), but all elements were discussed in depth. The stronger candidates also made compelling links between this decision and the overall strategic orientation that Fancy had put forward, and that was mentioned in the requireds. Strong candidates generally provided a convincing recommendation, based on the arguments they had made.

Most weak candidates generally only repeated several case facts, in the form of a list of "pros" and "cons," without explaining why the case facts listed were actually arguments for or against the introduction of the new product line. Their responses usually lacked the depth required, and provided little added value to the client. Other weak candidates were able to show some depth in the discussion of some points, but the breadth of their analysis was generally lacking.

AO#9 (Virtual store)

Candidates were asked to determine, from a quantitative standpoint only, whether it would be better to sell some products online or to maintain the status quo. Information on the virtual store's projected revenues and expenses, as well as its impact on physical stores, was presented in Appendix V (Performance Management). To demonstrate competence, candidates were expected to provide a reasonable calculation of the incremental operating income (or loss) generated by the introduction of the virtual store, taking into consideration the fact that some of the rings sold online would otherwise have been sold in stores. They were also expected to exclude items related to information provided that were not relevant to the calculation.

Candidate performed adequately on this AO. Candidates were generally able to calculate the additional contribution margin generated by the rings sold online, and to incorporate the fixed costs that would be generated by, and specific to, the virtual store. Most candidates saw the need to include in their analysis an "opportunity cost" related to the cannibalization of sales that would otherwise have occurred in-store rather than online. However, the calculation of this impact generally contained one of the following two errors: 1) basing the calculation on the selling price of the rings sold in stores rather than on their contribution margin; or 2) basing the calculation on the selling price of the rings sold online rather than on the selling price of the rings sold in stores. Despite this, most candidates made a reasonable adjustment related to the cannibalization of in-store sales. The main differentiator in responses was often the ability to exclude from the calculation items related to information provided that was not relevant to the analysis. Many candidates included several elements that should have been excluded, such as the regional manager's salary that would be paid regardless of the decision, the shipping costs that were paid by the customers, the sunk cost of developing the online platform, and the fixed manufacturing and facility overhead costs that would have remained unchanged regardless of the decision.

Strong candidates were able to perform very well in all three aspects of this AO: they correctly calculated the contribution margin of the rings sold online, had reasonable calculations of the impact of the sales cannibalization, and excluded most of the elements that were irrelevant to the decision.

Weak candidates generally made a poor attempt at quantifying the effect of the cannibalization of sales. Instead of using either an incremental approach or a global approach, many combined both approaches, which generated a calculation that made little sense. For example, they would present their calculation using two columns, one for the status quo, and one for the introduction of the new virtual store, but would calculate an opportunity cost in the second one, which would in fact double count the cannibalization effect. Other weak candidates ignored the cannibalization effect altogether. Weak candidates also performed poorly in excluding irrelevant items, and included every single piece of information provided to them in their calculation.

AO#10 (Flagship store allocations)

Candidates were asked to review the financial results of Fancy's Toronto flagship store, and provide the adjustments necessary for compliance with the company's current allocation policy. They were also asked to comment on the policy. The flagship store's income statement for 2023, notes on how certain costs were allocated, quantitative information on the store's bridal bar, and information on the company's allocation policy, were presented in Appendix V (Performance Management). To demonstrate competence, candidates were expected to recalculate the operating income of the flagship store by adjusting for the errors made in applying Fancy's current allocation policy, and to provide supported suggestions for how to improve the policy going forward.

Candidates struggled with this AO. Most candidates had difficulty understanding the case facts presented to them, specifically, differentiating the description of the allocation policy from the description of how the revenues and costs had actually been allocated for the 2023 fiscal year. This misunderstanding led many candidates to suggest adjustments to the store's operating income that were not required. For example, Fancy's current allocation policy states that all revenues should be allocated to the store where the first contact with the customer was made. This meant that the policy required that all revenues earned at the bridal bar from customers referred by other stores be allocated to those other stores. This is how they were actually allocated in 2023, but many candidates still adjusted the operating income of the flagship store because they felt that allocation was unfair. They were therefore mixing up the two components of the required by suggesting modifications to the policy, while at the same time attempting to provide quantitative adjustments that were not required under the policy. Many candidates were able to provide a few valid adjustments to revenues and expenses that were misallocated under the current policy, often mentioning the promotional costs linked to the launch of new products that should have, under the policy, been split evenly among all 13 stores, but that were currently allocated entirely to the flagship store. They also noted the IT expenses related to the product launches (one third of the store's IT costs) should also have been split evenly across all stores, rather than being allocated entirely to the flagship store. Most candidates were able to provide a few supported recommendations for changes to the policy, such as allocating the revenues to the store having made the sale, accompanied by a commission or fee paid to the store that made the referral. They also often recommended that head office costs be allocated based on actual cost drivers (many suggested revenues), rather than being split evenly among all stores, as is the case with the current policy.

Strong candidates were able to identify additional adjustments required to comply with the policy, on top of the two most common ones mentioned above. For example, they noted that, under the policy, the revenues other stores made from customers referred by the flagship store's concierge service should have been allocated to the flagship store, rather than allocated to the stores having made the sale. They also noted that the commissions linked to these revenues should also be reallocated accordingly. As another example, they often mentioned that, under the policy, the distribution costs associated with the revenues generated by the bridal bar, for sales made by other stores, should have been allocated to those stores rather than allocated to the flagship store. Strong candidates were able to make relevant recommendations for how to modify the policy, which were generally discussed in more depth, explaining in more detail the problem with the current policy and its repercussions. They often linked their recommendation to the fact that the company's bonus pools are currently based on the individual store's operating income, or to the fact that commissions are based on sales, and that the current policy could therefore be potentially unfair to the employees making the actual sale if the corresponding revenue is allocated to the store that made the referral.

Weak candidates attempted one or two adjustments, generally linked to the bridal bar revenues and expenses, which had in fact correctly been allocated under the policy. They seemed overwhelmed by this AO, and their responses were generally very short. They recommended some changes to the current policy, but without providing adequate support for their recommendations. Some weak candidates were confused by the table presented in the case, which showed the bridal bar's revenues and expenses, and mistakenly thought that their task was to determine the adequate operating income of the bridal bar itself, rather than the flagship store's operating income in its entirety.

AO#11 (Salespeople – KPI)

Candidates were asked to propose metrics for assessing sales employee performance, specifically in the areas in which they receive training. They were also asked to identify any potential drawbacks of relying on the metrics they proposed. Information on the training provided to salespeople was presented in Appendix V (Performance Management). Candidates could also use information on the industry and the company, also provided in that appendix. To demonstrate competence, candidates were expected to provide supported KPIs associated with the three areas in which sales employees had received training, as well as some potential drawbacks of using those metrics at Fancy.

Candidate performance on this AO was disappointing. Although most candidates attempted to provide the metrics requested, many of them made the following two mistakes: 1) providing recommendations on how to improve performance, as opposed to metrics to measure performance; and 2) providing metrics to measure the store's performance, as opposed to the individual salespeople's performance. Many candidates made at least one of the two mistakes noted, and as a result, were not able to demonstrate competence on this AO. Most candidates were able to provide a few valid metrics that could be used to measure individual salespeople performance, but they were generally presented within a list of other metrics that displayed one of the two mistakes noted above, or often both. Most candidates took the time to identify valid drawbacks to the metrics they were proposing, but their discussion was generally not adequately supported. The metrics most commonly discussed were the greet rate (or greet time), the results obtained on knowledge tests, and the results obtained on client satisfaction surveys.

Strong candidates were able to focus on metrics useful for measuring individual employee performance. They provided a good structure to their response, addressing, one by one, the three areas of the salespeople's training (customer satisfaction, selling skills, and product knowledge), and providing actual metrics, as opposed to recommendations on how to improve performance. When they did suggest metrics that would be difficult to use for measuring performance of specific salespeople (such as, for example, results of satisfaction surveys or greet rates), they mentioned it, and attempted to provide a way to make these metrics work, through potential improvements in Fancy's systems or operations.

Weak candidates often provided lists of metrics with little support or description, some of them being either suggestions for improvement, or metrics that would be useful to measure store performance rather than individual salespeople's performance. When they did provide metrics to measure individual performance, these were often generic, and not tied to the training that the salespeople had obtained.

AO#12 (Diamond-tracking technology)

Candidates were asked to comment on the benefits, and potential issues, related to the use of a diamond-tracking technology that Fancy is contemplating using going forward. Information related to the technology was presented in Appendix V (Performance Management). To demonstrate competence, candidates were expected to present a balanced and supported qualitative analysis of the benefits, and potential issues, associated with using this technology.

Candidates performed well on this AO. Most candidates provided a qualitative analysis that included several relevant links to the case facts, and displayed a good understanding of the issue discussed. Most candidates were able to address numerous attributes of the technology, such as the additional traceability of the diamonds, the provision of additional customer confidence in its authenticity or origin, the impossibility of modifying the virtual ledger, the lack of a third-party verification of the information inputted by the diamond miner, and the inventory-tracking capabilities associated with the technology.

Strong candidates provided more depth of analysis associated with the various elements. They were able to articulate clearly and precisely the advantages and potential issues of the various attributes of the technology. They were often also able to link their discussion to other components of the case, such as the pricing of the diamonds, the customers' preference for diamonds mined in conflict-free zones, or the brand's reputation. Strong candidates also made strong links between this decision and the overall strategic orientation that Fancy had put forward, which was presented to candidates in the requireds.

Weak candidates generally repeated several case facts in the form of a list of "pros" and "cons," without explaining why the case facts listed were actually arguments for or against the adoption of the new technology. As a result, their responses generally lacked the depth required for demonstrating competence. Weak candidates also seemed overwhelmed by the technical aspects of the blockchain technology described in the case, and were unable to identify the various risks associated with it. Many weak candidates limited their analysis of the risks of adopting the technology to the generic security risks associated with using the internet to share information.

AO#13 (Strategy versus initiatives)

Candidates were asked to explain how the decisions and initiatives mentioned in the case fit with Fancy's strategy, which 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." They were also asked if they believed that changes to this strategy were needed, and to propose potential changes to the strategy going forward.

Fancy's strategy was presented in the requireds, and candidates were expected to use it to consider all initiatives, including those that were presented in the Common section of the case. To demonstrate competence, candidates were expected to take each of the initiatives mentioned in the case, and assess whether they were in line with Fancy's current strategic statement. They were also expected to discuss Fancy's strategic direction, and provide recommendations for change if needed.

Candidates performed well on this AO. The fact that the strategic statement was presented in the requireds led most candidates to structure their responses appropriately, which allowed them to address the various components of the strategy: the brand's reputation, the exclusive nature of the products sold, the high quality of the products, and the wide range of price points. This structure helped candidates analyze each initiative in more depth. Most candidates then took each initiative one by one (the lab-grown diamonds, virtual store, flagship store, salespeople training, diamond-tracking technology, new warranty program, tracking of customer information, closure of the Victoria store, and management terminations), and analyzed whether they were a good fit with the various aspects of Fancy's strategy. Most candidates focused their analysis on three initiatives: the lab-grown diamonds, virtual store, and diamond-tracking technology, and were able to make appropriate links with Fancy's strategic direction.

Strong candidates took a step back, and analyzed the strategic direction as a whole. Many of them identified some potential contradictions in the current strategy described by Fancy. For example, Fancy is focusing on high-quality, exclusive products, and yet aspires to sell its products at various price points. Strong candidates suggested that Fancy clarify the targeted demographic for its product, and present a strategy that is more in line with the demographic selected. Many strong candidates also analyzed each strategy in more depth, explaining more precisely and in more detail how each initiative fit (or failed to fit) with Fancy's strategy.

Weak candidates provided short discussions on this AO, with some of them appearing to run out of time. Some weak candidates presented their responses in a templated format: for each initiative, they addressed each component of the strategy, and only concluded briefly as to whether the component was "met" or "not met," with little support for their assessment. Other weak candidates addressed very few initiatives, mostly focusing on the lab-grown diamonds and the virtual store, and did not break down the strategy into its various components, which led to very vague and generic discussions, often not sufficiently supported. Weak candidates also generally did not attempt to address the broader part of the required, and as a result, their response lacked depth.

Paper/Simulation: **Day 2, Taxation Role (Fancy)**

Estimated time to complete: 300 minutes

Simulation difficulty: Average

Competency Map coverage: Taxation (7)

Evaluators' comments by Assessment Opportunity (AO)

AO#7 (Residence)

Candidates were asked about the tax situation for the new CFO, Steven; specifically, they were asked to determine his residency status for 2023. In Appendix V (Taxation), candidates were provided with an email from Steven, outlining a number of facts about his move to Canada in 2023. To demonstrate competence, candidates were expected to discuss several residential ties, including at least one of the significant ones, and either draw a reasonable conclusion supported by their analysis or discuss the tax implications of the residence status they determined.

Candidates performed well on this AO. Most candidates listed most or all of the residential ties, although there was a range of quality of discussions in terms of linking the ties to their impact on the determination of residence. They were usually able to draw a supported conclusion, although some relied too heavily on the deemed resident (sojourning) rule in their analysis.

Strong candidates usually addressed nearly all of the ties, focusing on the significant ones (the home in each country, and the location of immediate family members). They then proceeded to draw a supported conclusion about Steven's residence, and discussed the date at which he would become resident, and the manner in which he would be taxed before and after that date.

Weak candidates, if they identified the residential ties at all, often simply provided a list; some provided generic lists of residential ties without integrating case facts, while others listed the case facts without explaining whether they were arguments in favour of residence or non-residence. Weak candidates frequently relied heavily on the sojourning/ deemed resident test, stating that Steven had spent more than 183 days in Canada and was therefore resident (or often, stating incorrectly that he had spent fewer than 183 days in Canada and was therefore non-resident) for the entire year, even though the facts around his residential ties were more relevant in this case.

AO#8 (Tax administration)

Candidates were asked to address several questions from Steven regarding tax administration. Specifically, they were asked whether the CRA had missed its opportunity to reassess 2021 (in light of a recently issued Notice of Reassessment), to help Steven understand the objection process, and to explain Fancy's options if the objection is unsuccessful. They were also asked to explain how new tax laws are developed, and to describe the corporate income tax instalment requirements. In Appendix V (Taxation), candidates were told that Fancy had already disposed of its books and records for 2021, and they were expected to identify why this was a problem. Additional information about some of these items was provided in the email from Steven in Appendix V (Taxation), and candidates could have also integrated the results of their calculations in AOs #9–11 (for example, income taxes for the year exceeded $3,000, so instalments were required). To demonstrate competence, candidates were expected to use case facts to discuss several of the qualitative points addressed by this AO, across at least two of the areas (reassessment, legislative life cycle, and instalments).

Candidates performed adequately on this AO, which was not expected to be easy. Most candidates addressed at least two of the three areas, identifying several of the applicable concepts. Many made technical errors, especially around the various deadlines that applied, and many struggled to apply the concepts to the case facts, often providing technical knowledge without applying it to the case.

Strong candidates addressed all three areas, providing some depth in their discussions and applying them to case facts. Strong candidates more often identified the objection deadline (90 days from the Notice of Assessment), and determined what that date would be, based on the dates provided to them. They also provided a brief overview of the role of the CRA and of parliament, and explained the instalment bases available to Fancy, including an explanation of why they would not qualify for quarterly instalments.

Weak candidates often attempted to provide a list of technical knowledge, and often made technical errors in doing so. Commonly, weak candidates would identify an incorrect number of years (or incorrect starting point) for the normal reassessment period, as well as incorrect books and records retention periods, and incorrect timelines for filing notices of objection. If they attempted to discuss the legislative process at all, they often demonstrated significant technical errors (for example, suggesting that the courts are solely responsible for developing new tax laws). Weak candidates most often attempted to discuss tax instalments, often concluding that Fancy would qualify to remit quarterly, even though it clearly did not qualify, for multiple reasons.

AO#9 (Taxable income (quantitative) for Fancy)

Candidates were asked to determine Fancy's federal income taxes payable for the year ended December 31, 2023. This AO assessed the quantitative component of the calculation of taxable income that was needed for addressing this request. Information was provided throughout the Common portion of the case about Fancy's income for the year, particularly in the financial statements in Appendix II (Common). Additional information about some of the items that were included in income, along with information about transactions affecting CCA, was provided in Appendix V (Taxation), and candidates could have also integrated the results of their financial reporting analyses from the Common section into their calculations. To demonstrate competence, candidates were expected to calculate taxable income, incorporating many valid adjustments.

Candidates performed well on this AO. Most candidates provided detailed calculations of net income for income tax purposes and taxable income, incorporating many adjustments from throughout the case. Most commonly, they adjusted income for the results of their financial reporting discussions, as well as for amortization, CCA, meals and entertainment, green fees, life insurance, and interest and penalties on taxes. Their CCA calculations usually correctly reflected the assets disposed of during the year as well as the Class 13 additions, although they sometimes struggled to correctly apply the accelerated investment incentive to net additions (rather than gross additions) in Class 8. Most candidates made some minor technical errors, such as confusing capital gains dividends with capital dividends.

Strong candidates also provided detailed calculations of net income for income tax purposes and taxable income, but incorporated more adjustments in their calculations. In addition to the ones adjusted by most candidates, strong candidates also tried some of the more difficult ones, such as the tax impact of the warranty and restructuring reserves, donations, dividends, and the financial statement loss on the disposition of assets. They also provided more detailed (and often exactly correct) CCA calculations, correctly applying the accelerated investment incentive, and identifying the treatment of the software additions, in addition to the items done well by most candidates.

Weak candidates attempted to calculate net income for tax purposes and taxable income, making relatively few adjustments and making significant technical errors in their calculations. Weak candidates often adjusted for inappropriate items, often adding back nearly every expense they were provided with information about (for example, interest paid on late-paid supplier invoices), even if no tax adjustment was required. Their CCA calculations were often brief, if present at all, and usually contained many technical errors. Common technical errors on CCA from weak candidates included failing to apply the accelerated investment incentive, double-counting additions and opening amounts in Class 13, and adjusting balances for the greater of cost and proceeds (instead of the lesser of these amounts) on disposed assets.

AO#10 (Taxable income (qualitative) for Fancy)

Candidates were asked to determine Fancy's federal income taxes payable for the year ended December 31, 2023, including an explanation of the adjustments they made, as well as the income tax treatment of the financial reporting issues. As with AO#9, information was provided throughout the Common portion of the case about Fancy's income for the year, particularly in the financial statements in Appendix II (Common). Additional information about some of the items that were included in income was provided in Appendix V (Taxation), and candidates could have also integrated the results of their financial reporting analyses from the Common section into their discussions. To demonstrate competence, candidates were expected to discuss several of the adjustments.

Candidates struggled with this AO, which was not expected to be difficult. Most candidates attempted to provide some explanations, but these explanations were often very brief or were technically incorrect. For example, many adjustments were explained with a note that said simply "not deductible" or "add" or "subtract." Most candidates attempted to explain several elements of the meals and entertainment calculation, but often made multiple mistakes in doing so (for example, stating that 100% of the costs of attending a hockey game should be added back, or that only 50% of the golf fees should be added back). They often correctly explained the items that required little discussion, such as life insurance or interest/penalties on taxes, but often neglected to explain other items, or provided technically incorrect reasons for the adjustments they made.

Strong candidates attempted to discuss most or all of the adjustments they made in their AO#9 calculations, most often addressing meals and entertainment (with fewer errors), green fees, interest/penalties on taxes, amortization, life insurance, and the tax treatment of the two financial reporting issues that affected income.

Weak candidates often failed to provide any discussions of the adjustments they were making, despite being directly asked to provide explanations. Those who did attempt to provide explanations frequently made significant technical errors on fundamental topics, such as meals and entertainment expenses, or dividend income earned by a corporation.

AO#11 (Taxes payable for Fancy)

Candidates were asked to determine Fancy's federal income taxes payable for the year ended December 31, 2023. Candidates were provided with information about investment income in Appendix V (Taxation), along with information on the corporation's taxable capital from the financial statements in Appendix II (Common). Candidates also needed to integrate the results of the work they performed in AO#9 and AO#10, to complete the taxes payable calculation. To demonstrate competence, candidates were expected to perform a reasonable calculation of some of the basic components of tax, and to show depth either by performing one of the more difficult parts of the calculation (such as calculating a business limit grind, or calculating the RDTOH and dividend refund), or by correctly calculating all the basic components of tax.

Candidates struggled with this AO. Most candidates calculated some of the basic elements of tax, but often struggled to understand the ways in which investment income is taxed, especially the dividend income. Those who did attempt to calculate the taxable capital grind usually included the lease liabilities in their calculations, which led to incorrect conclusions (without the lease liabilities, taxable capital was low enough that some small business deduction would be available).

Strong candidates correctly calculated most or all of the basic elements of tax, and attempted one or both of the business limit grinds. They also determined either Part IV tax or the addition to NERDTOH from the aggregate investment income for the year (rarely both), and calculated a dividend refund consistent with the amount of dividends paid for the year.

Weak candidates attempted to calculate taxes payable but made many technical errors in their calculations. They rarely attempted any of the more difficult elements (such as the business limit grinds, or the RDTOH and dividend refund), often struggling to even apply the basic rate and provincial abatement, and usually making errors on the other elements (or omitting them altogether), such as the small business deduction, additional refundable tax, or general rate reduction.

AO#12 (Taxable income for Daiki)

Candidates were asked to calculate Daiki's federal income tax balance owing for the 2023 tax year, and had to calculate taxable income in order to be able to calculate taxes payable. Candidates were provided with information about Daiki's income and deductions in Appendix V (Taxation). To demonstrate competence, candidates were expected to calculate taxable income for Daiki, showing depth in two of the three major components of this calculation (principal residence exemption (PRE), other capital gains/losses, and other income and deductions).

Candidates performed adequately on this AO. Most candidates calculated the gain per year on the house and cottage, concluded that the cottage had the higher gain per year and should be chosen for the PRE, and usually calculated the remaining PRE available on the house. They then attempted calculations of the other gains/losses and the other income and deductions, which was generally well done, despite some common errors (such as applying the listed personal property (LPP) loss against all gains instead of just the LPP gains).

Strong candidates calculated the gain per year on the house and cottage, concluded that the cottage had the higher gain per year and should be chosen for the PRE, and consistently applied the remaining PRE to the house, correctly using the +1 rule to determine the correct taxable capital gain. Strong candidates usually calculated most of the capital gains and losses on personal-use property (PUP) and LPP, and made the various required inclusions and deductions for personal taxable income.

Weak candidates usually attempted the calculations, but often omitted, or attempted only briefly, the PUP and LPP gains and losses. Weak candidates made significant technical errors in their calculations, often including in taxable income the income earned inside the taxpayer's TFSA and/or RRSP accounts, misapplying the PUP and LPP rules (for example, applying losses from PUP against other gains), and either applying the PRE to the property with the lower gain per year or only applying it to one property, even though additional years were available for the other.

AO#13 (Taxes payable for Daiki)

Candidates were asked to calculate Daiki's federal income tax balance owing for the 2023 tax year, including any interest and penalties that may apply. Candidates were provided with information in Appendix V (Taxation) about amounts Daiki had incurred that could be eligible for personal income tax credits. Candidates also needed to integrate the results of the work they performed in AO#12, to complete the taxes payable calculation. To demonstrate competence, candidates were expected to calculate personal income taxes using the graduated tax rates, and to deduct credits from tax (not from income), including several valid credits and/or interest or penalty calculations.

Candidates struggled with this AO. Most candidates determined the basic parts of the calculation (such as calculating tax using the graduated tax rates, and determining the basic personal amount and Canada employment amount), but struggled with other areas; often, donation credits were calculated inappropriately (using incorrect rates, for example), and the dividend tax credits were omitted altogether or calculated using the wrong rates. Candidates rarely attempted to determine interest or penalties, and those who did often used inappropriate rates for determining interest (such as 1%), despite the information being available in the reference schedule provided with the exam.

Strong candidates correctly determined taxes payable using the graduated rates, applied the basic credits correctly (such as the basic personal amount, spousal amount, Canada employment amount, and CPP), and performed some correct calculations on the more difficult credits, such as the donations, political contributions, and dividends. Strong candidates usually attempted one or more of the interest and penalty calculations.

Weak candidates often failed to attempt this AO altogether. Those who did attempt it usually made significant technical errors, such as misusing the tax tables to determine the base amount of tax (by adding together all the base amounts, or by manually recalculating them and doing so incorrectly), deducting all or most credits against income instead of against tax, and claiming unrealistically high credits on donations and political contributions (often as high at 100%). Weak candidates did not attempt to determine interest or penalties.

BOARD OF EXAMINERS' COMMENTS ON DAY 3 SIMULATIONS

Paper/Simulation:	**Day 3, Case 1 (BB)**
Estimated time to complete:	85 minutes
Simulation difficulty:	Average
Competency Map coverage:	Management Accounting (1); Strategy and Governance (1); Finance (2); Audit and Assurance (1); Financial Reporting (1); Taxation (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (Breakeven analysis) (Mgmt Acct)

Candidates were asked to provide advice regarding Jesse's plan to sell seasonal boxes containing the newest children's products. In Appendix I, candidates were presented with information regarding the seasonal boxes, and asked to determine how many individual boxes would need to be sold in order to break even, how many seasonal box subscriptions would need to be sold to break even, and which option they would recommend, given Jesse's sales estimates of 500 individual boxes or 115 subscriptions. Appendix I provided all relevant sales price, variable cost, and fixed cost information for calculating the breakeven point and estimated profits under both options. To demonstrate competence, candidates were expected to calculate a reasonable breakeven amount for both the individual boxes and the subscriptions, and provide a supported recommendation regarding which option to pursue.

Candidates performed well on this AO. Most candidates provided a reasonable breakeven calculation for both the individual boxes and the subscriptions. In general, candidates properly distinguished between fixed costs and variable costs, and used accurate breakeven formulas to determine the breakeven point for both options. When errors were made, the most common one was treating the digital advertising as a variable cost rather than a fixed cost. Most candidates did not calculate the estimated profits under both options, but still provided a supported recommendation based on other quantitative factors, such as the total number of boxes needed to break even under each option.

Strong candidates provided accurate breakeven calculations for both the individual boxes and the subscriptions. These candidates further calculated the estimated profit under each option, and used the results to provide a supported recommendation for which alternative to pursue. A few strong candidates further supported their recommendation with an in-depth, qualitative analysis of the options, considering factors such as the predictability provided to BB by the subscription option versus the flexibility provided to customers by the individual-box option.

Weak candidates provided calculations with many errors, such as omitting the product costs associated with each box, or failing to multiply the variable costs by four to account for the four boxes provided under the subscription option. Weak candidates showed less ability to properly distinguish between fixed and variable costs, and struggled to properly apply a breakeven formula. For example, rather than dividing total fixed costs by the contribution margin, weak candidates used estimated sales volumes to calculate total expected costs, and divided that value by sales price to conclude on the breakeven point. Some weak candidates attempted a calculation for only one of the two options, or did not attempt a breakeven analysis at all, instead calculating only estimated profits under each option.

AO#2 (Goals and metrics) (Strat & Gov)

Candidates were asked to critique each of BB's goals, to explain why Jesse has had difficulty measuring the company's progress toward achievement, and to provide metrics for measuring performance against these goals. Appendix II listed BB's five goals. To demonstrate competence, candidates were expected to critique some of the stated goals, explain why the goals were difficult to measure, and provide specific metrics that BB could use, to measure performance against the goals.

Candidates performed adequately on this AO. Most candidates attempted to critique the goals and provide specific metrics for measuring performance. The typical response demonstrated breadth of analysis by addressing most of the goals. Most candidates provided valid metrics, especially in relation to being a desirable employer or a recognized community supporter. Many also provided valid metrics regarding profitability and being parents' number one choice for children's products. Most candidates attempted to critique BB's goals, but their critiques lacked depth. For example, they would simply state that the goals had been difficult to measure because they were not measurable, without explaining why the goals were not measurable or how they could be revised to enhance their measurability. Another common approach was to discuss the need for SMART goals, and to critique BB's goals for lacking certain features, such as achievability or a set time frame. Candidates who took this approach provided useful information about designing goals in general, but failed to answer the specific question of why BB's goals had been difficult to measure. When candidates did provide a valid critique, it was usually in relation to the profitability goal, where they either recognized that the goal was already relatively clear, or recommended the establishment of specific growth targets, to make the goal more precise.

Strong candidates addressed all the goals and provided several strong critiques and metrics. These candidates recognized that most of BB's goals were vague, and contained terms that needed to be defined before they could be measured. For example, these candidates would identify the need to specify what it means to be parents' number one choice, or to be recognized by the community, and suggested measurable characteristics that could be associated with these concepts. Strong candidates provided very well-explained metrics, that included not only a precise metric, but also the method for collecting the data needed to measure performance. For example, strong candidates would recommend conducting an employee survey to obtain an overall employee satisfaction score, that could be compared on a regular basis to a pre-determined target.

Weak candidates did not attempt to critique the goals, and provided invalid or poorly explained metrics. For example, weak candidates recommended conducting a survey to determine if BB was parents' number one choice for children's products, but did not explain what information the survey would collect, or how it would be used to compare BB to its competitors. Other weak candidates made suggestions that were not clearly linked to a valid metric, for example, recommending that BB use informal conversations with employees to gauge their satisfaction. Some weak candidates provided metrics that were essentially just a restatement of the goal, such as "measure year-over-year profitability," or "measure the amount of waste in BB's packaging." Many weak candidates addressed this AO by providing advice on how to achieve the goals, for example, recommending that BB promote work-life balance in order to be a desirable employer. In doing so, these candidates provided neither critiques nor metrics, and failed to address the client's explicit request.

AO#3 (Cash flow forecast) (Fin)

Candidates were asked for advice on how to finance the opening of a second store. Appendix III introduced three options for obtaining the needed $500,000, one of which was to use internally-generated funds. Appendix III asked candidates to determine how long it would take BB to generate the needed $500,000, and presented information on expected future income and cash flows. To demonstrate competence, candidates were expected to prepare a reasonable cash flow forecast that included several adjustments, and demonstrate an understanding of the difference between cash flow and income. They were further expected to conclude on when the $500,000 target would be reached.

Candidates performed as expected on this relatively straightforward AO. Most candidates prepared a reasonable multi-year cash flow forecast that incorporated several relevant adjustments. Most candidates began their analysis with the projected 2024 income before tax, and adjusted it for expected growth, along with expenses related to the owner's salary and planned donations. Most candidates also demonstrated an understanding of the difference between cash flow and income by adjusting income for the cash outflow related to capital expenditures, and attempting to adjust for changes in working capital and non-cash items such as amortization expense. Most candidates correctly concluded on how long it would take BB to internally generate $500,000.

Strong candidates prepared a robust, multi-year cash flow forecast that incorporated many relevant items, including correct adjustments for amortization expense and changes in working capital. Strong candidates were also more likely to include the more difficult adjustments, including those related to the introduction of seasonal boxes, the owner's bonus, and taxes.

Weak candidates generally included only a few correct adjustments, or focused exclusively on income statement items. Weak candidates who did attempt cash flow adjustments typically had significant errors in those adjustments, such as deducting rather than adding back amortization expense, or increasing the investment in working capital to $50,000 in 2025, and $75,000 in 2026 and beyond. Some weak candidates provided only a one-year cash flow forecast, which left them unable to accurately adjust for the items that occurred or changed after 2024. Many weak candidates did not conclude on when the $500,000 target would be reached, either stopping their analysis short of the $500,000 mark, or ignoring the need for a conclusion altogether.

AO#4 (Financing options) (Fin)

Candidates were asked for advice on how to finance the opening of a second store. Appendix III introduced two investor proposals that could be used to obtain the needed $500,000: a convertible preferred shares option, and a debt financing option. Candidates were asked to analyze each of these proposals, and provide an overall recommendation on how to finance the second store. To demonstrate competence, candidates were expected to discuss some of the factors to consider under the two financing options, and provide a recommendation.

Candidates performed adequately on this AO, which was expected to be a bit more difficult. Most candidates discussed the decision factors for both options, and provided a recommendation. Candidates seemed particularly comfortable addressing the preferred share option, with most candidates quantifying the cost of the preferred shares and discussing how the conversion of preferred shares to common shares would dilute Jesse's ownership percentage. Many candidates were also able to provide some analysis of the debt option, either quantitatively comparing it to the preferred share option in terms of cost or cash flows or, less frequently, explaining that interest on the debt would be tax deductible while preferred share dividends would not.

Strong candidates discussed several relevant factors for each option, and provided greater accuracy and depth in their discussion. For example, strong candidates not only recognized that Jesse's shareholdings could be diluted under the preferred share option, but also calculated the 20% equity stake that would be given up upon conversion. Strong candidates provided accurate calculations regarding cost of financing, clearly comparing the 7% interest rate on the debt to the implicit interest rate of 15% on the preferred shares. Many strong candidates also discussed the relevant features of the cumulative preferred shares, including the ability to delay dividend payments or the requirement to pay all dividends in arrears when dividends are eventually declared. While rare, some strong candidates discussed that the cost of converting the preferred shares to common equity would depend on the value of BB at the time of conversion, and that Jesse might therefore be forced to give up equity for less than it is worth.

Weak candidates lacked depth and breadth in their discussion, typically discussing only a few valid decision factors, or providing a list of generic pros and cons that were not specific to the options under consideration. For example, weak candidates would explain that the debt option would require compliance with covenants, even though there was no indication in the case that the loan under consideration had covenants attached to it. Weak candidates also focused their discussion on factors that did not differ between the two options, for example, stating that each option provided the required financing amount of $500,000. Other weak candidates provided technically inaccurate responses, for example, calculating a negative interest rate on the preferred shares, or attempting to recalculate the cost of debt, despite the rate of 7% provided in the case. Weak candidates would also often restate case facts without further analysis, for example, noting that the loan required $100,000 in annual principal repayments, without explaining how that would impact BB or how it compared to the preferred shares option.

AO#5 (Compilation versus review and independence) (Assu)

Candidates were told that the potential investor would require financial statements, and were asked to explain the differences between a compilation engagement and a review engagement, and recommend one. They were further asked whether CPA could perform either of these engagements for BB. To demonstrate competence, candidates were expected to discuss the difference between a compilation and a review engagement, and recommend one. To provide further depth to their discussion, candidates could have also addressed the independence issue related to whether CPA could perform the work.

Candidates performed as expected on this typical assurance AO. Most candidates were able to discuss some of the differences between a compilation and a review engagement, primarily focusing on the level of assurance each can provide, the type of work involved in each, and the fees charged in relation to the work involved. Most candidates also used the information provided in the case to recommend an engagement, based on the users' needs. Many candidates also recognized that there was an independence issue associated with CPA performing a review engagement, although they typically failed to explain why this was the case.

Strong candidates explained in detail the difference between a compilation and a review, usually covering many concepts, such as the level of assurance, type of work, fees, independence requirements, and occasionally, the applicability of financial reporting standards under each engagement. Strong candidates made good recommendations in the context of user needs, and addressed the independence issue by explaining why their role presented an independence concern, often mentioning the existence of a self-review threat, given the advice they have provided in other areas.

Weak candidates lacked depth and breadth in their responses, typically only providing very brief statements about assurance level or fees. Other weak candidates provided technically inaccurate discussions that confused the differences between the engagements, for example, concluding that the review is the lower-cost alternative. Some weak candidates briefly discussed only one of the two engagements, or discussed an audit in place of a compilation or review. Weak candidates also generally failed to recommend an engagement based on user needs, and did not address CPA's independence. Some even concluded that CPA could perform a review engagement, without any recognition of the potential threat to independence.

AO#6 (Inventory) (Fin Rep)

Candidates were asked to help Jesse with the accounting treatment of some inventory items. Appendix IV introduced three products (sweaters, stuffed animals, and books) from a children's television show that had been cancelled, and provided cost, and selling or disposal information for these products. To demonstrate competence, candidates were expected to identify that, under *ASPE 3031 Inventory*, inventory must be measured at the lower of cost and net realizable value, and to properly analyze the net realizable value of the products, using case facts.

Candidates performed well on this AO. Most candidates correctly identified the relevant guidance from ASPE 3031, explained the need to measure the inventory at the lower of cost and net realizable value, and properly analyzed the net realizable value of the sweaters and the stuffed animals. Many candidates also properly analyzed the net realizable value of the books, concluding that, since the items were being donated, their net realizable value was nil.

Strong candidates correctly analyzed the net realizable value of all three products and prepared an adjusting journal entry to write the inventory down to the correct value. Strong candidates also provided more depth in their discussions by analyzing more case facts in the context of ASPE 3031. For example, these candidates would explain that the cancellation of the television show suggests that the inventory cost may not be recoverable, or that net realizable value needs to be determined on an item-by-item basis, thus requiring a separate calculation for each type of product. While rare, some strong candidates used ASPE 3031 guidance to support their net realizable value calculations, for example, explaining the need to include the broker's commission in the net realizable value of the stuffed animals because it is a "cost of sale."

Weak candidates addressed fewer inventory items or provided technically incorrect responses. For example, weak candidates would often omit the broker's commission from the net realizable value of the stuffed animals, or conclude that the books should be valued at 15% of cost, even though the decision had been made to donate them. Some weak candidates calculated the net realizable value of the sweaters, and concluded that they needed to be written up to this value, despite the fact that it was above cost. Other weak candidates provided inaccurate net realizable value calculations, for example, using 50% of cost to determine the net realizable value of the sweaters, or adding the broker's commission to the selling price of the stuffed animals. A few weak candidates did not apply the appropriate Handbook guidance to their analysis, instead using *ASPE 3063 Impairment of Long-Lived Assets*, to attempt to address the inventory issues.

AO#7 (Expense deductibility) (Tax)

Candidates were asked for tax advice on some expenses incurred in BB's first year of operations. Appendix V provided information about three expenses incurred by BB, and two expenses incurred by Jesse personally. Candidates were asked to comment on the deductibility of the expenses for BB and for Jesse, respectively. To demonstrate competence, candidates were expected to discuss the deductibility of some of the expenses.

Candidates performed adequately on this AO. Most candidates recognized that only 50% of convention-related meals would be deductible. Many also provided brief discussions regarding the home office expenses, or the deductibility of CPA's consulting fees. Most candidates attempted to address some of the other expenses, but were sometimes unable to provide in-depth discussions. For example, many candidates concluded that the costs of attending the children's expo were deductible since they were incurred for the purpose of earning business income, but did not explain any of the specific tax rules related to conventions, such as the fact that they are limited to two per year. Many candidates also failed to correctly analyze the use of a personal car for business purposes, instead assuming BB was the owner of the vehicle and concluding that a taxable benefit would be attributed to Jesse for his personal use of the vehicle. Few candidates provided valid discussions regarding the product testing costs, or the year in which the consulting fees should be deducted.

Strong candidates provided several in-depth, technically correct discussions. Many strong candidates described all the various rules related to conventions, and tied these rules to case facts, to conclude that the expo-related costs would be deductible. Other strong candidates used case facts to assess whether Jesse met either of the conditions for deducting home office expenses, and concluded that, since he worked primarily at BB and that was the only place he met customers, he could not deduct home office costs. Some strong candidates provided technically accurate discussions regarding the use of the personal vehicle, explaining that only the business-use portion of the costs would be deductible, and advising that Jesse would need to keep a log of business-versus-personal kilometres, or that Jesse's travel between home and the BB location would be viewed as a personal expense. A few strong candidates provided accurate discussions about the product testing expenses, explaining either that the costs were likely to be viewed as personal since his daughter was a non-arm's length party, or describing situations that would make these costs more clearly related to business purposes.

Weak candidates addressed fewer of the expenses, reached conclusions about deductibility without any explanation, or provided technically incorrect discussions. For example, weak candidates would often conclude that the home office expenses could be deducted. Other weak candidates concluded that consulting fees were not deductible, or that product testing would be viewed as research and development costs that needed to be capitalized. Many weak candidates would just list all or most of the expenses, and either state they were deductible, with no justification, or provide a brief repetitive comment that they were deductible because they were incurred for business purposes, which does not provide enough detail to justify the treatment of those items.

Paper/Simulation:	**Day 3, Case 2 (GR)**
Estimated time to complete:	85 minutes
Simulation difficulty:	Average to Hard
Competency Map coverage:	Financial Reporting (2); Taxation (1); Management Accounting (1); Audit and Assurance (1); Strategy and Governance (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (Government assistance) (Fin Rep)

Candidates were asked to review the accounting treatment for the government assistance. An excerpt from the government assistance agreement, which contained details such as how the funds are to be used, the capital and non-capital portion of the grant, and the period covered, was provided in Appendix II. Candidates were also provided with an excerpt from the 2023 draft financial statements in Appendix I, to use as a reference for how the government assistance was currently recorded. To demonstrate competence, candidates were expected to discuss the accounting treatment of the capital and non-capital components of the government assistance, using the Handbook guidance from *ASPE 3800 Government Assistance*.

Candidates struggled with this AO. Many candidates began their analysis by discussing whether the government assistance could be recognized, assessing whether there was reasonable assurance that the funds would be received and that the conditions would be met. This analysis did not add value to their discussion as it was clear the funds had already been received, and nothing indicated that the conditions stated in the agreement would not be met. Most candidates only identified one of the two options available for the accounting of the capital portion. Candidates who recognized that the capital portion of the government assistance could be netted against the capital asset struggled to recognize that an alternative policy option was to defer and amortize the capital portion in the same manner as the asset to which it relates. Most candidates did not address the subsequent measurement of the capital portion of the grant. Candidates were slightly more comfortable addressing the non-capital component of the government assistance, recognizing that it would need to be allocated evenly across the period, and usually performed a calculation to split the non-capital portion between the current period and the subsequent period, to determine the amount to defer.

Strong candidates provided an analysis of the capital and non-capital components separately. Strong candidates recognized that there were two accounting policies available for the accounting of the capital portion of the government assistance, and appropriately described how the accounting for each policy differed. These candidates often recommended accounting for the capital portion by netting it against the asset, and supported their recommendation, noting that it was more straightforward to implement. Strong candidates were able to explain the accounting treatment for the non-capital portion, and supported it with a calculation of the amount to record in income, and the amount to defer to the future period. Many strong candidates provided journal entries to support their analysis for both components of the government assistance, and calculated the amortization in future years on the capital component.

Weak candidates often started their discussion by addressing whether the government assistance could be recognized. These candidates analyzed whether the funds had already been received, and whether the conditions of the grant were likely to be met. The case clearly stated that the funds were received in 2023, and there was no indication that the conditions would not be met; therefore, this discussion did not add value to their analysis. After concluding that the grant could be recorded in the current period, most of these candidates did not go any further in their analysis, failing to address how to account for the capital and non-capital portions of the government assistance. Many of the weak candidates who did attempt to address the components of the government assistance often did so by evaluating whether to use an income or capital approach, demonstrating their misunderstanding in applying ASPE 3800. Most of these candidates associated the income approach with the non-capital portion of the assistance, concluding that it should be recorded to revenue now, and that the capital portion of the assistance needed to be treated as a capital transaction and credited to contributed surplus.

AO#2 (Franchise fee) (Fin Rep)

Candidates were asked to review the accounting treatment for the initial franchise fee. Appendix III contained an excerpt from the franchise agreement, which provided the amount of the initial franchise fee as well as the breakdown between an initial fee for the right of the franchisee to operate indefinitely under the GR name, and an amount for hardware required for the point-of-sale (POS) system. To demonstrate competence, candidates were expected to provide a reasonable discussion of the intangible asset (right to operate under the GR name) and the PP&E (POS system), using the Handbook guidance from *ASPE 3064 Goodwill and Intangible Assets,* and from *ASPE 3061 Property, Plant and Equipment*.

Candidates struggled with this AO. Many candidates were able to identify the initial franchise fee as an intangible asset; however, they were unable to adequately integrate case facts to analyze whether it met the definition and recognition criteria for an intangible asset, often arriving at a conclusion without any analysis. When they did address the definition criteria, candidates struggled to analyze how the asset was identifiable, often just listing the criteria with no integration of case facts. Candidates were more comfortable addressing that control existed since LS has the right to use the GR name, and that future economic benefits would flow to LS since it operated the store. Candidates rarely addressed the subsequent measurement of the intangible asset, failing to recognize that it had an indefinite life and should not be amortized annually. Although many candidates identified the PP&E as a component of the initial franchise fee, most did not analyze the recognition criteria, and reached a conclusion to capitalize and amortize the asset, without analysis.

Strong candidates identified the initial franchise fee as an intangible asset and addressed most of the definition and recognition criteria, integrating case facts into their analysis. These candidates were able to explain how the case facts supported the recognition and definition criteria. They were able to identify the indefinite nature of the asset, and discussed that it would not be amortized annually but rather tested for impairment as required. Strong candidates identified the POS system as PP&E, and integrated case facts into their analysis before concluding to record it as an asset. These candidates also addressed the need to amortize it based on its useful life, and provided some basis for what the useful life might be, based on information provided in the case.

Weak candidates often concluded to expense the initial franchise fee as incurred, without any analysis, suggesting they did not identify the initial franchise fee as an intangible asset. When they did identify it as an intangible asset, they did not analyze the definition and recognition criteria for the intangible asset. Their discussions simply listed Handbook criteria with no integration of relevant case facts, or provided superficial statements, such as "met" or "not met," without explanation. Most weak candidates did not identify the separate components of the initial franchise fee, and discussed the initial franchise fee as one item. Weak candidates who addressed the PP&E often provided incorrect conclusions, such as stating that the PP&E had to be expensed because it was not used for the production of goods or services, failing to recognize that the POS system would be used for administrative purposes. Some weak candidates approached the issue from a revenue recognition perspective, applying *ASPE 3400 Revenue,* or *AcG-2 Franchise fee revenue*, which is inappropriate, given that the fee was an expenditure paid by GR.

AO#3 (Corporate taxes payable) (Tax)

Candidates were asked to calculate the federal corporate income taxes payable for the year ended December 31, 2023. Appendix I included a draft income statement, and the notes contained information necessary for adjusting the net income for tax purposes. To demonstrate competence, candidates were expected to provide a reasonable calculation of taxable income, including the CCA deduction, and to use a reasonable tax rate for calculating federal corporate income taxes payable.

Candidates performed adequately on this AO. Most candidates were able to address the more straightforward adjustments, such as meals, amortization, and recreation fees. Many candidates were able to integrate their financial reporting adjustments from AO#1 and AO#2 into their calculation of taxable income. In terms of CCA calculations, most candidates were comfortable addressing Class 10 (vehicles); however, many struggled to incorporate the financial reporting issues into their CCA analysis. For example, many candidates did not consider the intangible asset and the PP&E additions that were part of the initial franchise fee in their calculation of Class 14.1 (intangible) and Class 8 (POS system), and did not adjust the leasehold improvements for the government assistance received. Most candidates used a reasonable tax rate in their calculation, but few addressed how they arrived at that rate.

Strong candidates were able to appropriately integrate their adjustments from AO#1 and AO#2 into their calculation of taxable income, including adjustments for the leasehold improvements and the POS system to their CCA calculations. Strong candidates incorporated several tax adjustments to their taxable income calculation, including the straightforward concepts of meals, amortization, and recreation fees, demonstrated an understanding of the rules around staff party costs, and incorporated the royalty fee as a deduction. Strong candidates appropriately applied the rate and class applicable to the assets, to calculate CCA for a few classes. They applied a reasonable tax rate to their calculation of taxes payable, and either showed the breakdown of the applicable rate or explained why the company would qualify for the small business rate on the first $500,000 of taxable income.

Weak candidates incorporated only the straightforward tax adjustments, such as meals, amortization, and recreation fees. Many identified incorrect rules for staff parties, often applying a $150 per employee maximum or concluding they were not deductible, with no explanation. Most weak candidates failed to incorporate adjustments from their accounting analysis into their calculation of taxable income. Weak candidates were unable to incorporate CCA into their calculation, or incorrectly assumed all assets were eligible for immediate expensing, without considering the CCA class of the assets. Most weak candidates did not use a reasonable tax rate; many used 38%, with no explanation or identification of the lower rate available to the company. Many weak candidates used the personal income tax rates instead of the corporate tax rates.

AO#4 (Budget) (Mgmt Acct)

Candidates were asked to prepare a budgeted before-tax income statement for 2024. Appendix I included excerpts from the 2023 draft income statement, with notes containing information on the expected changes for 2024. Appendix IV included sales information useful for preparing the 2024 budget. This information was presented in the form of two pie charts, requiring candidates to use data analytic skills to extract the necessary information relevant to the preparation of their budget. To demonstrate competence, candidates were expected to prepare a budget that incorporated several adjustments from the 2023 income statement.

Candidates performed adequately on this AO. Most candidates incorporated the straightforward adjustments, such as the 3% adjustment to sales, the 2% adjustment to cost of sales, the additional salary for Laura and the new employee, and the 5% increase in advertising expenses. When candidates integrated the result of their financial reporting analysis into their budget, it was most often by including the remaining months of the government assistance from AO#1. Most candidates were able to correctly identify that Laura already had a base salary of $50,000, and therefore only increased her salary by the difference between that salary and her new salary, and also recognized that there was already an existing employee whose salary needed to be accounted for when calculating the new employee salary. Candidates rarely incorporated the more difficult adjustments, such as the change in biography revenue, or the impact of additional store hours on revenue. When they attempted to calculate the biography revenue, many candidates increased the total revenue by 10% instead of first calculating which part of the total revenue related to biography sales. Candidates also rarely recognized the need to calculate the gross margin from 2023, to correctly determine cost of sales for 2024. Few candidates incorporated the royalty fee correctly, often calculating it on gross revenue, or even expenses, and many candidates left the initial franchise fee of $120,000 expensed in 2023 in their 2024 budget.

Strong candidates were able to incorporate multiple accounting adjustments into their budget, including the remaining months of the government assistance from AO#1, and recognized that amortization would need to increase due to the POS system addition from AO#2, or the leasehold improvement for the 2024 year. Strong candidates were able to correctly estimate the biography revenue, and used the correct rate of 3% for the increase of the remaining revenue. Some strong candidates attempted to consider how the change in store hours would impact revenue, showing an ability to evaluate data presented in various forms. Other adjustments considered by some strong candidates included calculating the margin on cost of sales, and applying it to the increased revenue before factoring the 2024 rise in cost of sales of 2%, and calculating a royalty expense amount for the 2024 year, based on the 2023 net income.

Weak candidates struggled with how to approach the budget. For example, some attempted to restate the 2023 net income by using an incremental approach, but many got confused and included the full amount of some expenses, when only the incremental portion should have been considered. This issue was most seen in the calculation of advertising, or Laura's salary. Many candidates who did not use an incremental approach only included the increase in salaries, failing to consider the salary of the existing employee, or Laura's current salary. Weak candidates were unable to incorporate many adjustments into their budget. Most commonly, they addressed straightforward adjustments, applying a percentage increase to the prior year's amounts for revenue, cost of sales, and advertising. Many weak candidates applied the same increased rate to both revenue and cost of sales instead of using the case information, which applied a different rate to each. Some weak candidates made up their own rate to increase revenues, without support. They were often unsure of how to treat the Book It program, and just included the same costs as 2023, ignoring the increase to the program costs or the administration fee associated with the program. Most weak candidates included the franchise fee expense from 2023 in their 2024 budget, and did not calculate a royalty fee expense for 2024. Most weak candidates also did not incorporate the impact of their AO#1 and AO#2 analysis into their budget.

AO#5 (Materiality/approach/risk on accounts) (Assu)

Candidates were asked to explain what the auditor's audit approach and materiality assessment will likely be, and to identify which accounts in the financial statements have a high risk of material misstatement, and explain why. Information necessary for addressing this required was provided throughout the case. To demonstrate competence, candidates were expected to provide a reasonable discussion of the audit approach, the materiality assessment, and/or the high-risk accounts.

Candidates performed adequately on this AO. Candidates were most comfortable discussing materiality, recognizing that the basis for determining materiality was the users of the financial statements. Most candidates identified Laura as a user, and were able to provide a calculation of materiality, using a reasonable basis. Most candidates were able to have a general discussion of the differences between a substantive and combined audit approach, but many were unable to integrate case facts to explain which approach would be most appropriate for the company. Most candidates assumed a combined approach could not be used because the company was in its first year of operations, or because this would be the first audit. Candidates struggled to identify the high-risk accounts, many not addressing them at all, or only listing one account without any explanation as to why it might be high risk.

Strong candidates addressed all three parts of the required. Their analysis of the audit approach considered relevant case facts, such as how the limited number of staff involved may impact the segregation of duties and that very few processes were in place, limiting the availability of internal controls designed to reduce the risk of error and fraud. Strong candidates understood a combined audit approach could be used, but explained its challenges in the current situation, using the information provided in the case to support their discussion. When addressing the users of the financial statements, strong candidates were able to identify both Laura and the franchisor as users, some even identifying the bias for Laura to manipulate the net income, to reduce the royalty fee that would be calculated based on net income. Strong candidates supported their assessment of materiality with a discussion of the users of the financial statements, and most calculated a reasonable range for both materiality and performance materiality. Strong candidates were able to appropriately identify several high-risk accounts, and many integrated their accounting analysis, identifying the government assistance discussed in AO#1 and the franchise fee discussed in AO#2 as areas of high risk due to known accounting errors. Many strong candidates were also able to discuss the high-risk nature of revenue, based on LS being the type of business that may collect a lot of cash. When identifying inventory as risk areas, strong candidates were able to identify that books might be easily stolen, which would make existence a concern.

Weak candidates often started their response with a discussion of the overall risk of the engagement, or the financial statement level risks, which was not required. These candidates then struggled to address the three-part required, as they spent undue time addressing the risks at the wrong level. Most weak candidates who discussed the audit approach provided a generic discussion, concluding on a substantive approach without further explanation. Weak candidates did not demonstrate an understanding of the basis of materiality, often stating that materiality was based on the level of risk of material misstatement present in the financial statements, rather than based on the users of the financial statements. Many weak candidates did not support their analysis of materiality, only providing a range of percentages without analysis as to how to determine an amount. Weak candidates rarely addressed the high-risk accounts, focusing instead on the financial statement level risks. When they did attempt to address the high-risk accounts, they focused on generic balance sheet accounts such as cash and accounts receivable, instead of focusing on high-risk accounts that were specific to LS, and were therefore unable to use case facts to support their discussion.

AO#6 (Strategic fit of options) (Strat & Gov)

Candidates were asked for advice on which program (donation program or writing program) would be the best for Laura to initiate from a strategic standpoint. Factors that have made GR successful, Laura's vision for her company, additional information about what Laura likes about the current program she implemented during the year (Book It), and details about the two programs were all provided in the first two pages of the case. To demonstrate competence, candidates were expected to discuss some of the factors that Laura should consider in choosing between the two program options, giving consideration to her vision and GR's success factors.

Candidates performed adequately on this AO. Most candidates were able to address how the two programs would impact Laura's available time, identifying that the writing program would require an investment of her time whereas the donation program would not. Many candidates were able to address the cost of the donation program, often providing a calculation for the amount of the donation based on the gross profit for the year, compared to the writing program, which had no out-of-pocket cost. However, candidates struggled to address the strategic factors, as they were more comfortable addressing operational considerations such as time, cost, and lost Saturday sales. When candidates addressed the strategic factors, they most commonly restated the case fact that Laura wanted to be a pillar in the community; however, many could not explain what that meant, or how either program might achieve her vision. Most candidates addressed both programs, but many did not identify any strategic factors at all, showing an inability to determine what was strategically important in this situation. Many candidates provided lists of the pros and cons of each program without any explanation of whether they aligned with Laura's personal interests, for example, saying the donation program did not align and the writing program did, but not explaining these statements further. Most candidates provided a recommendation of which program Laura should pursue.

Strong candidates were able to identify what the strategic factors were, recognizing both Laura's vision and what made GR successful. These candidates most often integrated the first strategic consideration that Laura wanted LS to become a pillar in the community, often discussing how the donation would allow her to be better known in the community whereas the writing program would have a limited audience who were likely already familiar with LS. Strong candidates were able to recognize how the strategic considerations fit with the two possible programs, integrating case facts, such as how Laura being able to teach writing allowed her to facilitate learning for children, or that the donation program, by providing access to more books, also facilitated learning in the school environment. Strong candidates were also able to focus on the drawbacks of each program, recognizing that the writing program had a very limited number of children who could attend, and the donation program did not facilitate creation as it only provided an opportunity for schools to purchase books, with Laura having no control over content.

After presenting a balanced discussion of the considerations, strong candidates made a supported conclusion on which program Laura should choose.

Weak candidates generally listed case facts, sorting them between the two programs, for example, stating that the writing program facilitates learning and the donation program does not, without addressing how the programs would differ in facilitating a learning environment. Weak candidates recommended which program to select without any consideration of the strategic factors, focusing only on Laura's time and the cost of the programs rather than on her vision for LS. Some weak candidates compared the Book It program to the two programs Laura contemplated, which was not part of the required.

Paper/Simulation:	**Day 3, Case 3 (Lotoski)**
Estimated time to complete:	70 minutes
Simulation difficulty:	Average
Competency Map coverage:	Management Accounting (1); Strategy and Governance (1); Audit and Assurance (1); Taxation (1); Finance (1)

Evaluators' comments by Assessment Opportunity (AO)

AO#1 (Capacity for engagements) (Mgmt Acct)

Candidates were asked to determine whether Lotoski currently has the capacity to accept two potential engagements (Rader and Jet), and which engagement is the most attractive from a quantitative perspective. Appendix I provided details on the number of hours and contribution margin for the two engagements. Appendix II provided detailed information on Lotoski's resources and the number of direct labour hours required for the current engagements, to help calculate the number of hours available for new engagements. To demonstrate competence, candidates were expected to provide a reasonable calculation of Lotoski's capacity, broken down by position, and conclude on whether they could accept both engagements. They were also expected to calculate the total contribution margin of both engagements, and to recommend the most attractive one from a quantitative perspective.

Candidates struggled with this AO. Most candidates attempted a calculation of Lotoski's capacity to accept the two new engagements. Their calculation took into consideration the total capacity, the required number of hours for the current engagements, and the number of hours required for each of the two new engagements. However, most candidates did not break down their calculation by position while assessing the capacity, which led them to conclude that Lotoski could accept both engagements, not recognizing that there was not enough associate capacity to do so. Most candidates were able to recommend the most attractive engagement from a quantitative perspective, supporting their recommendation with a calculation of the contribution margin of each engagement.

Strong candidates provided a reasonable calculation of Lotoski's capacity to accept the two new engagements, using the breakdown of direct labour hours that was provided in the case and calculating the capacity of each position (partner, associate, and paralegal). Strong candidates concluded that Lotoski did not have enough associate capacity to accept both engagements. Having identified the capacity constraint, strong candidates calculated the total contribution margin for the two engagements, and recommended acceptance of the engagement with the highest total contribution margin.

Weak candidates attempted to provide a calculation of Lotoski's capacity, but their calculation often contained several technical errors. For example, many weak candidates did not use a consistent unit basis for their calculations (often mixing up a six-month basis approach with a weekly basis approach). Weak candidates were unable to correctly apply the breakdown per position in their calculation, and only compared the capacity on an overall basis. Most weak candidates either did not provide a recommendation, or their recommendation was not consistent with their analysis.

AO#2 (Strategic fit for engagements) (Strat & Gov)

Candidates were asked how each of two potential engagements aligned with Lotoski's strategic objectives, and to recommend which engagement to accept, based on their analyses. Candidates were provided with Lotoski's strategic objectives in the first paragraph of the case. In Appendix I, candidates were provided with details of the two potential engagements, including numerous case facts, to help them assess their alignment with Lotoski's strategic objectives. To demonstrate competence, candidates were expected to discuss how the strategic objectives aligned with Lotoski's two potential engagements, and provide a recommendation of which engagement to accept, based on their analyses.

Candidates performed well on this AO. Most candidates were able to draw on the information provided about Lotoski's strategic objectives, and used it to analyze the strategic fit with the two potential engagements. Most candidates addressed a few of the strategic objectives and analyzed their fit with at least one of the two engagements. The most commonly discussed considerations were the fact that Rader has a proven history of providing prompt responses, documents, and information needed to complete the engagements; that the Jet engagement was for legal services related to real estate, specifically purchasing a condo building and selling individual units; and that, since Rader is an existing client of Lotoski, if the engagement is accepted, Lotoski would continue to build its relationship and trust with Rader. Most candidates also provided a recommendation of which engagement to accept that was consistent with their analysis.

Strong candidates provided an analysis of several of Lotoski's strategic objectives and their fit with both potential engagements. Strong candidates were often able to address considerations that required more integration, such as recognizing that Jet has grown rapidly and constantly has new real estate projects that require legal services, which could contribute to "grow the law firm's real estate customer base" if Jet is willing to engage Lotoski for these services. Strong candidates were also able to provide clear links between the strategic objectives and the two new engagements, which provided more depth in their analyses, and resulted in a well-supported recommendation.

Weak candidates often simply restated the case facts without clear links to any of the strategic objectives, or discussions on how they were relevant for Lotoski. For example, they would restate that Jordan, Jet's owner, is a long-time friend of Rosie, and note this as favourable for the Jet engagement without explaining their rationale. Some weak candidates seemed to have missed the strategic objectives that were provided to them in the first paragraph of the case, which made their analysis less useful for the client. Some weak candidates also provided a general pros-and-cons analysis of the two engagements, with few or no links to the strategic objectives. Although the points were sometimes valid, they were not tied to any of Lotoski's strategic objectives, which limited their usefulness to Lotoski.

AO#3 (Risks and controls – JH-Cloud) (Assu)

Candidates were asked to discuss the risks and related implications of a new cloud platform that Lotoski recently started using, and to recommend controls to mitigate those risks. Appendix III provided information on the new platform and related processes. To demonstrate competence, candidates were expected to identify some of the risks, discuss their implications on Lotoski's operations, and recommend controls that should be implemented to address these risks.

Candidates performed well on this AO. They typically addressed multiple risks, often choosing to apply a "weakness, implication, recommendation" approach that proved to be effective. Candidates most frequently addressed the more obvious risks, such as the security of the web portal, the use of shared user names, and the frequency of backups. Most candidates were able to identify clear risks, and provide a clear implication, and relevant recommendation of controls to be implemented.

Strong candidates were able to discuss several risks, explaining the implication of each risk to Lotoski and providing a well-supported control to be implemented, to address that risk. They were able to suggest practical controls that, when implemented, would be effective in mitigating the risk identified. Strong candidates provided good coverage of the different risks at Lotoski, and addressed the less obvious risks, such as the frequency of maintenance. Many strong candidates went beyond simply stating the risk, and provided a clear explanation of the risk they identified. Some strong candidates provided more than one valid recommendation for addressing a risk they had identified.

Weak candidates had very limited coverage of the different risks at Lotoski, often only discussing one or two risks. Weak candidates provided incomplete analyses, for example, recommending controls without first identifying or explaining the risk that the control was meant to address. If they attempted to provide a complete discussion around one risk, weak candidates often provided vague implications, or impractical or not useful recommendations. For example, some candidates simply indicated that there is a risk of fraud or error as an implication of shared user names, without explaining how this could happen. To address the risks associated with maintenance being performed during working hours, other candidates recommended having paper files for Lotoski's clients so employees could still work when the platform is inaccessible, whereas Lotoski had just purposely moved away from paper files.

AO#4 (Change in use) (Tax)

Candidates were asked to help provide tax advice to one of Lotoski's clients, Ming Lessard. Appendix IV provided information on the client's properties (a house and a cottage), such as the purchase date, purchase price, current fair value, and the fact that she rented the house for 10 years but never claimed CCA, and moved into the house in December 2023. In the appendix, candidates were asked about the tax implications of the changes for the 2023 tax year, and for the future. To demonstrate competence, candidates were expected to discuss both the impact on the current year, and any future tax implications related to this situation.

Candidates struggled with this AO. A significant proportion of candidates did not identify that, because the property was used as a rental property and is now a principal residence, Ming has changed the use of the property, and this triggers a change in use, with tax consequences. When they did identify the change in use, candidates often struggled to apply the concept correctly to the specific context of the case. On the other hand, most candidates were able to properly identify that Ming could eventually claim the principal residence exemption. However, they had difficulty applying their technical knowledge to the specific context of the case, often providing inaccurate tax advice.

For example, many candidates suggested that Ming should claim the principal residence exemption on the rental property for the whole period it was rented, not realizing that a rental property does not meet the definition of a principal residence, since it is not "ordinarily inhabited" by her. Other candidates provided incorrect advice to the client, indicating that, moving forward, Ming would be obligated to claim the principal residence exemption on the house as it is where she will live, not realizing that the cottage could still qualify as a principal residence, and that a choice would therefore need to be made. Most candidates displayed a clear lack of technical knowledge regarding the change-in-use and principal-residence topics.

Strong candidates were able to address both the change-in-use and the principal-residence exemption considerations. They recognized that, because the rental property is now a principal residence, Ming has changed the use of her property, and will be considered to have sold the property at its fair market value and immediately reacquired it for the same amount. Strong candidates usually also provided a reasonable calculation of the capital gain associated with the deemed disposition of the rental property. Strong candidates generally also identified that Ming could claim the principal residence exemption, and many provided useful tax advice, such as eventually claiming the exemption on the property that had the highest average gain per year, or to claim one less year than the total years owned since the formula to claim principal residence exemption adds one year. A very small proportion of strong candidates identified that, since Ming never claimed CCA on the rental property, she could elect under ss. 45(3) to treat the deemed disposition as not taking place, and would be able to claim the principal residence exemption for any years she actually resided there, plus up to four additional years before she resided there.

Weak candidates were usually unable to appropriately identify any of the tax considerations of this AO. Their discussions were often focused on the wrong issues. For example, many candidates used the case facts noting that Ming has never claimed CCA on the property, and provided an analysis of what the CCA deduction should have been. Many weak candidates provided inaccurate tax advice, such as suggesting that Ming refile her tax returns for the last 10 years in order to claim CCA, not realizing that this would generate a recapture of CCA with the deemed disposition associated with the change in use, and would prevent Ming from using the election in ss. 45(3). Other weak candidates concluded that, since Ming has not yet sold the rental property, there would not be any tax consequences until it is actually sold, demonstrating a clear lack of understanding of the change-in-use tax rules. Weak candidates often provided very brief responses to this AO, potentially because they were not comfortable with the technical knowledge required for addressing it.

AO#5 (Investment options) (Fin)

Candidates were asked to analyze potential investment opportunities for extra funds the client has, and to recommend one. Appendix V provided information on three options (a mutual fund, guaranteed investment certificate (GIC), and mandatorily redeemable preferred shares in a construction company owned by a partner of the firm's husband). Candidates were told that Lotoski has $400,000 to invest for four to five years, has a low-to-moderate risk tolerance, and expects an annual rate of return of 5% or greater. To demonstrate competence, candidates were expected to analyze these investment options quantitatively and qualitatively, and recommend one to Lotoski.

Candidates performed adequately on this AO. Most candidates attempted a calculation of the rate of return, most frequently for the mutual fund and the GIC, with reasonable accuracy. When they attempted to calculate the rate of return of the mandatorily redeemable preferred shares, most candidates had difficulty factoring the two main components in their calculation: the cumulative dividends of 2%, and the higher repurchase price of the shares. For example, they would consider the future value of the investment in their calculations ($440,000), but forget to include the annual cumulative dividends of $8,000. Most candidates attempted to discuss the alignment of these investment options with the objectives that were stated in the case, such as the expected rate of return of 5%, or the low-to-moderate risk tolerance. Most candidates also attempted to discuss some specific considerations related to the investment options, but often struggled to provide clear discussions. For example, many suggested that a GIC is guaranteed, not explaining what is guaranteed or why that was an important consideration for the client. Most candidates provided a valid recommendation of which investment option to proceed with.

Strong candidates provided a calculation of the rate of return for all three options with reasonable accuracy. They discussed the alignment of the three investment options with the objectives that were stated in the case, including the time frame, as Lotoski was looking for an investment option for four to five years, the expected rate of return of 5%, and the low-to-moderate risk tolerance. Strong candidates discussed multiple specific considerations for the three investment options, for example, discussing that the third investment option was riskier as the company was incorporated only five years ago and only started earning profit after two years, so would still be considered a new business and may not be successful in the future. Strong candidates provided a well-supported recommendation of an investment option that was consistent with their analysis, and that took Lotoski's objectives into consideration.

Weak candidates often attempted a calculation of the rate of return for some of the investment options, but their calculations contained technical errors, the most common being not considering the time value of money. For example, those candidates would provide a calculation of the total return in dollars of each option, when the options were on a different time-frame basis. Weak candidates usually did not discuss the alignment of the investment options with the objectives stated in the case, or provided very generic discussions for the investment options. Many of these weak candidates simply restated case facts without any further analysis, for example, saying that the mutual fund was invested in well-established companies, not explaining why this was a positive factor, or what the impact was on the risk level of the investment. Weak candidates often did not provide any recommendation of which investment to go with.

APPENDIX G

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

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

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%

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

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.

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%	

The CPA certification program prepares future CPAs to meet the challenges that await them. For more information on the qualification process, the common final examination (CFE), and the specific education requirements for your jurisdiction, contact your provincial/regional CPA body.

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