CPA CHARTERED PROFESSIONAL ACCOUNTANTS PEP CPA COMPTABLES PROFESSIONNELS AGRÉÉS PFP

Core 1 Self-Assessed Entrance Exam — Answers

Financial Reporting

1. Explain the difference between a cash flow statement prepared using the indirect method versus the direct method

Catherine, your audit manager, has asked you to explain to your client, Michael, the difference between a cash flow statement prepared using the indirect method and a cash flow statement prepared using the direct method. How would you explain this to him?

a. The presentation and the amount of net cash flow from the operations section is different under both methods. The presentation and the amount of net cash flow from the investing and the financing sections is the same under both methods.

@ Answer a) is incorrect. The amount of net cash flow from operations is the same under both methods, not different.

b. The presentation and the amount of net cash flow from the operations and investing sections are different under each method. The presentation and the amount of net cash flow from the financing section is the same under both methods.

@ Answer b) is incorrect. The amount of net cash flow from operations and investing is the same under both methods, not different. As well, the presentation of the investing section is the same under both methods, not different.

c. The presentation of the operations, investing, and financing sections are different under both methods but the amount of net cash flow from the operations, investing, and financing sections under both methods are the same.

@ Answer c) is incorrect. The presentation of the investing and financing sections is the same under both methods, not different.

*d. The amount of net cash flow from the operations, investing, and financing sections is the same under both methods. The presentation of the operations section is different under both methods. The presentation of the investing and financing sections is the same under both methods.

@ Answer d) is correct. The presentation of the operations section is different under both methods but the amount of net cash flow from the operations section is the same under both methods. The presentation and the amount of net cash flow from the investing and financing sections is the same under both methods.

2. Calculate the impact of transactions on the cash account

Judy is preparing the cash flow statement for a client, AAA Moving and Storage. The company has several trucks as well as its own warehouse. The balance for property, plant, and equipment (PP&E) is as follows:

	20X6	**20X5**
PP&E, net of accumulated amortization	$825,000	$756,000

Other information available:

- Amortization expense is $79,000.
- A delivery van with a cost of $64,000 and accumulated amortization of $40,000 was sold. The sale took place halfway through the year.

What are the additions for PP&E for the year?

a. $ 69,000

@ Answer a) is incorrect. PP&E, beginning of the year ($756,000) – PP&E, end of the year ($825,000) = $69,000. This calculation does not recognize the net book value of the truck sold and the amortization expense for the year.

b. $ 93,000

@ Answer b) is incorrect. PP&E, beginning of the year ($756,000) – cost of the delivery van sold ($64,000) + accumulated amortization of the van sold ($40,000) – PP&E, end of the year ($825,000) = $93,000. This calculation does not recognize the amortization expense for the year.

c. $148,000

@ Answer c) is incorrect. PP&E, beginning of the year ($756,000) – amortization expense for the year ($79,000) – PP&E, end of the year ($825,000) = $148,000. This calculation does not recognize the net book value of the truck sold in the year.

*d. $172,000

@ Answer d) is correct. PP&E, beginning of the year ($756,000) – amortization expense for the year ($79,000) – cost of the delivery van sold ($64,000) + accumulated amortization of the van sold ($40,000) – PP&E, end of the year ($825,000) = $172,000.

3. Analyze accounts receivable

The entry to write off a previously allowed-for uncollectable account does which of the following?

a. It increases the allowance for doubtful accounts (AFDA).

@ Answer a) is incorrect. An increase in AFDA would arise when recording the estimate for bad debts.

b. It has no effect on the allowance for doubtful accounts (AFDA).

@ Answer b) is incorrect. Writing off an uncollectable account would decrease AFDA.

*c. It has no effect on net income.

@ Answer c) is correct. Writing off an uncollectable account would have no impact on income, because it debits AFDA and credits AR.

d. It decreases net income.

@ Answer d) is incorrect. Bad debt expense is not affected by this entry.

4. Analyze accounts receivable

Kima Inc. had credit sales of $600,000 and cash collections of $450,000 last year. The ending balance in accounts receivable was $175,000. The allowance for doubtful accounts has a balance of $2,600. Bad debt expense is estimated at 1% of credit sales.

What was the bad debt expense for the year?

a. $1,500

@ Answer a) is incorrect. This response incorrectly applies the rate to the cash collections of $450,000 ($450,000 × 1%) and nets this $4,500 against the bad debt expense of $6,000. The cash collections do not impact the calculation of bad debt expense.

b. $1,750

@ Answer b) is incorrect. This response incorrectly uses the balance of accounts receivable multiplied by 1% to calculate bad debt expense.

*c. $6,000

@ Answer c) is correct. Bad debt expense would be calculated as credit sales multiplied by a rate of 1% ($600,000 × 1% = $6,000).

d. $8,600

@ Answer d) is incorrect. This response gives the ending balance of AFDA.

5. Analyze the component of an entity

In order to qualify for separate presentation on the income statement, a discontinued operation must be considered a component of an entity.

Which of the following would be considered a component of an entity?

*a. A hotel in a hotel chain

@ Answer a) is correct. A hotel in a hotel chain is considered to be a component of an entity because it is a group of assets directly generating cash flows that are clearly distinguishable from the rest of the entity.

b. The administration building of a large manufacturing company

@ Answer b) is incorrect. The administration building of a large manufacturing company is not considered to be a component of an entity because it is a single asset not directly generating its own cash flows and its operations and financial elements are not clearly distinguishable from the rest of the entity.

c. A truck stop for a national trucking company

@ Answer c) is incorrect. A truck stop for a national trucking company is not considered to be a component of an entity because it is a group of assets that is not a separate legal entity and it does not have financial elements that are clearly distinguishable from the rest of the entity.

d. The warehouse of a communications company

@ Answer d) is incorrect. The warehouse of a communications company is not considered to be a component of an entity because it is not a group of assets comprising an operating segment that directly generates cash flows, nor are its operations and financial elements clearly distinguishable from the rest of the entity.

6. Discuss the criteria that define held-for-sale assets

Assets are considered to be held for sale when several criteria have been met. Which of the following criteria must be met in order to define an asset as held for sale?

a. The asset is available for immediate sale in its present condition.

@ Answer a) is incorrect. This is a criterion that must be met in order to define an asset as held for sale, but so is answer b), there being an authorized plan to sell the asset.

b. There is an authorized plan to sell the asset.

@ Answer b) is incorrect. This is a criterion that must be met in order to define an asset as held for sale, but so is answer a), the asset being available for immediate sale in its present condition.

c. The asset is actively marketed and expected to be sold within two years.

@ Answer c) is incorrect. While it is true that the asset must be actively marketed in order to define the asset as held for sale, the asset should be expected to qualify for recognition as a completed sale within one year from the date of classification.

*d. Both a) and b) above.

@ Answer d) is correct. Both answers a) and b) above are correct because the asset being available for immediate sale in its present condition and there being an authorized plan to sell the asset are both criteria that must be met in order to define an asset as held for sale.

7. Evaluate required adjustments to consolidated retained earnings

Which of the following statements is false?

a. Consolidated ending retained earnings is impacted by amortization to date of fair value differentials that arose at acquisition.

@ Answer a) is incorrect. This statement is true. Consolidated retained earnings is adjusted for amortization to date of fair value differentials that arose at acquisition.

b. Consolidated retained earnings is impacted by unrealized profit in closing inventory on intercompany inventory sales.

@ Answer b is incorrect. This statement is true. Consolidated retained earnings is reduced for unrealized profit in closing inventory as a result of intercompany sales.

*c. Consolidated retained earnings is impacted by intercompany management fees recognized in the current year.

@ Answer c) is correct. This statement is false. One of the companies will have reported management fee revenue while the other company will have reported an expense in the same amount. The net impact on net income and retained earnings is nil.

d. Consolidated retained earnings is impacted by an unrealized loss on an intercompany sale of equipment.

@ Answer d) is incorrect. This statement is true. Consolidated retained earnings is increased for unrealized losses on an intercompany equipment sale.

8. Evaluate the impact of a transaction on the consolidated financial statements

On November 1 of the current year, Bait Co. sold inventory to its wholly owned subsidiary, Tackle Ltd.; 80% of these goods were then sold by Tackle to customers of Tackle prior to the December 31 year end. What are all of the adjustments required for the preparation of the consolidated financial statements related to this transaction? (Ignore the effects of income taxes.)

*a. Decrease sales and cost of sales by the intercompany selling price, and increase cost of sales and decrease inventory by the unrealized profit in ending inventory.

@ Answer a) is correct. Sales are overstated by the full intercompany selling price. The required adjustment to cost of sales is a net decrease equal to the intercompany selling price less unrealized profit in ending inventory. Inventory is correctly reduced by the unrealized profit in ending inventory.

b. Decrease cost of sales by the unrealized profit in ending inventory and increase inventory by the same amount.

@ Answer b) is incorrect. Inventory should be reduced by the unrealized profit in ending inventory, and cost of sales should be increased by the same amount. An additional entry is required to adjust sales and cost of sales for the full current-year intercompany selling price.

c. Increase cost of sales by the unrealized profit in ending inventory and decrease inventory by the same amount.

@ Answer c) is incorrect. The adjustment to cost of sales and ending inventory is correct. However, an additional entry is required to adjust sales and cost of sales for the full current-year intercompany selling price.

d. Decrease sales and cost of sales by the intercompany selling price of the inventory.

@ Answer d) is incorrect. The entry to reduce sales and cost of sales by the intercompany selling price of the inventory is correct. However, an additional entry is required to adjust cost of sales and ending inventory for the unrealized profit in ending inventory.

9. Consolidation at acquisition — Acquisition-related costs

How should acquisition-related costs, such as due diligence and legal costs, be accounted for?

*a. Expensed as incurred

@ Answer a) is correct. Paragraph 53 of IFRS 3 *Business Combinations* states that the acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received. The same treatment is required under paragraph 55 of ASPE Section 1582 *Business Combinations*.

b. As part of the total consideration

@ Answer b) is incorrect. According to paragraph 53 of IFRS 3 *Business Combinations*, these costs are expensed as incurred. These costs are not accounted for as an addition to the total consideration because there is no future economic benefit as the costs are not likely to result in an increase in future cash inflows.

c. As a reduction in equity

@ Answer c) is incorrect. According to paragraph 53 of IFRS 3 *Business Combinations*, these costs are expensed as incurred. However, under IFRS 3.53, the costs to issue equity securities should be recognized in accordance with IAS 32 *Financial Instruments: Presentation* or IAS 39 *Financial Instruments: Recognition and Measurement*, which would mean netting them against the proceeds of any financing received.

d. As a deferred asset

@ Answer d) is incorrect. These costs do not meet the definition of an asset. According to paragraph 53 of IFRS 3 *Business Combinations* and paragraph 55 of ASPE Section 1582 *Business Combinations*, these costs are expensed as incurred.

10. Consolidation at acquisition — Bargain purchase

A bargain purchase arises when the price paid to acquire a controlling interest in another company is less than the acquirer's share of the fair value of net assets of the company being acquired. At the end of your preliminary analysis, you believe that a business combination results in a bargain purchase. What is your next step?

a. Recognize an immediate gain in the consolidated statement of profit and loss without any further analysis.

@ Answer a) is incorrect. While a bargain purchase could result in a gain, another step is required first.

b. Recognize a liability in the consolidated balance sheet.

@ Answer b) is incorrect. The result is not a liability according to the definition of a liability.

c. Contact the acquiree to confirm its intention.

@ Answer c) is incorrect. You would not contact the acquiree. The purchase price is established in the purchase and sale agreement and is not subject to revision after both parties have agreed to it.

*d. Reassess each step of your analysis to confirm your finding.

@ Answer d) is correct. Under paragraph 36 of IFRS 3 *Business Combinations*, the acquirer is required to reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed, and shall recognize any additional assets or liabilities that are identified in that review. In addition, the acquirer must then review the fair values assigned to individual assets and liabilities of the subsidiary company to determine whether any of the fair values have been incorrectly measured.

11. Analyze cash and cash equivalents

Which of the following statements is true?

a. Under IFRS, publicly traded bonds with a maturity less than or equal to three months are considered to be cash and cash equivalents.

@ Answer a) is incorrect. Publicly traded bonds are a specified exclusion from cash and cash equivalents.

*b. There are no significant differences between IFRS and ASPE in the treatment of cash and cash equivalents.

@ Answer b) is correct. There are no significant differences between IFRS and ASPE in the treatment of cash and cash equivalents.

c. Under ASPE, publicly traded bonds with a maturity less than or equal to three months are considered to be cash and cash equivalents.

@ Answer c) is incorrect. Publicly traded bonds are a specified exclusion from cash and cash equivalents.

d. Under ASPE, minimum balance requirements in bank accounts are considered to be cash and cash equivalents.

@ Answer d) is incorrect. Minimum balance requirements in bank accounts are considered restricted cash.

12. Analyze cash and cash equivalents

Which of the following is considered restricted cash?

a. Foreign currency where there is a limited market for exchange into the company's operating currency

@ Answer a) is incorrect. This is an example of an exclusion from cash and cash equivalents but is not considered restricted cash.

b. Minimum balance requirements in bank accounts

@ Answer b) is incorrect. While a minimum balance requirement in a bank account is considered to be restricted cash, answer c) is also correct because donations provided for a specific purpose in a not-for-profit organization are also considered to be restricted cash.

c. Donations provided for a specific purpose in a not-for-profit organization

@ Answer c) is incorrect. While donations provided for a specific purpose are considered to be restricted cash, answer b) is also correct because minimum balance requirements in bank accounts are also considered to be restricted cash.

*d. Both b) and c)

@ Answer d) is correct. Both b) and c) are correct because minimum balance requirements in bank accounts and donations provided for a specific purpose in a not-for-profit are both examples of restricted cash.

13. Analyze changes in accounting policies, estimates, and errors

Kevin, an audit associate at your firm, Stanford and Poor LLP, is reviewing accounting changes. Which of the following statements is correct?

a. If a company decides to change the amortization period of kitchen equipment from three years to five years because the equipment is lasting longer than originally intended, this change should be accounted for retrospectively.

@ Answer a) is incorrect. This statement is incorrect. The change in the amortization period of the kitchen equipment is a change in estimate because the amortization period is an estimate of the asset's useful life. Changes in estimates are applied prospectively, not retrospectively.

b. If a company changes any of its accounting policies, it should include a note to the financial statements indicating the effect of the change on the current period and prior periods, but a description of the change is not required.

@ Answer b) is incorrect. This statement is incorrect. When a company changes its accounting policies, full disclosure of both the effect and a description of the change is required so that readers of the financial statements can understand the impact of the change on both the current and prior periods.

*c. A company can account for changes in accounting policies prospectively if the change is required by a primary source of GAAP that permits or requires prospective application.

@ Answer c) is correct. This statement is true. Where a change to the company's accounting policies is required by a primary source of GAAP that permits or requires prospective application, the company can account for the policy change prospectively. Changes made to existing standards and new standards will provide transitional guidance.

d. Under ASPE, a company may account for a change in its revenue recognition policy prospectively if the financial data needed to determine the impact on previous periods is readily available.

@ Answer d) is incorrect. This statement is not true. ASPE requires opening balances of assets, liabilities, and equity for the earliest prior period presented to be restated except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

14. Analyze changes in accounting policies, estimates, and errors

Which of the following describes a change in accounting policy?

a. Inventory was sold below its carrying amount even though the inventory had been previously written down to what was believed to be the net realizable value.

@ Answer a) is incorrect. This would be considered a change in estimate, as the net realizable value was previously management's best estimate of what the company would receive for the inventory.

*b. A public company changes from the cost model to the revaluation model for measuring the value of land.

@ Answer b) is correct. A change from the cost model to the revaluation model for measuring the value of land is an acceptable change in accounting policy under IFRS.

c. Development costs were capitalized when only five of six criteria for capitalization had been satisfied.

@ Answer c) is incorrect. This would be an error; the costs should have been expensed, as not all the criteria were met.

d. The company miscalculated the weighted average number of ordinary shares outstanding because it used the wrong date for a share issuance.

@ Answer d) is incorrect. This is an error in the calculation of the earnings per share.

15. Analyze the accounting treatment for contingent losses and gains — ASPE

You, CPA, are the audit senior on the Louise's Landscaping (Louise's) file. in The year-end financial statements of Louise's were prepared in accordance with ASPE. Which of the following items has been reported correctly?

a. Louise's has been sued by a customer to whom Louise inadvertently sold poison ivy instead of Virginia creeper. The lawsuit is for $500,000. A liability for $500,000 has been recognized. Louise's legal counsel believes that Louise's is liable, but is unable to estimate the amount.

@ Answer a) is incorrect. While the loss is likely, the amount cannot be estimated. A contingent loss is recognized in income and recorded as a liability only if it is likely that a liability has been incurred and the loss amount can be reasonably estimated.

*b. Louise's has been sued by a supplier for a disputed payment of $280,000. Louise's legal counsel believes that there is a 55% probability that she will have to pay. There is no liability recognized on the statements, but a description of the lawsuit and an estimate of the amount of loss is disclosed.

@ Answer b) is correct. Because the probability of loss is less than 70%, there is no accrual required. Disclosure of the nature and estimate of the amount of the contingent loss is required.

c. Louise's has sued Bruce's Manure, a supplier of bovine manure, for defamation. Louise's legal counsel has advised that Louise's is 95% certain to win the lawsuit and estimates the amount of the proceeds to be between $300,000 and $350,000. A receivable for $300,000 has been recognized.

@ Answer c) is incorrect. Contingent gains are not recognized; however, the gain should be disclosed because the inflow of economic benefits is seen as probable

d. Louise's has sued Rimmer's Reeds, a supplier of water flowers for $400,000. Louise's legal counsel has advised that Louise's is 90% certain to win, but cannot accurately estimate the amount that Louise's will collect. A receivable for $400,000 has been recognized.

@ Answer d) is incorrect. Contingent gains are not recognized; however, the gain should be disclosed as the inflow of economic benefits is seen as probable.

16. Analyze the accounting treatment of a contingent liability — ASPE

Academy Vending Machines Inc. (Academy), along with several other parties, is being sued for $500,000 by a man who was badly burned when he spilled a cup of hot chocolate on himself at a skating rink.

Academy sold the hot chocolate machine to the rink during the year. At year end, Academy's lawyer and management team were unable to estimate the probability of a loss or the amount of the loss.

If Academy reports in accordance with ASPE, what is the appropriate treatment for the lawsuit in Academy's financial statements?

a. Accrue $500,000 and disclose that the outcome of the lawsuit is not determinable.

@ Answer a) is incorrect. An accrual of $500,000 is not appropriate if the outcome is not determinable and an estimate cannot be made.

b. Disclose $500,000 and that the occurrence of the future event is unlikely.

@ Answer b) is incorrect. Academy's lawyer has not been able to determine whether or not Academy will lose the lawsuit; therefore, Academy cannot state that the loss is unlikely. Also, if the loss was unlikely, disclosure of the loss would not be required.

c. Accrue only a portion of the $500,000, based on management's best estimate.

@ Answer c) is incorrect. An accrual of the losses is required only if the loss is likely and estimable. Neither of these conditions exists at the present time.

*d. Disclose $500,000 and indicate that the result of the lawsuit is not determinable.

@ Answer d) is correct. Because the outcome is not determinable and the amount of the loss is not estimable, disclosure is appropriate.

17. Calculate diluted earnings per share

Company A is a public company. They have:

- a total of 100,000 common shares outstanding.
- Six months before year end, Company A issued 20,000 debentures that are convertible into a total of 10,000 common shares.
- All of these debentures are outstanding at year end.

In computing diluted earnings per share calculation, the following would apply:

a. The common shares arising from the convertible debenture issued during the period would be included from the date the current fiscal period began.

@ Answer a) is incorrect. Potential common shares arising from a dilutive convertible security issued during the period are not included from the date the current fiscal period began.

b. Only the current common shares outstanding would be included in the denominator of the calculation.

@ Answer b) is incorrect. Potential common shares arising from a dilutive convertible security are included in the denominator.

*c. The common shares arising from the dilutive convertible debenture issued during the period would be included from the date of issuance of the debenture.

@ Answer c) is correct. In accordance with the IAS 33.36, potential common shares arising from a dilutive convertible security issued during the period are included from the date of issuance of the dilutive security. Therefore, they must be weighted for the period the convertible debentures were outstanding.

d. The common shares arising from the convertible debenture issued during the period would only be included once converted.

@ Answer d) is incorrect. The potential common shares issued upon conversion are included in the denominator of the diluted earnings per shares calculation.

18. EPS — basic

Stampede Inc. (SI) is a public company.

On January 1, Year 1, 65,000 common shares were issued and outstanding. During the year:

- 15,000 additional common shares were issued on April 1
- 20,000 preferred shares were issued on June 1
- these shares are non-cumulative and carry an annual dividend entitlement of $2 per share.
- no dividends were declared
- net income was $2,000,000

What is the basic EPS for SI for its fiscal Year 1 year end?

a. $24.50

@ Answer a) is incorrect. The annual dividend entitlement does not need to be deducted in the numerator because the shares are non-cumulative and no dividend was declared in Year 1.

b. $25

@ Answer b) is incorrect. The denominator must use the weighted average of the shares outstanding during the year.

c. $25.70

@ Answer c) is incorrect. The annual dividend entitlement does not need to be deducted in the numerator because the shares are non-cumulative and no dividend was declared in Year 1.

*d. $26.23

@ Answer d) is correct. Proof of correct answer:

= Income available to common shareholders / WACSO
= $2,000,000 / [(65,000 × ¼) + (80,000 × ¾)]
= $2,000,000 / 76,250
= $26.23

19. Defined contribution pension plan

Savon Inc. has a defined contribution plan. During 20X6, its current service cost was $350,000 and Savon paid this amount by the end of 20X6.

In 20X5, Savon had amended its plan for past services. The amendment required $890,000 to be paid into the plan. Savon paid this amount in two equal instalments of $445,000 in 20X5 and $445,000 in 20X6. The plan amendment related to past services provided by employees in 20X2, 20X3, and 20X4.

What is the amount of the pension expense for 20X6?

*a. $350,000

@ Answer a) is correct. The past service cost is expensed in the year the amendment is made, which was 20X5. Only the current service cost for 20X6 is recognized in the pension expense for 20X6.

b. $528,000

@ Answer b) is incorrect. A past service cost is expensed in the year of amendment, not spread over the years 20X2 and 20X6.

c. $795,000

@ Answer c) is incorrect. Even though there was a payment made in 20X6 related to the past service cost, the total past service cost was expensed in 20X5.

d. $1,240,000

@ Answer d) is incorrect. This is the total of the past services cost and the current service cost expensed ($890,000 + $350,000 = $1,240,000). Even though there was a payment made in 20X6 related to the past service cost, the total past service cost was expensed in 20X5.

20. Defined contribution pension plan

Jeff has just joined a company that provides a defined contribution pension plan as a benefit for its employees. Jeff has come to you, CPA, to understand this pension plan and the obligations of the employer and employee.

Which of the following statements represents a defined contribution pension plan?

a. The employer has an obligation to ensure that the plan assets are sufficient to pay for the employee's pension benefit.

@ Answer a) is incorrect. Under a defined contribution pension plan, the employer has no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to make pension payments.

b. The pension expense includes the current service cost, interest costs, and any returns on the plan assets.

@ Answer b) is incorrect. The defined contribution pension expense does not include the returns on the plan assets. It does include the current service cost and any interest costs on discounted current service or past service costs.

*c. Annually, the employer pays fixed amounts that have been defined by the plan.

@ Answer c) is correct. The plan defines the amount of current service cost and past service costs that must be paid annually by the employer.

d. The employer guarantees a set amount to be paid on the employee's retirement.

@ Answer d) is incorrect. In a defined contribution pension plan, the employer does not guarantee a set pension amount and the employee bears the risk that there will be sufficient assets in the plan to fund retirement payments.

21. Discuss foreign currency gains or losses

Angela's Artwork Inc. (Angela's) recently entered into a contract to supply artwork to a U.S. company. The controller of Angela's is not experienced with translation of foreign currency transactions and has made the following entries to record sales to the U.S. company without factoring in the impact of foreign currency on the transactions:

To record sales in USD dollars:

DR	Accounts receivable	$156,000	
CR	Sales		$156,000

To record the collection of a portion of the receivable:

DR	Cash (USD)	$90,000	
CR	Accounts receivable		$90,000

To record the conversion of a portion of USD cash to CDN cash:

DR	Cash (CDN)	$78,000	
CR	Sales		$18,000
CR	Cash (USD)		$60,000

Sales were made evenly over a period when the exchange rate was US$1.00 = C$1.33, and the exchange rate at the end of the fiscal year was US$1.00 = C$1.25.

The foreign exchange gain or loss to be reported on these transactions is determined as follows:

a. By comparing translated year-end receivables to translated sales

@ Answer a) is incorrect. The translated year-end U.S. cash balance and Canadian cash balances must also be included when determining the foreign exchange gain or loss.

*b. By comparing the sum of Canadian cash, translated year-end receivables, and translated U.S. cash to translated sales

@ Answer b) is correct. All balance sheet accounts related to the sale are compared to the translated sales.

c. By comparing the sum of translated year-end receivables and translated U.S. cash to translated sales.

@ Answer c) is incorrect.

d. There would be no foreign exchange gain or loss because the difference is an adjustment to sales

@ Answer d) is incorrect. The difference is not an adjustment to sales. The difference should be classified as a foreign exchange gain or loss.

22. Analyze foreign currency transactions

An entity's functional currency is the dollar (or equivalent) in the environment:

a. Where the largest purchases occurred

@ Answer a) is incorrect. Large purchases do not impact the entity's functional currency.

b. In which its CEO resides

@ Answer b) is incorrect. The residence of the CEO does not impact the entity's functional currency.

c. Where it has disclosed in the notes at the end of the year

@ Answer c) is incorrect. An entity cannot declare its own functional currency.

*d. In which it operates day to day

@ Answer d) is correct. An entity's functional currency is the dollar (or equivalent) that it primarily uses in day-to-day operations.

23. Analyze foreign operations

Which of the following statements regarding functional currency is true?

a. It is the currency that a company reports its financial results in.

@ Answer a) is incorrect. Presentation currency is the currency that a company reports its financial results in.

*b. It is the currency that a company primarily uses in its daily operations.

@ Answer b) is correct. Functional currency is the currency that a company primarily uses in its daily operations.

c. It is the currency that a company's key management receives remuneration in.

@ Answer c) is incorrect. A company's management compensation may contribute to a primary factor in determining functional currency, but it is not always the currency in which key management is compensated.

d. It is the currency that a company primarily invests in.

@ Answer d) is incorrect. Investing or financing activities can be a secondary factor when determining a company's functional currency.

24. Analyze foreign operations

When discussing an integrated operation, which of the following statements is true?

a. Its functional currency is the same as in a self-sustaining operation.

@ Answer a) is incorrect. The functional currency of a self-sustaining operation is not the Canadian dollar.

b. Its functional currency can vary depending on the presentation currency

@ Answer b) is incorrect. Its functional currency does not vary depending on the presentation currency.

*c. Its functional currency is the Canadian dollar.

@ Answer c) is correct. The functional currency of an integrated operation is the Canadian dollar.

d. Its functional currency can vary depending on the company's reporting framework.

@ Answer d) is incorrect. A company's functional currency is not different under IFRS and ASPE.

25. Discuss the capitalization of intangible assets

Under IFRS, intangible assets that may be capitalized include:

a. Internally generated goodwill

@ Answer a) is incorrect. Under IFRS, internally generated goodwill cannot be recognized as an asset (IAS 38.48).

b. Internally developed brands

@ Answer b) is incorrect. Under IFRS, the costs of internally developed brands cannot be distinguished and measured, and are specifically excluded from capitalization for these reasons (IAS 38.63).

*c. Overhead costs directly related to development activities

@ Answer c) is correct. Overhead costs directly related to development activities of preparing the asset for use are eligible for capitalization. These costs have a future benefit, they can be distinguished from other costs, and they can be appropriately measured (IAS 38.66).

d. Borrowing costs related to research activities

@ Answer d) is incorrect. Under IFRS, borrowing costs related to research cannot be recognized as an asset (IAS 38.54).

26. Analyze development costs

Carson Inc. spent $25,000 to redesign the layout of its offices to improve efficiency. No new equipment or other expenditures were incurred. Carson Inc.'s CFO, Jim Peltice, reviewed all costs and noted no research amounts. Jim believes that all costs incurred are development costs per IAS 38 *Intangible Assets*.

How should Carson Inc. record the $25,000 redesign cost?

a. Add the $25,000 redesign cost to the cost of the office building as a betterment and amortize it over the remaining life of the building.

@ Answer a) is incorrect. The $25,000 redesign cost does not improve the future benefit of the building, but rather the employees and equipment within it.

*b. Record the $25,000 redesign cost as a specifically identifiable intangible asset if future benefit is likely and amortize it over the estimated period of benefit.

@ Answer b) is correct. The specifically identifiable intangible asset should be amortized over the estimated period of benefit; however, in reality, it may be difficult to estimate the period of future benefit.

c. Expense the $25,000 redesign cost as a period cost.

@ Answer c) is incorrect. The $25,000 redesign cost should be expensed as a period cost only if future benefit is not likely and the period of benefit cannot be estimated. It appears that the improved efficiency is likely, and therefore future benefits would be likely.

d. Record the $25,000 redesign cost as goodwill since it improves the efficiency of the business.

@ Answer d) is incorrect. Internally generated goodwill cannot be recorded; goodwill must be acquired in a business purchase in order to be recognized, per IAS 38.48.

27. Accounting for government grants

J1 Inc. (J1) received a government grant of $100,000 in fiscal 20X7. The purpose of the grant was to enable J1 to replace manufacturing equipment with "greener" options. The new equipment cost $800,000 and has an estimated useful life of five years. J1 applies IFRS. Which of the following is true about how to account for the government grant?

*a. It must be recognized in income on a systematic basis over the life of the manufacturing equipment.

@ Answer a) is correct. See IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance,* paragraphs 26 and 27.

b. It must be recognized in income evenly over the life of the manufacturing equipment, which equals $20,000 per year.

@ Answer b) is incorrect. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance,* paragraphs 26 and 27, do not require the grant to be recognized evenly over the life of the manufacturing equipment. It must be recognized on a systematic basis that is consistent with the depreciation policy selected for the asset. For example, if the asset is depreciated on a declining-balance basis, the grant income recognized each year would not be $20,000 per year, but it would be consistent with IAS 20 requirements.

c. It must be deducted from the cost of the manufacturing equipment in calculating the carrying amount of the asset, which equals a net carrying amount of $700,000.

@ Answer c) is incorrect. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* allows two options for accounting for a government grant. Deducting from the cost of the asset is one of those options, per paragraph 27. However, paragraph 26 allows for the grant to be recognized as deferred income and recognized on a systematic basis over the useful life of the asset.

d. It must be recognized as deferred income and recognized on a systematic basis over the useful life of the asset.

@ Answer d) is incorrect. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* allows two options for accounting for a government grant. Recognizing the grant as deferred income and recognizing it on a systematic basis over the useful life of the asset is one of those options, per paragraph 26. Deducting from the cost of the asset is also a valid option, per paragraph 27.

28. Accounting for government grants

The following case facts pertain to Bok Choy Inc. (BCI) and a grant received from the Ontario government:

- On day 1 of the 20X7 fiscal year, BCI received a grant for $5,000,000 toward the construction of a new building.
- The total construction cost of the building, which was completed on day 1 of the 20X7 fiscal year, was $25,000,000.
- The building is to be depreciated on a straight-line basis over the useful life of the building, which is expected to be 25 years.
- The grant does not have to be repaid unless BCI fails to meet certain conditions imposed by the Ontario government.
- Management has assessed that it is likely that BCI will meet all conditions of the grant.

What is the impact on income in 20X7 as a result of the above transaction?

a. Income will increase by $200,000.

@ Answer a) is incorrect. This option ignores depreciation expense on the building.

*b. Income will decrease by $800,000.

@ Answer b) is correct. Proof: ($25,000,000 – $5,000,000) / 25 years = $800,000.

c. Income will decrease by $1,000,000.

@ Answer c) is incorrect. This option does not take into account that a portion of the grant can be recognized in income. Because there is reasonable assurance that the conditions of the grant will be met, it can be recognized according to the provisions of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, paragraph 7: "Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that: (a) the entity will comply with the conditions attaching to them; and (b) the grants will be received."

d. It is not possible to calculate the impact on income without knowing which method BCI will use to account for the grant.

@ Answer d) is incorrect. Regardless of which method is used of the two allowable options noted in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, the impact on income is the same.

29. Impairment — ASPE and IFRS differences

Which of the following is a difference in impairment between IFRS and ASPE?

*a. IFRS requires an assessment of indicators of impairment at least every reporting date, while ASPE requires assessment only when events or a change in circumstances require it.

@ Answer a) is correct. This describes a difference between IFRS and ASPE. Paragraph 9 of IAS 36 Impairment of Assets: "An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset." Paragraph 9 of ASPE Section 3063 Impairment of Long-Lived Assets: "A long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable."

b. Reversals of impairment losses are permitted under ASPE up to the original cost of the asset, while reversals are not permitted under IFRS.

@ Answer b) is incorrect. This is not a valid difference between ASPE and IFRS. IFRS permits reversals while ASPE does not.

c. ASPE uses discounted cash flows in assessing the recoverable amount, while IFRS uses the undiscounted cash flows.

@ Answer c) is incorrect. IFRS uses discounted cash flows when assessing the recoverable amount, whereas ASPE uses the undiscounted cash flows.

d. Recognition of impairment under the ASPE model compares the carrying amount to the higher of the value in use and the fair value less costs to sell. The IFRS model compares the carrying amount to the undiscounted future net cash flows from use and disposal.

@ Answer d) is incorrect. Recognition of impairment under the IFRS model compares the carrying amount to the higher of the value in use and the fair value less costs to sell. The ASPE model compares the carrying amount to the undiscounted future net cash flows from use and disposal.

30. Impairment — ASPE

Nuts and Bolts Inc. (NBI) reports its financial statements in accordance with ASPE. Manufacturing equipment used to manufacture products that have not been selling as well as expected has been identified as potentially impaired. Relevant information to assist management in accounting for the equipment properly is as follows:

Cost of equipment	$200,000
Accumulated depreciation — equipment	$40,000
Undiscounted future net cash flows associated with the equipment (estimated)	$120,000
Fair value of equipment	$100,000

What is the impairment loss to be reported by NBI with respect to this equipment?

a. $40,000

@ Answer a) is incorrect. The loss was calculated by taking the difference between the carrying value of the equipment and the undiscounted future cash flows. Proof of incorrect answer: ($200,000 – $40,000) – $120,000 = $40,000.

*b. $60,000

@ Answer b) is correct. The loss was calculated by taking the difference between the carrying value of the equipment and the fair value. Proof of correct answer: ($200,000 – $40,000) – $100,000 = $60,000. This is in accordance with ASPE 3063.05-.06: "The carrying amount of a long-lived asset is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. This assessment is based on the carrying amount of the asset at the date it is tested for recoverability, whether it is in use or under development. An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value."

c. $80,000

@ Answer c) is incorrect. The loss was calculated by taking the difference between the cost of the equipment and the undiscounted future cash flows. Proof of incorrect answer: $200,000 – $120,000 = $80,000.

d. $100,000

@ Answer d) is incorrect. The loss was calculated by taking the difference between the cost of the equipment and the fair value. Proof of incorrect answer: $200,000 – $100,000 = $100,000.

31. Prepare the journal entry to record income tax expense

ABC Co. is a privately owned company that reports under ASPE. For the year ending December 31, 20X6, the company reported earnings before tax of $100,000. The following additional information is available:

Depreciation	$20,000
Meals and entertainment	$2,000
Maximum possible capital cost allowance (CCA) claim	$25,000
Applicable tax rate	20%

What is the journal entry to record the total income tax expense for the year, assuming the company uses the taxes payable method and wishes to minimize taxes?

a. Dr. Income tax expense $20,000; Cr. Income taxes payable $20,000

@ Answer a) is incorrect. $100,000 × 20% = $20,000. The increase to income tax expense was based on income before tax, multiplied by the tax rate. Schedule 1 adjustments were not considered.

*b. Dr. Income tax expense $19,200; Cr. Income taxes payable $19,200

@ Answer b) is correct. The $19,200 debit to income tax expense is calculated as follows:

Net income before tax	$100,000
Add back depreciation	20,000
Add back non-deductible portion of meals and entertainment	1,000
Less CCA	(25,000)
Net income and taxable income	96,000
Tax rate	20%
Income tax expense	$ 19,200

c. Dr. Income tax expense $20,200; Cr. Income taxes payable $19,200, Cr. Future income tax liability $1,000

@ Answer c) is incorrect. This option recorded an additional $1,000 [($25,000 – $20,000) × 20%] of income tax expense in 20X6, resulting from the difference between the net book value and the undepreciated capital cost of ABC's depreciable assets. The future income tax method was incorrectly applied, as the question states that the company uses the taxes payable method, not the future income tax method of calculating income tax expense.

d. Dr. Income tax expense $19,000, Cr. Income taxes payable $19,000

@ Answer d) is incorrect. The $19,000 debit to income tax expense is calculated as follows:

Net income before tax	$100,000
Add back depreciation	20,000
Less CCA	(25,000)
Net income and taxable income	95,000
Tax rate	20%
Income tax expense	$ 19,000

This calculation is incorrect because it does not factor in the non-deductible portion of meals and entertainment into the calculation of taxes payable.

32. Which of the following statements is true with respect to accounting for income taxes?

a. Under IFRS, companies may choose to use either the deferred method or the future income tax method.

@ Answer a) is incorrect. Under IFRS, companies have no choice and must use the deferred income tax method.

b. Under ASPE, companies must use the taxes payable method.

@ Answer b) is incorrect. Under ASPE, companies have the choice to use the taxes payable method or the future income tax method.

c. Under IFRS, the deferred income tax asset and the deferred income tax liability accounts are classified as current or noncurrent, according to the type of asset or liability that created them.

@ Answer c) is incorrect. Under IFRS, companies classify all deferred income tax assets and liabilities as noncurrent.

*d. Under ASPE, companies choosing to use the future income tax method are not allowed to discount future income tax assets and liabilities.

@ Answer d) is correct. Under ASPE, discounting of future income tax assets and liabilities is not allowed (paragraph 52 of ASPE Section 3465 *Income Taxes*).

33. Interim reporting — comparatives

Sammy Ltd. is a public company. Sammy is preparing its statement of comprehensive income for quarter 2, which ended on June 30, Year 2. What periods must be presented on the statement of comprehensive income?

a. Quarter 2, Year 2, and quarter 2, Year 1

@ Option a) is incorrect.

*b. Quarter 2, Year 2, quarter 2, Year 1, year-to-date, Year 2, and year-to-date, Year 1

@ Option b) is correct. The statement of comprehensive income must show the current interim period, cumulatively for the current financial year and comparatives for both the interim period and year-to-date of the preceding financial year.

c. Quarter 2, Year 2, and year-to-date Year 2

@ Option c) is incorrect.

d. Quarter 2, Year 2, year-to-date Year 2, and year-to-date Year 1

@ Option d) is incorrect.

34. Interim reporting — accounting policies

Isla Inc.'s controller is new and is preparing interim financial statements for the first time. At the year-end date, she spends a significant amount of time updating estimates for items like allowance for doubtful accounts. She is wondering about the work required to complete the interim statements, and has asked you, CPA, for guidance.

Which of the following statements is true?

a. The allowance for doubtful accounts remains the same as it will be updated at year end.

@ Option a) is incorrect.

b. The allowance for doubtful accounts should be updated based on the same bad debt rates as the prior year.

@ Option b) is incorrect.

*c. The allowance for doubtful accounts should follow the same policies as at year end and be updated to reflect the appropriate measurement of accounts receivable.

@ Option c) is correct. Measurement objectives for interim reporting are the same as those for annual reporting, meaning that they shall be made on a year-to-date basis.

d. The allowance for doubtful accounts is **NOT** disclosed in the interim financial statements; therefore, an adjustment is unnecessary.

@ Option d) is incorrect. The allowance for doubtful accounts may or may not be disclosed based on the company's requirements for interim reporting. The balance will impact the financial statements regardless of the level of disclosure.

35. Calculate the ending balance in inventory

Red Rocket Inc. had a beginning inventory on January 1 of 300 boxes of fuses at a cost of $9 per box. During the year, the following transactions occurred:

	Transaction	**Boxes**	**Cost**
February 10	Purchase	700	$ 7
March 20	Sale	500	
October 30	Purchase	100	$12
November 15	Sale	400	

Determine ending inventory using the FIFO (first in, first out) cost formula.

*a. $1,900

@ Answer a) is correct. Ending inventory of $1,900 is determined as follows:

	Purchases			**Cost of goods sold**			**Inventory balance**		
	Units	**Cost**	**Total**	**Units**	**Cost**	**Total**	**Units**	**Cost**	**Total**
Opening							300	$ 9	$2,700
Feb 10	700	$7	$4,900				300 700	$ 9 $ 7	$7,600
March 20				300 200	$9 $7	$4,100	500	$ 7	$3,500
Oct 30	100	$12	$1,200				500 100	$ 7 $12	$4,700
Nov 15				400	$7	$2,800	100 100	$ 7 $12	$1,900

b. $1,800

@ Answer b) is incorrect. Ending inventory was determined using the LIFO (last in, first out) cost formula.

c. $1,666

@ Answer c) is incorrect. Ending inventory was determined using the weighted average cost formula on a perpetual basis.

d. $1,600

@ Answer d) is incorrect. Ending inventory was determined using the weighted average cost formula on a periodic basis.

36. Identify costs to be included in the value of the finished goods inventory

Kaltech manufactures toolboxes for trucks in Sudbury, and maintains a head office in Toronto. The toolboxes are painted in a paint booth that requires Kaltech to adhere to strict safety standards, including always having a safety supervisor on site. Kaltech has a manufacturing facility and a separate sales and administration building.

Which of the following would be included in the value of finished goods inventory?

*a. Safety supervisor's wages

@ Answer a) is correct. The safety supervisor's wages are a direct cost and should be included in the value of inventory.

b. Amortization on the corporate headquarters

@ Answer b) is incorrect. Paragraph 12 of IAS 2 *Inventories* allows for an allocation of fixed costs (which are part of the production of the inventory) to the value of finished goods inventory, not amortization on corporate head offices.

c. Storage costs, once production is complete

@ Answer c) is incorrect. While paragraph 16(b) of IAS 2 *Inventories* allows for storage costs to be added to the cost of inventory, where the storage costs are necessary in the production process before a further production stage, the same standard excludes post-production storage costs from being added to the cost of finished goods inventory.

d. CEO's wages

@ Answer d) is incorrect. The CEO's salary is not a part of manufacturing overhead.

37. Discuss classification of leases under ASPE

You are discussing the classification of leases with Howie, a fellow associate at Burns and Pickle LLP. Which one of Howie's statements regarding leases for a company reporting under ASPE is correct?

a. A lease is a capital lease if the present value of the minimum lease payments is 75% or more of the fair market value of the property at the inception of the lease.

@ Answer a) is incorrect. Where the lessor recovers substantially all of its investment in the leased property and earns a return on that investment (where the present value of the minimum lease payments is equal to 90% or more of the fair value of the leased asset), the lease is classified as a capital lease.

b. If a lease has no bargain purchase option, it must be classified as an operating lease.

@ Answer b) is incorrect. Where there is no bargain purchase option, a lease can still be classified as a capital lease where the lessee will benefit from most of the asset benefits due to the length of the lease term and/or the lessor recovers substantially all of its investment and earns a return on that investment.

c. From a lessee's perspective, when determining the present value of the minimum lease payments, you only include annual lease payments.

@ Answer c) is incorrect. From a lessee's perspective, the minimum lease payments include the following: the minimum rental payments, any amounts guaranteed by the lessee related to the residual value of the leased asset, and a bargain purchase option (which may or may not be included in the lease conditions).

*d. When calculating the interest rate implicit in the lease, you include the minimum lease payments plus the unguaranteed residual value of the leased property.

@ Answer d) is correct. The interest rate implicit in the lease is the discount rate at the beginning of the lease that makes the present value of the minimum lease payments plus any unguaranteed residual values equal to the fair value of the asset being leased.

38. Calculate the present value of the minimum lease payments

On January 1, 20X6, Beatty Inc. entered into a five-year lease to acquire some machinery. Beatty reports under ASPE and is the lessee. The terms of the lease are as follows:

- Lease payments of $25,000 are made annually on the first day of the year.
- Included in the annual lease payments are maintenance fees of $2,000 per year.
- The machinery reverts to the lessor at the end of the lease and the lease contains no renewal options.
- Beatty uses straight-line depreciation for the machinery that it owns.
- The machinery has a fair value of $100,000 on January 1, 20X6, and has an estimated economic life of five years with no residual value.
- Beatty's incremental borrowing rate is 11% per year.
- The lease's implicit interest rate is 10%.

What is the present value of the minimum lease payments?

*a. $95,907

@ Answer a) is correct. The present value of the minimum lease payments = $23,000 ($25,000 – $2,000 in maintenance fees) × present value of an annuity due of $1 for five periods at 10% = $23,000 × 4.16986 = $95,907. The lessor's implicit rate of 10% was correctly used instead of the lessee's incremental borrowing rate of 11%, as this is the lower of the two rates. ASPE states that the lower of the two rates must be used when calculating the present value of the minimum lease payments.

b. $94,356

@ Answer b) is incorrect. Proof of calculation: The present value of the minimum lease payments = $23,000 ($25,000 – $2,000 in maintenance fees) × present value of an annuity due of $1 for five periods at 11% = $23,000 × 4.10245 = $94,356. The lessee's incremental borrowing rate of 11% was incorrectly used instead of the lessor's implicit rate of 10%. ASPE states that the lower of the lessor's implicit rate and the lessee's incremental borrowing rate must be used when calculating the present value of the minimum lease payments.

c. $104,247

@ Answer c) is incorrect. Proof of calculation: The present value of the minimum lease payments = $25,000 × present value of an annuity due of $1 for five periods at 10% = $25,000 × 4.16986 = $104,247. The lessor's implicit rate of 10% was correctly used instead of the lessee's incremental borrowing rate of 11%, as this is the lower of the two rates. ASPE states that the lower of the two rates must be used when calculating the present value of the minimum lease payments. This calculation is incorrect because the $2,000 in maintenance fees was not removed from the annual lease payment.

d. $102,561

@ Answer d) is incorrect. Proof of calculation: The present value of the minimum lease payments = $25,000 × present value of an annuity due of $1 for five periods at 11% = $25,000 × 4.10245 = $102,561. The lessee's incremental borrowing rate of 11% was incorrectly used instead of the lessor's implicit rate of 10%. ASPE states that the lower of the lessor's implicit rate and the lessee's incremental borrowing rate must be used when calculating the present value of the minimum lease payments. Also, the $2,000 in maintenance fees was not removed from the annual lease payment.

39. Analyze deferred revenue

During the year, MNR Ltd. entered into a contract to provide monthly consulting services to XYZ Inc. The contract is expected to last for 12 months. It commenced on March 1 and MNR's year end is October 31. The total value of the contract is $120,000. XYZ paid the full amount on July 11.

Which of the following statements is correct with respect to MNR's October 31 financial statements?

*a. MNR should record $40,000 as deferred revenue because the contract is not complete.

@ Answer a) is correct. The obligation is satisfied over time as the service is provided. The portion of the contract fee that has yet to be earned at October 31 should be recorded as deferred revenue for the period November 1 to February 28 = 4/12 × $120,000: $40,000.

b. MNR should record $80,000 as deferred revenue because that is the amount earned.

@ Answer b) is incorrect. Revenue has been earned for eight months from March 1 to October 31 (8/12 × $120,000 = $80,000). Because $80,000 in revenue has been earned, it should not be recorded as deferred revenue on the October 31 financial statements.

c. MNR should record $120,000 as deferred revenue because the contract is not complete.

@ Answer c) is incorrect. Revenue has been earned for eight months from March 1 to October 31 (8/12 × $120,000 = $80,000). Because this revenue has been earned, it can be recorded as revenue on the October 31 financial statements.

d. MNR should record $120,000 as revenue because that is the amount of cash received.

@ Answer d) is incorrect. This answer assumes that the entire contract fee has been earned as at October 31. This assumption is incorrect because the contract will not be completed until February — there are still four months of consulting services that have yet to be provided.

40. Analyze the timing of revenue recognition

Amaris Corp. manufactures and installs air conditioning systems. It recently signed a contract with Barkley Inc. to provide 10 custom-built air conditioning units, including installation, for total consideration of $250,000. Of this amount, $50,000 is non-refundable and is due in advance; the balance is due after all 10 units have been installed. The units will be manufactured and shipped over a one-month period, and the full installation will occur the following month. Amaris also sells air conditioning units without installation because several of its customers hire independent installers that they have used for other projects.

Which of the following statements is true?

a. Amaris should recognize $250,000 as revenue only when all installations are complete.

@ Answer a) is incorrect. The contract is composed of both goods (the air conditioners) and services (the installation), which are distinct. The fact that Amaris sells air conditioners without installation supports the fact that the revenue from the goods can be recognized before the installation occurs.

b. The non-refundable deposit should be recognized in revenue at the beginning of the contract.

@ Answer b) is incorrect. The deposit is related to the contract, and at the beginning of the contract no performance obligations have been met.

c. The revenue related to the sale of air conditioning units cannot be recognized separately because the Barkley contract specifies that the installation must be completed.

@ Answer c) is incorrect. Since Amaris also sells units without installation, the revenue related to the sale of the air conditioning unit is distinct from the revenue related to installation.

*d. The revenue related to the installation of air conditioning units can be recognized separately because there is evidence of a fair market value for the air conditioners.

@ Answer d) is correct. The contract has two distinct components. The sale of the goods would normally be complete when the units are delivered. This amount is measurable and is separate from the amount that is related to installation.

41. Non-monetary transactions (NMTs) — ASPE and IFRS differences

You, CPA, are preparing a comparison of ASPE versus IFRS for a professional development session. You are looking at how ASPE and IFRS account for non-monetary transactions (NMTs). Which of the statements below is true?

a. IFRS and ASPE standards are completely converged in terms of NMTs; there are no differences.

@ Answer a) is incorrect.

*b. IFRS requires non-monetary, revenue-generating transactions to be recorded at the fair value of the asset received when known.

@ Answer b) is correct. The main difference is that under IFRS (IAS 18 *Revenue*), non-monetary, revenue-generating transactions are recorded at the fair value of the asset received, unless it is unknown, in which case the fair value of the asset given up is used. Under ASPE (Section 3831 *Non-monetary Transactions*), when the fair value of the asset given up is known, this is used as the measurement.

c. IFRS does not provide guidance on measurement of NMTs and ASPE does.

@ Answer c) is incorrect. While ASPE has a separate section for NMTs, IFRS does provide guidance within individual sections.

d. ASPE does not provide guidance on measurement of NMTs and IFRS does.

@ Answer d) is incorrect. ASPE Section 3831 *Non-monetary Transactions* provides guidance on NMTs.

42. Non-monetary transactions (NMTs) — Analyze the appropriate accounting treatment

Sunnybrae Inc. agrees to exchange inventory with a cost of $10,000 and a fair value of $14,000 for paving services from Tar Ltd. The paving has a cost of $8,000 and a fair value of $16,000. Sunnybrae compensates Tar with an additional $1,000 in cash. Sunnybrae reports under ASPE. At what value should Sunnybrae record the paving services?

a. The transaction should be measured at the $1,000 cash given up.

@ Answer a) is incorrect.

b. The transaction should be measured at $14,000.

@ Answer b) is incorrect. This is the fair value of the non-monetary asset given up.

*c. The transaction should be measured at $15,000.

@ Answer c) is correct. This is an NMT because part of the transaction is an exchange of non-monetary items. The transaction does not meet any of the exclusions for measurement at fair value. The transaction has commercial substance, as the timing of cash flows would differ for paying for pavement versus selling inventory; the items exchanged are not similar; and both fair values are known. The transaction should be measured at the fair value of the asset given up, as both fair values are known. Sunnybrae has given up inventory with a fair value of $14,000 and cash with a fair value of $1,000, so it should record the paving services at a value of $15,000.

d. The transaction should be measured at $16,000.

@ Answer d) is incorrect. This is the fair value of the asset received.

43. Analyze not-for-profit accounting

Under accounting standards for not-for-profit organizations (ASPNO), fund accounting is:

*a. A self-balancing set of accounts for each fund

@ Answer a) is correct. Fund accounting works as a self-balancing set of accounts for each fund.

b. Required for each fund

@ Answer b) is incorrect. Fund accounting is optional under ASNPO and only required when an NPO uses the restricted fund method of accounting for contributions.

c. Typically shown as a row for each fund in the financial statements

@ Answer c) is incorrect. Fund accounting is typically shown as a column for each fund in the financial statements.

d. Made up of net asset funds

@ Answer d) is incorrect. Common funds that are presented in fund accounting include general, restricted, and capital asset funds. Net assets are the net of total assets and liabilities, but are not their own fund.

44. Analyze not-for-profit accounting

Under ASNPO:

a. The deferral method facilitates tracking externally restricted contributions.

@ Answer a) is incorrect. Fund accounting facilitates tracking of externally restricted contributions, not the deferral method.

*b. The NPO may have one bank account that includes the balances of several funds.

@ Answer b) is correct because under ASNPO, the NPO may have one bank account that includes the balances of several funds.

c. The statement of operations helps users understand which funds are available for use.

@ Answer c) is incorrect. Net assets help users understand which funds are available for use.

d. The fund method tracks all contributions separately in their own fund.

@ Answer d) is incorrect. The fund method tracks all restricted funds in separate funds as set forth by the restricted contribution. It also has a general fund for all items not subject to restrictions.

45. Passive investments — ASPE and IFRS differences

You, CPA, are teaching your firm’s co-op student about passive investments. You decide to compare how ASPE and IFRS account for passive investments. Which of the following statements is true?

a. IFRS reports all passive investments at fair value, and ASPE reports passive investments at any of cost, fair value, or amortized cost.

@ Answer a) is incorrect. IFRS does not report all passive investments at fair value. Debt investments that meet specified criteria are accounted for at amortized cost.

b. Under both ASPE and IFRS, investments adjusted to fair value at each reporting date require the changes in fair value to be reported in net income.

@ Answer b) is incorrect. ASPE reports changes in fair value through net income; however, IFRS reports only some changes in fair value through net income. IFRS reports the change in other comprehensive income for fair value through other comprehensive income (FVTOCI) investments.

*c. For amortized cost investments, IFRS requires the use of the effective interest method, and ASPE permits a choice between the straight-line and effective interest methods.

@ Answer c) is correct. IFRS does not permit this choice, but ASPE does.

d. Accounting is the same under IFRS and ASPE for passive investments.

@ Answer d) is incorrect. There are significant differences between ASPE and IFRS in how passive investments are accounted for.

46. Passive investments

Brown Inc. (BI) reports an investment in bonds using the amortized cost method. The bonds have a face value of $1,000,000 and were purchased on January 1, 20X7. The market interest rate is 8% and the bonds pay interest at a rate of 6%. Interest payments are made every June 30 and December 31. The bonds mature 10 years from the date of purchase, on December 31.

What journal entry records the acquisition of the bonds on January 1, 20X7?

*a.

Dr. Investment in bonds	$864,100	
Cr. Cash		$864,100

@ Answer a) is correct:

$1,000,000 × (P/F 4%*, 20) = $1,000,000 × 0.45639 = $456,390

$30,000 interest × (P/A 4%*, 20) = $30,000 × 13.59033 = $407,710

Issuance price (fair value) = $456,390 + $407,710 = $864,100

*4% = 8% / 2 to reflect 20 half-year periods

b.

Dr. Cash	$864,100	
Cr. Bonds payable		$864,100

@ Answer b) is incorrect. The journal entry reflects what the bond issuer would record.

c.

Dr. Investment in bonds	$1,000,000	
Cr. Cash		$1,000,000

@ Answer c) is incorrect. This answer uses the stated rate to calculate the bond price (reports at face value instead of the fair value).

d.

Dr. Investment in bonds	$664,496	
Cr. Cash		$664,496

@ Answer d) is incorrect. This answer used 10 periods as the amortization period at 8%, but there are actually 20 interest periods.

47. Property, plant, and equipment

Under IFRS, which of the following can be capitalized to the cost of land?

a. CEO's salary

@ Answer a) is incorrect. The CEO's salary cannot be directly attributed to the cost of the land.

b. Construction materials

@ Answer b) is incorrect. Construction materials would be capitalized to the cost of the building, not to the cost of the land.

c. Utilities

@ Answer c) is incorrect. Utilities are not directly attributable to the cost of the land and would be expensed to the income statement (or a part of manufacturing overhead attributed to inventory).

*d. Title search

@ Answer d) is correct. Costs to perform a title search can be capitalized to the cost of the land.

48. Property, plant, and equipment

The units of production method of depreciation:

a. Assumes that the benefit derived from the asset is higher in its initial years

@ Answer a) is incorrect. The declining balance method assumes that the benefit derived from the asset is higher in its initial years and less as the asset ages.

b. Is the cost of the asset, net of the residual value, divided by the estimated useful life

@ Answer b) is incorrect. The straight-line method is the cost of the asset, net of the residual value, divided by the estimated useful life.

*c. Is based on allocating the cost in proportion to the fraction of capacity used

@ Answer c) is correct. The units of production method of depreciation is based on allocating the cost in proportion to the fraction of capacity used.

d. Is the book value of the asset multiplied by the depreciation rate

@ Answer d) is incorrect. The declining balance method is the book value of the asset multiplied by the depreciation rate.

49. Determine whether an entity is a related party to the reporting entity using IAS 24

Flowers International Ltd. (Flowers), a wholesaler of plants, is a subsidiary of Blooms Inc. Flowers has a 25% ownership interest in Blooms Inc. Blooms Inc. sells floral bouquets nationwide and applies ASPE.

Which one of the following parties would be a related party to Blooms Inc.?

a. The sister to the spouse of Blooms' CEO

@ Answer a) is incorrect. The spouse of Blooms' CEO would be a related party to Blooms Inc. Per IAS 24.9(a)(iii), one definition of a related party is a person who is a member of key management personnel of the reporting entity, or a close member of that person's family. The sister of the CEO's spouse, a member of key management at Blooms Inc., would not be considered a related party.

b. National Delivery Service, a company owned 15% by Flowers

@ Answer b) is incorrect. Neither Bloom nor Flowers have significant influence over National Delivery Service. Bloom is not a related party to National Delivery Service.

c. CostGo, the largest customer of Blooms Inc.

@ Answer c) is incorrect. CostGo is not a related party to Blooms Inc. Customers are not related parties (they have no ability to exercise, directly or indirectly, control, joint control, or significant influence over Blooms Inc.)

*d. The minority shareholder of Bloom, who accounts for the investment using the equity method

@ Answer d) is correct. The minority shareholder is a related party to Blooms Inc. As per IAS 24.9(a)(ii), a person who has significant influence over the reporting entity is a related party. Since the minority shareholder accounts for its investment in Blooms Inc. using the equity method, this implies that the minority shareholder has significant influence and qualifies as a related party to Blooms Inc.

50. Related-party transactions — ASPE and IFRS differences

Which of the following is a required disclosure under IFRS but not ASPE?

a. Transactions

@ Answer a) is incorrect. This is a disclosure required under both ASPE and IFRS.

b. Amounts

@ Answer b) is incorrect. This is a disclosure required under both ASPE and IFRS.

*c. Key management compensation

@ Answer c) is correct. Per IAS 24.13, key management compensation is a required disclosure.

d. Obligations

@ Answer d) is incorrect. This is a disclosure required under both ASPE and IFRS.

51. Operating segments

Ninja Frog Inc., a publicly traded company, has seven operating segments all producing different products with the following results:

Segments	Sales	Profit (Loss)	Assets
Orange	$100	$50	$500
Yellow	15	(50)	60
Purple	200	25	100
Blue	125	10	10
Red	65	15	5
Pink	200	50	100
White	65	20	50
	$770	$120	$825

Based on the quantitative thresholds, how many reportable segments are there?

a. 3

@ Answer a) is incorrect.

b. 4

@ Answer b) is incorrect.

c. 5

@ Answer c) is incorrect.

*d. 6

@ Answer d) is correct. The orange, yellow, purple, blue, pink and white segments are all reportable. Proof:

Note: Greater of absolute profit or absolute loss= total profit (170) or total loss (50) = $170.

Segments	Sales	Profit (Loss)	Assets	Reportable?
Orange	13%	29%	61%	Y
Yellow	2%	(23%)	7%	Y
Purple	26%	15%	12%	Y
Blue	16%	3%	1%	Y
Red	8%	9%	1%	N
Pink	26%	29%	12%	Y
White	8%	12%	6%	Y
	100%	N/A	100%	

52. Operating segments

Each reportable segment must have which of the following disclosed?

*a. Net earnings

@ Answer a) is correct. Profit or loss is required to be disclosed by each reportable segment.

b. Gross revenues

@ Answer b) is incorrect. Gross revenues are not required to be disclosed for each reportable segment.

c. Related parties

@ Answer c) is incorrect. Related parties are not required to be disclosed for each reportable segment.

d. Earnings per share

@ Answer d) is incorrect. Earnings per share are not required to be disclosed for each reportable segment.

53. Analyze the timing of revenue recognition

Kingsmere Properties (Kingsmere) has just commenced construction on a multi-unit townhome development. Although construction will not be completed for another 12 months, some units have been pre-sold, and the future homeowners have made a down payment for homes in this popular new development. Payments are refundable if the development is not completed. The homes are a standard construction, and the future homeowners are not involved in the decision-making. Kingsmere is anxious to record this revenue as soon as possible in order to secure the necessary financing.

What would be the most appropriate accounting policy recommendation?

*a. Recognize revenue when the home is completed and legal title transfers, because the performance obligation will not be satisfied until this time.

@ Answer a) is correct. The performance obligation is satisfied at a point in time when the unit is transferred to the purchaser. The purchaser is purchasing the asset of the house, not the service of construction, which is evident by the purchasers' lack of involvement in the process and the ability of the down payment to be refunded. Therefore, no revenue should be recognized until title transfers.

b. Recognize revenue when payments are received, because the amount to be recognized is measurable and collectable, and the performance obligation has been satisfied.

@ Answer b) is incorrect. The payments do not reflect the obligation being met by Kingsmere.

c. Recognize payments into revenue when the related operating expenses are recorded, because this will ensure that revenues match their related expenses.

@ Answer c) is incorrect. The revenue recognition criteria must be met, irrespective of when the related operating expenses are recorded.

d. Recognize revenue for the payments in accordance with the owners' wishes, because there appears to be uncertainty and, as such, the policy can match user objectives.

@ Answer d) is incorrect. The revenue recognition criteria must be met, irrespective of the owners' wishes.

54. Evaluate a wholesale inventory transaction using revenue recognition criteria

A company sells clothes wholesale from its factories overseas to department stores in Canada. The shipping terms are FOB Shipping. Under ASPE, at what point are revenues generally recognized in the financial statements?

a. When the return period has expired

@ Answer a) is incorrect. The right of return is usually an insignificant risk that should not delay revenue recognition, provided the seller can reliably estimate future returns and recognizes a liability for returns.

*b. When the clothes are shipped to the customer

@ Answer b) is correct. Performance is achieved when the significant risks and rewards of ownership transfer to the buyer, and when reasonable assurance exists regarding the measurement of the consideration that will be derived from the sale of goods and the extent to which goods may be returned. Per ASPE, revenue is recognized when performance is complete, consideration is measurable, and collection is reasonably assured.

c. When future benefits of an asset expire

@ Answer c) is incorrect. The asset is clothing inventory, and it does not normally expire. When assets expire (for example, prepaid insurance), the future benefits become an expense, not revenue.

d. When contracts/invoices are prepared

@ Answer d) is incorrect. The completion of performance is normally considered to be the delivery of the goods, not the completion of the paperwork that documents the transaction.

55. Evaluate the treatment of subsequent events under their appropriate treatment — adjustment or disclosure

ASPE identifies two types of subsequent events:

i) those that provide further evidence of conditions that existed at the financial statement date; and

ii) those that are indicative of conditions that arose subsequent to the financial statement date.

How should event ii) be treated?

a. Adjust the financial statements

@ Answer a) is incorrect. Material conditions that arise subsequent to year end do not require adjustment in the financial statements.

*b. Disclose within the notes to financial statements

@ Answer b) is correct. The event occurred subsequent to the financial statement date but before the financial statements were completed and is material, therefore disclosure is.

c. No action required, as the company is a going concern

@ Answer c) is incorrect. The fact the company is a going concern does not impact whether or not the disclosure must be made.

d. Both options a) and b) above

@ Answer d) is incorrect. There is no need to both adjust and disclose the event.

56. Analyze the appropriate treatment of a subsequent event

Which of the following subsequent events would require an adjustment to the company's financial statements?

a. Purchase of a business by the company subsequent to the financial statement date

@ Answer a) is incorrect. Financial statements are not adjusted for events occurring between the date of the financial statements and the date of their completion that do not relate to conditions that existed at the date of the financial statements.

b. Change in foreign currency exchange rates subsequent to the financial statement date

@ Answer b) is incorrect. Financial statements are not adjusted for events occurring between the date of the financial statements and the date of their completion that do not relate to conditions that existed at the date of the financial statements.

*c. Initiation of bankruptcy proceedings subsequent to the financial statement date against a customer with a large accounts receivable balance

@ Answer c) is correct. When an event occurs between the date of the financial statements and the date of their completion, and that event provides additional evidence relating to conditions that existed at the date of the financial statements, financial statement adjustments are required.

d. Commencement of litigation where the cause of action arose subsequent to the date of the financial statements

@ Answer d) is incorrect. Financial statements are not adjusted for events occurring between the date of the financial statements and the date of their completion that do not relate to conditions that existed at the date of the financial statements.

57. Significant influence — equity

Bedford Inc. (BI) acquired 25% of the shares of Red Inc. (RI) in the current fiscal year for $150,000 with no fair value differentials. It was determined that BI's investment in RI should be accounted for using the equity method.

During the year:

- RI paid $100,000 in dividends.
- RI reported net income of $500,000, which included $20,000 (in profits) that resulted from sales of inventory to BI.

BI has yet to process the inventory it purchased from RI. This inventory will be processed next year and the resulting product will be sold to one of BI's customers.

What should be reported as "investment in RI" on BI's current-year statement of financial position? Ignore any potential tax consequences.

a. $150,000

@ Answer a) is incorrect. This option accounts for the investment at cost rather than using the equity method of accounting.

b. $170,000

@ Answer b) is incorrect. This option deducts the entire dividend rather than just the applicable percentage.

*c. $245,000

@ Answer c) is correct. The $150,000 investment cost less 25% of $100,000 in dividends paid, plus 25% of $500,000 of current-year profits, less 25% of unrealized profit of $20,000 = $150,000 – $25,000 + $125,000 – $5,000 = $245,000.

d. $250,000

@ Answer d) is incorrect. This option ignores the unrealized profit on the intercompany transaction.

58. Significant influence — equity

Company A has significant influence over Company B. Under IFRS, which one of the following factors could cause Company A's investment account to decrease?

a. Purchase price

@ Answer a) is incorrect. Purchase price increases the investment account.

b. Goodwill

@ Answer b) is incorrect. Goodwill and negative goodwill do not impact equity income; rather, it is an account created from the acquisition differential after any fair value differentials.

c. Net income

@ Answer c) is incorrect. Net income would increase the investment account.

*d. Unrealized profit in inventory

@ Answer d) is correct. Until the inventory has been sold to a third party, profit in inventory is considered to be unrealized and needs to be reduced from equity income.

59. Describe the possible outcomes related to a sale to a foreign customer

Recently, Claries Clothing Inc. (CCI), a Canadian company, received an order to sell to a new customer in the United States. The invoice is for US$300,000. The customer has agreed to pay on October 15, 20X6, two months from the date of sale and shipment.

It is now the date of sale and shipment, and the exchange rate is US$1 = C$1.20. The company has taken no action to offset its foreign exchange risk at this point.

Which of the following statements BEST describes possible outcomes related to this sale?

a. If the customer pays the invoice immediately, at the date of sale, there is foreign exchange risk associated with the amount of the sale and an exchange gain of $60,000 is recorded [$300,000 × ($1.00 – $1.20)].

@ Answer a) is incorrect. The sale has been completed and is reported at the spot rate in effect at the date of sale. If the invoice is paid immediately, there is no foreign exchange risk as the amount of cash is received immediately.

b. If CCI enters into a forward contract on the date of sale and shipment, based on a two-month forward rate of US$1 = C$1.23, CCI will record an exchange loss of $9,000 on the date the customer pays.

@ Answer b) is incorrect. The company will actually record an exchange gain of $9,000 [$300,000 × ($1.23 – $1.20)] on the date the customer pays and settles the bill.

c. If the customer pays in two months, and if the exchange rate is US$1 = C$1.25 at that time, CCI will realize an exchange loss of $15,000.

@ Answer c) is incorrect. This exchange rate is more favourable for CCI and will result in an exchange gain of $15,000 [$300,000 × ($1.25 – $1.20)], not a loss.

*d. If the customer pays in two months, and if the exchange rate is US$1 = C$1.25 at that time, CCI will realize an exchange gain of $15,000.

@ Answer d) is correct. The company will realize an exchange gain of $15,000 [$300,000 × ($1.25 – $1.20)].

60. Describe the difference between a forward contract and options used to hedge a sale

With respect to the differences between a forward contract and options when used to hedge, which of the following statements is correct?

a. One drawback of a forward contract is that there is very little flexibility in the amounts that can be agreed upon for the notional amount of currency to be contracted.

@ Answer a) is incorrect. A forward contract is highly customized to the amount and rates that the two parties to the agreement decide on.

*b. One advantage of an option is that the company is not obligated to fulfil the contract.

@ Answer b) is correct. The company has the right, but not the obligation, to fulfil the contract by the expiry date.

c. One disadvantage of an option is that there is a margin account that must be maintained with the broker and settled with cash on a daily basis.

@ Answer c) is incorrect. An option does not require a margin account — a futures contract requires a margin account.

d. One advantage of a forward contract is that there is counterparty risk requiring each party to comply with the contract.

@ Answer d) is incorrect. Counterparty risk is a disadvantage since there is a risk that the other party may not perform under the contract.

61. Analyze the timing of revenue recognition

Joe’s Cycling Shop (Joe’s), a private company selling both road and leisure bicycles, held a year-end sale. On December 31, Joe’s year end, a customer wanted to purchase a road bike with a cost of $3,000 and a sales price of $3,500. The customer decided to pay $200 to put the bike on hold under the agreement that he could walk away from the purchase within seven days and still have his money refunded. The accountant for Joe’s recorded the following entry to recognize the arrangement on December 31:

Dr. Cash	$200	
Dr. Accounts receivable	$3,300	
Cr. Sales		$3,500

You are performing the review engagement of Joe’s. What adjusting entry, if any, would be required to properly account for this arrangement?

a. Dr. Cost of goods sold $3,000; Cr. Inventory $3,000

@ Answer a) is incorrect. This adjusting entry recognizes $3,500 in sales, but no sale has taken place. Joe’s has only received a deposit to hold the bicycle, but there is no obligation for the customer to buy the bicycle. Control of the asset has not been transferred to the customer.

b. Dr. Sales $3,300; Cr. Accounts receivable $3,300

@ Answer b) is incorrect. This adjusting entry recognizes $200 in sales but no sale has taken place. Joe’s has only received a deposit to hold the bicycle, but there is no obligation for the customer to buy the bicycle. The risks and rewards of ownership have not been transferred to the customer.

*c. Dr. Sales $3,500; Cr. Accounts receivable $3,300, Cr. Deferred revenue $200

@ Answer c) is correct. This adjusting entry properly accounts for the customer deposit as deferred revenue (a liability) and the cash received. The customer has only paid a deposit and has not agreed to buy the bicycle; therefore, no sale has taken place.

d. Dr. Sales $200; Cr. Deferred revenue $200

@ Answer d) is incorrect. This adjusting entry recognizes $3,300 in sales, but no sale has taken place. Joe’s has only received a deposit to hold the bicycle, but there is no obligation for the potential customer to buy the bicycle. The risks and rewards of ownership have not been transferred to the customer.

Assurance

62. Assesses the risks of the project

P&M Ltd. is a property development company. Lately, it has been struggling, as the turmoil in the economy has caused the real estate market and P&L's assets to decline in value. P&M has debt coming due in the current year and the covenants are only marginally being met at this time. P&M has also just reported operating losses and was forced to cancel its dividend. You have assessed and performed audit procedures on management's action plan and found that the plan appropriately supports that the company will be able to renegotiate terms of the maturing debt.

Which issue exists?

a. No issue exists.

@ Answer a) is incorrect. An issue does exist because the looming debt maturity, the marginal covenant compliance, the operating losses, and the cancellation of the dividend are all indicators of a potential going-concern issue.

b. A going-concern issue exists.

@ Answer b) is incorrect. You found management's action plan to be reasonable, which implies that there is not a going-concern issue.

*c. A material uncertainty exists.

@ Answer c) is correct. You found management's action plan to be reasonable. This means management's action plan is likely to be successful in carrying on the business, and therefore a going-concern issue does not exist. However, there should still be disclosure around this significant uncertainty.

d. A going-concern issue and a material uncertainty exist.

@ Answer d) is incorrect. An event cannot be both a going-concern issue and a material uncertainty.

63. Analyze client acceptance considerations

Which of the following is true regarding an engagement letter?

a. It describes the responsibilities of management, but does not describe the responsibilities of the practitioner.

@ Answer a) is incorrect. The engagement letter describes the responsibilities of both management and the practitioner.

*b. It identifies the applicable financial reporting framework for the preparation of the financial statements.

@ Answer b) is correct. The engagement letter identifies the applicable financial reporting framework for the preparation of the financial statements.

c. It outlines any new or emerging risks that could have an impact on the engagement.

@ Answer c) is incorrect. Risk assessment is done after a practitioner has accepted an engagement for which an engagement letter is required.

d. It is prepared by the auditor prior to the start of the audit and is acknowledged by the client at the end of the audit.

@ Answer d) is incorrect. The engagement letter is both prepared by the auditor and acknowledged by the client prior to the start of the audit.

64. Analyze audit planning stages

Which of the following statements regarding testing is true?

a. Tests of controls are always performed.

@ Answer a) is incorrect. Tests of controls are not performed during a purely substantive audit.

b. Test of controls and substantive tests are always performed.

@ Answer b) is incorrect. Tests of controls are not performed during a purely substantive audit.

c. Test of controls and analytics are always performed.

@ Answer c) is incorrect. Tests of controls are not performed during a purely substantive audit.

*d. Detailed substantive tests are always performed.

@ Answer d) is correct. During the execution of an audit, either tests of controls and detailed substantive tests *or* detailed substantive tests alone are performed

65. Analyze audit approach

In which of the following situations would a practitioner use a purely substantive approach instead of a combined approach when planning the audit?

a. The company’s chief financial officer is a CPA.

@ Answer a) is incorrect. A company that employs a CPA as its chief financial officer would likely have a stronger control environment, which would not support a purely substantive approach.

b. The company has many transactions.

@ Answer b) is incorrect. Many transactions would mean that more substantive work would need to be performed, so it would take longer to use a purely substantive approach over a combined approach.

c. The company has controls that can be relied on.

@ Answer c) is incorrect. Having controls that can be relied on qualifies for the use of a combined approach.

*d. The company has few transactions.

@ Answer d) is correct. A company whose controls can be relied on would qualify for a combined approach; however, the practitioner may decide to use a purely substantive approach because it would be faster to test the accounts rather than spend time performing tests of controls.

66. Analyze audit evidence

If the practitioner is unable to obtain sufficient appropriate audit evidence related to all accounts, classes of transactions, and disclosures in the financial statements, then the practitioner is unable to:

a. Continue with the engagement

@ Answer a) is incorrect.

*b. Issue an unqualified opinion

@ Answer b) is correct. If sufficient and appropriate audit evidence is not obtained, then the practitioner is unable to issue an unqualified audit opinion.

c. Perform a combined audit

@ Answer c) is incorrect.

d. Rely on management's statements as fact

@ Answer d) is incorrect.

67. Analyze audit evidence

Which of the following statements regarding audit evidence is true?

a. Sufficiency is the measure of the quality of audit evidence.

@ Answer a) is incorrect. Sufficiency is the measure of the quantity of audit evidence.

b. The higher the relevance and reliability, the lower the quality of results

@ Answer b) is incorrect. The higher the relevance and reliability, the higher the quality of results.

*c. The higher the quality, the less evidence may be required.

@ Answer c) is correct. The higher the quality, the less evidence may be required.

d. Reliability refers to the connection between audit procedures and assertions.

@ Answer d) is incorrect. Relevance refers to the connection between audit procedures and assertions.

68. Analyze sampling

When a sample is stratified, which items would the practitioner judgmentally select from the population for testing?

a. High-value items

@ Answer a) is incorrect because answer b) is also correct.

b. High-risk items

@ Answer b) is incorrect because answer a) is also correct.

c. Representative items

@ Answer c) is incorrect.

*d. Both a) and b) above

@ Answer d) is correct. Both high-value items and high-risk items are considered to be “specific” items when stratifying a population.

69. Analyze substantive procedures

Obtaining written communication from a third party and footing subledger are examples of which two types of substantive procedures, respectively?

a. Inspection and observation

@ Answer a) is incorrect.

*b. Confirmation and recalculation

@ Answer b) is correct. Written communication from a third party is a confirmation type of substantive procedure; footing a subledger is a recalculation type of substantive procedure.

c. Analytical reviews and reperformance

@ Answer c) is incorrect.

d. Inquiry and reperformance

@ Answer d) is incorrect.

70. Auditor's report

Steven, CPA, has completed his audit of Abbots Machining Inc. (AMI). The confirmation of accounts receivable did not go well, and the majority of AMI's customers were unresponsive to the confirmations and follow up requests. Steven is now preparing the auditor's report.

This failure to be able to obtain external confirmation of customers' outstanding balances was determined to potentially have material and pervasive impacts on the financial statements.

As a result, the auditor's report will have:

a. A qualified opinion

@ Answer a) is incorrect. A qualified opinion is required when a scope limitation could limit the ability to identify errors that may be material but not pervasive.

*b. A disclaimer of opinion

@ Answer b) is correct. A disclaimer of opinion is provided when the effect of the scope limitation is determined to limit the ability to identify errors that may be material and pervasive.

c. An emphasis of matter paragraph

@ Answer c) is incorrect. An emphasis of matter paragraph is provided when there is no material misstatement or scope limitation but there is an important point that the practitioner wants to draw attention to.

d. An adverse opinion

@ Answer d) is incorrect. An adverse opinion is required when sufficient appropriate audit evidence is obtained to determine that the misstatements are material and pervasive.

71. Types of misstatements found in audits

You, CPA, are conducting an audit of your client, Window Installers Inc. You have just completed your audit of the inventory and found that the opening inventory had incorrectly included the inventory at an off-site storage facility twice, causing the opening inventory to be overstated by $135,000.

What type of misstatement does this represent?

a. Fraud

@ Answer a) is incorrect. There is no indication that this represents fraud.

*b. Factual

@ Answer b) is correct. This is a factual misstatement since there is no doubt as to the amount by which the opening inventory is overstated. In this case, the misstatement arises due to including certain inventory items twice.

c. Projected

@ Answer c) is incorrect. Projected misstatements are calculated by projecting misstatements identified in audit samples to the entire representative population from which the sample was drawn.

d. Judgmental

@ Answer d) is incorrect. A judgmental misstatement arises when management has applied estimates that the auditor believes are not appropriate.

72. Analyze a breach of the rules of professional conduct

Bartle and Nibson LLP (BN) accepted the audit engagement of Austin Design Ltd. (Austin) from one of its competitors:

- Austin indicated it chose BN after seeing BN’s advertisement in the yellow pages.

- Austin is going public and has agreed to compensate BN for its services at a rate of 1% of the funds raised from the public offering.
- Austin is BN's largest client.

Which of the following represents a breach of the rules of professional conduct regarding BN's relationship with Austin?

a. Association with a disreputable client

@ Answer a) is incorrect. There is no indication in the scenario that Austin is a disreputable client.

*b. Accepting a contingent fee for consideration

@ Answer b) is correct. A firm engaged in the practice of public accounting shall not offer or engage to perform a professional service for a fee, the amount of which is to be fixed as a percentage of the result of the service.

c. Soliciting another firm's client

@ Answer c) is incorrect. Austin indicated that it chose BN after seeing BN's advertisement in the yellow pages. There is no indication that BN solicited Austin from another firm.

d. Being economically dependent on a client

@ Answer d) is incorrect. Although Austin is BN's largest client, there is no indication in the scenario that BN is economically dependent on Austin.

73. Assess the risk of material misstatement (OFSL)

You, CPA, work for the public accounting firm Dickson and Doerksen LLP. You are the senior auditor of Aero Corp Inc. (Aero), a new client. While reviewing your notes from a meeting with the client for this year's upcoming audit, you note the following information related to Aero's risk assessment:

This is the first year the company is being audited by Dickson and Doerksen LLP.

- The company has generated stable profits for the last 10 years.
- The company is looking to issue an initial public offering (IPO) next year.
- The company lacks an internal audit function.
- The company's accounting department is stable.

Which of the following statements is true?

a. Aero is being audited by Dickson and Doerksen LLP for this first time this year. This factor has no impact on overall financial statement level risk.

@ Answer a) is incorrect. This statement is untrue. Your firm, Dickson and Doerksen LLP, will not have historic knowledge to rely on in assessing Aero's processes and operations. This is a factor that will increase overall financial statement level risk.

b. Aero's ability to generate stable profits for the last 10 years increases risk at the overall financial statement level.

@ Answer b) is incorrect. This statement is untrue. Aero's ability to generate stable profits for the last 10 years indicates that the company is in good financial health and is likely to continue to be a going concern. This factor decreases risk at the overall financial statement level.

c. Aero's plan to issue an IPO next year has no impact on overall financial statement level risk.

@ Answer c) is incorrect. This statement is untrue. An IPO will result in additional users relying on the financial statements of Aero to help them make investment decisions. The preparers of Aero's financial statements are biased to make the financial statements appear more favourable.

*d. The company lacks an internal audit function. This factor has an impact on overall financial statement risk.

@ Answer d) is correct. This statement is true. Aero's management and the Board of Directors may not be aware of the company's control deficiencies. This leads to an increased risk at the overall financial statement level.

74. Assess the risk of material misstatement (specific account)

You are planning the audit engagement of a new client, Campbell's Collectibles Ltd. (Campbell), a retailer of movie memorabilia. Which one of the following represents an inherent risk factor at the account level for sales?

*a. The majority of Campbell's sales are made to the U.S. and France. These sales are made in U.S. dollars.

@ Answer a) is correct. The complexities associated with converting sales made in a foreign currency to local currency for the purposes of financial reporting increase the risk of a material misstatement in the sales account due to error. Inherent risk at the account level is increased, as the risk can be specifically attributed to an account (sales).

b. Campbell has been experiencing poor financial health over the past five years, and revenues have declined dramatically in the current year.

@ Answer b) is incorrect. Given the company's poor financial health, it may no longer be considered a going concern. This is an overall financial statement level risk.

c. In an attempt to improve the financial results of Campbell, management has implemented a new employee bonus plan based on net income.

@ Answer c) is incorrect. Employees will have an inherent bias to make the financial statements appear more favourable in order to secure a larger bonus. This is an overall financial statement level risk.

d. Campbell is a new audit client for our firm.

@ Answer d) is incorrect. The auditor will not have historic knowledge to rely on in assessing the client's processes and operations. This is an overall financial statement level risk.

75. Analyze the materiality threshold

You are planning a continuing audit engagement. Several new events and factors have been identified in the planning stage. Which of the following would prompt you to consider reducing materiality from the prior year?

a. The client laid off 50% of the accounting department staff during the year.

@ Answer a) is incorrect. While a reduction of accounting department staff increases the risk that a material misstatement might occur, it does not need to be considered in the determination of materiality, as it does not impact the financial statement users.

*b. The client is currently negotiating the issuance of a new class of preferred shares to a potential investor.

@ Answer b) is correct. The new investor will be relying heavily on the financial statements of the company to make investment decisions. Given the sensitivity of the user to misstatements in the company's financial statements, a reduction in materiality from the prior year should be considered.

c. The client is in the process of renegotiating its operating line of credit with the bank. The client has used this bank for several years, and the bank's policy is to renegotiate every two years.

@ Answer c) is incorrect. A reduction of materiality from the prior year would be considered where there are users, either existing or new, who have an increased sensitivity to misstatements in the company's financial statements. While the client is renegotiating the operating line of credit with the bank, the bank's ongoing history with the client and the nature of the renegotiation are unlikely to lead to increased sensitivity on the part of the bank to misstatements in the company's financial statements.

d. The client introduced a new line of products that have a high risk of obsolescence.

@ Answer d) is incorrect. While the introduction of the new product line increases the risk of material misstatement, it does not need to be considered in the determination of materiality, as it does not impact the financial statement users.

76. Calculate materiality

You, CPA, are provided with the following financial information of your audit client Green Tee Ltd:

- Net income before tax is $200,000.
- Net income after tax (20%) is $160,000.
- The sale of public company shares resulted in a $50,000 gain.
- There was a one-time bonus paid to the production manager for $75,000.
- Green Tee paid severance of $25,000 to the production manager.
- Green Tee's assets include the purchase of a new chocolate mould for $25,000.
- Liabilities include a new bank loan to cover the cost of the new mould.

Using normalized net income before tax as a base and 5% as a threshold, what is the estimated materiality for Green Tee?

a. $7,500

@ Answer a) is incorrect. In this calculation, the adjustments are backward: $200,000 + $50,000 – $75,000 – $25,000 = $150,000 × 5% = $7,500.

b. $8,000

@ Answer b) is incorrect. This calculation does not include an adjustment for non-recurring items, and the calculation is based on net income after tax × 5% ($160,000 × 5% = $8,000).

c. $10,000

@ Answer c) is incorrect. This calculation uses net income before tax as a base: $200,000 × 5% = $10,000.

*d. $12,500

@ Answer d) is correct. Normalized net income before tax is correctly used as a base: $200,000 – $50,000 + $75,000 + $25,000 = $250,000 × 5% = $12,500.

77. Financial statement analysis

Financial statement analysis:

a. consists solely of ratio analysis and interpretation including current, quick, and debt ratios

@ Answer a) is incorrect. Financial statement analysis includes horizontal, vertical, and ratio analysis.

b. focuses on comparisons within a company, such as business units, departments, product lines, or employees

@ Answer b) is incorrect. Analysis allows for comparisons within a company as well as between organizations and industries.

c. requires analysis on the full balance sheet and income statement

@ Answer c) is incorrect. Especially in an exam setting, it can be time consuming to recalculate the dollar and percentage variance for all accounts. Candidates should be comfortable with scanning the financial statements to find major issues.

*d. relates to several competency areas including financial reporting and strategy governance

@ Answer d) is correct. Financial statement analysis relates to financial reporting, audit and assurance, strategy and governance, management accounting, and finance.

78. Financial statement analysis

Which of the following statements for financial statement analysis is true?

*a. A high debt-to-equity ratio is a negative qualitative factor.

@ Answer a) is correct. Debt service ratios provide an indication of a company's long-term solvency. A higher ratio means that the organization is more leveraged and is considered to be of higher financial risk.

b. A high gross-margin-percentage ratio is a negative qualitative factor.

@ Answer b) is incorrect. A high gross-margin-percentage is a positive qualitative factor as it indicates a company is more profitable.

c. A high dividend-payout ratio is positive qualitative factor.

@ Answer c) is incorrect. This would be case dependent. An excessively high dividend payout could be considered a return of capital to investors, not funds generated from the business's operations.

d. A high days-payable-outstanding ratio is a positive qualitative factor.

@ Answer d) is incorrect. A high days-payable-outstanding ratio could indicate a company's difficulty in paying its current obligations.

79. Discuss assertions — Cash

A bank confirmation tests which of the following assertions?

*a. Existence

@ Answer a) is correct. The existence assertion addresses whether the cash balance per the general ledger actually exists, and a bank confirmation provides third-party evidence to support the cash balance per the bank.

b. Rights and obligations, and existence

@ Answer b) is incorrect. The rights and obligations assertion addresses whether the entity holds or controls the rights to the cash.

c. Accuracy

@ Answer c) is incorrect. The accuracy assertion is an income statement assertion; bank confirmations are testing for the cash account on the balance sheet.

d. Rights and obligations

@ Answer d) is incorrect. The rights and obligations assertion addresses whether the entity holds or controls the rights to the cash.

80. Discuss assertions — Inventory

You are auditing the inventory of International Potash. The company stores a significant amount of potash inventory off-site at third-party warehouses. The audit manager would like you to send inventory confirmations to a sample of these off-site, third-party warehouses. The confirmation requests that the third-party warehouse indicate the quantity of inventory held. For the inventory account, which of the following assertions would be covered by this procedure?

*a. Existence

@ Answer a) is correct. The existence assertion addresses whether the inventory exists. The third-party confirmation of the quantity of inventory held will address this assertion.

b. Accuracy and existence

@ Answer b) is incorrect. The accuracy assertion is a class of transactions (income statement) assertion, not an account balance (balance sheet) assertion. Inventory is a balance sheet account.

c. Valuation and allocation, and existence

@ Answer c) is incorrect. The valuation and allocation assertion addresses whether inventory is recorded at the appropriate amount. Third-party confirmation of the quantity of inventory held does not address the valuation of the inventory (if the inventory is damaged or obsolete, for example).

d. Rights and obligations, and existence

@ Answer d) is incorrect. The rights and obligations assertion addresses whether International Potash holds or controls the rights to the inventory. Third-party confirmation of the quantity of inventory held does not address the rights and obligations assertion, as the third party would not necessarily be aware of any pledging of the inventory or other changes in ownership.

81. Evaluate internal controls — IT controls

Nabors Enterprises has 14 desktop computers in its accounting department, as well as six laptop computers. All the computers are password protected and connected by a secured wireless network. Staff can use the computers for personal use outside of working hours.

What should Nabors do to prevent a possible loss of information?

*a. Nabors should ensure the computers have up-to-date virus and spyware protection.

@ Answer a) is correct. If the computers are used for personal reasons, employees may be visiting sites that contain viruses and/or spyware. By ensuring that the computers have up-to-date virus and spyware protection, Nabors is guarding itself against a possible loss of information.

b. Nabors should monitor the personal use of the computers at work.

@ Answer b) is incorrect. This procedure helps Nabors to identify the cause of the information loss, but will not help prevent the information loss.

c. Nabors should perform regular backup procedures.

@ Answer c) is incorrect. Regular backups help to recover from a loss of information, but do not help to prevent the loss of information.

d. Nabors should eliminate the use of laptop computers.

@ Answer d) is incorrect. Eliminating laptop computers will not prevent the loss of information**.**

82. Evaluate internal controls — Sales and collection cycle

Denver Company has an online, real-time order entry system. Denver Company has two key business objectives:

- Ensure products are shipped only to good credit risk customers.
- Minimize any undue shipping delays.

Which one of the following controls would best contribute to meeting both of these key business objectives?

a. All orders that cause the customer's accounts receivable balance to exceed the credit limit are printed on an exception report for followup after the goods are shipped.

@ Answer a) is incorrect. While this control will minimize any undue shipping delays, it will not meet the business objective of only shipping products to good credit risk customers. Because the exception report is followed up on after shipment, product could be shipped to customers who have an inability to pay for it. This increases the risk of uncollectable accounts receivable.

*b. All orders that cause the customer's accounts receivable balance to exceed the credit limit are printed on an exception report and are reviewed by the credit manager on a daily basis before the shipment is released.

@ Answer b) is correct. This control will both minimize any undue shipping delays and ensure that products are only being shipped to customers with an ability to pay for it. Because the manager reviews the exception report on a daily basis, there will be minimal shipping delays once the order is approved. Because the manager reviews the exception report and only releases shipments to customers with a good credit risk, the risk of uncollectable accounts receivable is reduced.

c. Orders will not be accepted by the system once the customer's accounts receivable balance is greater than the customer's credit limit.

@ Answer c) is incorrect. This control will not meet Denver's business objective of ensuring that products are only shipped to good credit risk customers. Allowing customers to place orders that cause their accounts receivable balance to temporarily exceed their credit limit provides Denver with some flexibility as long as these orders are only being shipped to customers with good credit risk, thereby reducing the risk of uncollectable accounts receivable.

d. All orders that cause the customer's accounts receivable balance to exceed the credit limit are printed on an exception report and are reviewed by the credit manager on a weekly basis before the shipment is released.

@ Answer d) is incorrect. While this control will ensure that products are only being shipped to customers with an ability to pay for the product, this control does not minimize shipping delays because the exception report is not being reviewed frequently enough and these orders are being approved on a weekly, not daily, basis.

Taxation

83. Assesses general tax issues for an individual

Which of the following statements is true?

a. Where a tax-planning arrangement involves a series of transactions and most of those transactions are for bona fide non-tax purposes, the GAAR cannot be applied to the tax-planning arrangement.

@ Option a) is incorrect. This statement is false. Where a tax-planning arrangement involves a series of transactions and any one of those transactions is not for a bona fide non-tax purpose, the CRA may apply the GAAR to that tax-planning arrangement.

b. If the first two conditions under the GAAR are met (the planning arrangement resulted in a tax benefit and there was no bona fide non-tax purpose to the transactions in the planning arrangement), it is up to the taxpayer to prove a transaction or series of transactions in a tax-planning arrangement is not an abusive avoidance arrangement.

@ Option b) is incorrect. This statement is false. If the first two conditions are met, for the GAAR to apply, it is the CRA's responsibility to prove the tax-planning arrangement is an abusive avoidance arrangement. It is not the taxpayer's responsibility to prove the arrangement was not an abusive avoidance arrangement.

*c. Generally, all tax-planning arrangements result in a tax benefit to the taxpayer engaging in the transaction or series of transactions

@ Option c) is correct. This statement is true. The purpose of tax planning is to minimize or defer tax resulting in a tax benefit to the taxpayer engaging in the transaction or series of transactions.

d. The CRA will attempt to assess a taxpayer under the GAAR in any situation where a tax-planning arrangement results in a tax benefit to the taxpayer.

@ Option d) is incorrect. This statement is false. In the Canada Trustco case, the Supreme Court of Canada indicated the GAAR is a provision of last resort and should only be applied in a situation where the abusive nature of the transactions or series of transactions is clear — that is, the GAAR is only applicable to an abusive tax-planning arrangement.

84. Advise taxpayers with respect to assessment, notice of objection, and appeals

Telco Inc., a public corporation, received a notice of reassessment for its 2012 taxation year. The notice was dated July 27, 2016. Telco has a November 30 year end. The original assessment for 2012 was dated March 31, 2013.

Telco does not agree with the reassessment. By what date does Telco need to file the notice of objection?

a. May 31, 2016

@ Answer a) is incorrect. This is the corporate filing due date of the last taxation year.

b. August 27, 2016

@ Answer b) is incorrect. This is 30 days from the date of the notice of reassessment.

*c. October 25, 2016

@ Answer c) is correct. The notice of objection must be filed the later of within 90 days after the notice of reassessment and one year after the filing due date.

d. November 30, 2016

@ Answer d) is incorrect. This is the year end of the company.

85. Analysis of employee versus contractor

Which of the following additional case facts would indicate an assessment that the individual is a contractor?

a. The individual registers for a GST account.

@ Answer a) is incorrect. Registration of a GST account does not necessarily indicate an individual is a contractor.

b. The individual is not permitted to work for other catering business.

@ Answer b) is incorrect. This factor indicates the individual is an employee, not a contractor.

c. The individual receives a set monthly schedule.

@ Answer c) is incorrect. A set monthly schedule adds control to the employer, not the individual, and is a supporting factor of employment.

*d. The individual receives remuneration as a percentage of total clients served.

@ Answer d) is correct. The individual now has a chance of profit/risk of loss, as the individual is paid based on the number of clients served. If fewer clients attend and, therefore, there are fewer clients to serve, the individual's compensation would decrease.

86. Identify a taxable benefit

Which of the following is a taxable benefit to an employee?

a. Payments made for a private health services plan

@ Answer a) is incorrect. Where an employer makes contributions to a private health services plan (such as a medical or dental plan) on behalf of an employee, there is no taxable benefit to the employee.

b. Payment for a $400 gold watch to commemorate six years of service

@ Answer b) is incorrect. An employer can give an employee a non-cash, long-service or anniversary award valued at $500 or less, tax-free. The award must be for a minimum of five years of service. Any amount over $500 is a taxable benefit to an employee.

c. Payment for tuition for a course on "building good relationships with clients"

@ Answer c) is incorrect. Tuition paid on behalf of the employee for courses taken to maintain or upgrade employment-related skills where the employer is the beneficiary of the training is not a taxable benefit to an employee.

*d. Payment of an employee's spouse's travelling expenses incurred while accompanying the employee on a business trip

@ Answer d) is correct. If a spouse or common-law partner accompanies an employee on a business trip, the amount paid by the employer for the employee's spouse or common-law partner's travelling expenses is a taxable benefit to the employee.

87. Calculation of rental income or loss

Matilda owns two rental properties, both of which were acquired in 2010. You have been provided with the following information for the two properties for the current year:

	Property I	**Property II**
Undepreciated capital cost	$160,000	$190,000
Revenue	$ 33,000	$ 26,200
Expenses (1)	24,600	29,100
Net rental income	$ 8,400	$ (2,900)

Note 1: Expenses include property taxes, insurance, interest, and maintenance and repairs. The tenants pay the utilities.

What amount of net rental income or loss will be included in Matilda's personal tax return for the current year?

a. $(900)

@ Answer a) is incorrect. This was determined as follows: Property I: Rental income before capital cost allowance (CCA) of $8,400 less CCA of $160,000 × 4% = $6,400, resulting in rental income net of CCA on Property I of $2,000. Net rental income of $2,000 on Property I less rental loss before CCA on Property II of $2,900 equals $(900). A rental loss may not be created or increased through the deduction of CCA.

*b. $0

@ Answer b) is correct. Net rental income on both properties before capital cost allowance (CCA): $8,400 – $2,900 = $5,500. Maximum CCA claim permitted: $14,000 (Property I: $160,000 × 4% = $6,400; Property II: $190,000 × 4% = $7,600). The CCA claim is the lesser of $5,500 and $14,000, so the maximum is $5,500 and net rental income after CCA is reduced to nil. A rental loss may not be created or increased through the deduction of CCA.

c. $(8,500)

@ Answer c) is incorrect. This was determined as $8,400 – $2,900 = $5,500 (net rental income before capital cost allowance [CCA] on both properties) less CCA of $14,000 (Property I: $160,000 × 4% = $6,400; Property II: $190,000 × 4% = $7,600). A rental loss may not be created or increased through the deduction of CCA.

d. $2,000

@ Answer d) is incorrect. This was determined as follows: Property I: Rental income before capital cost allowance (CCA) of $8,400 less CCA of $160,000 × 4% = $6,400, resulting in rental income net of CCA on Property I of $2,000. The rental loss before CCA for Property II should have been deducted as well.

88. Discuss principal residence exemption

In Year 1, John purchased a house in the city. In Year 6, he purchased a cottage at the lake. In Year 13, he sold both the house and the cottage and realized capital gains of $195,000 and $168,000 on the house and cottage, respectively. John wishes to minimize the taxable capital gain to be included in his income as a result of the disposal of these two properties by claiming the principal residence exemption.

How many years should John designate each property as his principal residence to maximize the principal residence exemption and minimize his taxable capital gain?

a. House in city, 12 years; cottage, 1 year

@ Answer a) is incorrect. The capital gain on disposal of the house is higher than the capital gain on disposal of the cottage. However, the gain per year on the house is $195,000/13 = $15,000, and the gain per year on the cottage is $168,000/8 = $21,000. John can minimize his overall capital gain by designating the property with the highest gain per year (the cottage) as his principal residence for the number of years owned less one and designating the other property as his principal residence for the remaining years.

b. House in city, 5 years; cottage, 8 years

@ Answer b) is incorrect. The gain per year on the cottage is $168,000/8 = $21,000, and the gain per year on the house is $195,000/13 = $15,000. John can fully exempt the gain on the cottage by designating the cottage as his principal residence for seven years (number of years owned less one year). That leaves six years for the house, resulting in an increase in the principal residence exemption on the house.

*c. House in city, 6 years; cottage, 7 years

@ Answer c) is correct. The formula for determining the exempt gain is [(1 + number of years designated) / number of years owned] × capital gain on disposal of principal residence. Because of the “1 +” in the formula, a taxpayer may fully exempt a gain on a personal residence by designating the residence as his or her principal residence for the number of years owned less one. The gain per year on the cottage is $168,000/8 = $21,000, and the gain per year on the house is $195,000/13 = $15,000. The cottage was owned for eight years, so John may designate the cottage as his principal residence for seven years. That leaves six years (13 years less seven years) for the house.

d. House in city, 12 years; cottage, 0 years (not considered a principal residence)

@ Answer d) is incorrect. A principal residence includes any housing unit including a house, condo, cottage, mobile home, and so forth.

89. Determines income taxes payable for an individual in routine situations

During the year, Ken and Barbie were divorced. The divorce agreement states Ken is to pay Barbie $2,000 per month in spousal support and $2,500 per month in child support beginning April 1 of the current year. Which of the following statements is true?

a. Ken's current-year deduction from net income as a result of the payment of spousal and child support is $nil.

@ Answer a) is incorrect. This statement is false. In determining his net income for tax purposes, Ken may deduct the amount he paid for spousal support.

*b. Ken's current-year deduction from net income as a result of the payment of spousal and child support is $18,000.

@ Answer b) is correct. This statement is true. In determining his net income for tax purposes, Ken may deduct the amount he paid for spousal support of $2,000 × 9 = $18,000.

c. Barbie will include $22,500 in her net income as a result of receiving spousal and child support.

@ Answer c) is incorrect. This statement is false. $22,500 is the amount Barbie received for child support ($2,500 × 9 = $22,500). Child support is not taxable.

d. Barbie will include $40,500 in her net income as a result of receiving spousal and child support.

@ Answer d) is incorrect. This statement is false. $40,500 is the total Barbie received for both spousal and child support [($2,500 × 9 = $22,500) + ($2,000 × 9 = $18,000)]. Child support is not taxable.

90. Deductible moving expenses

Early in the current year, Ed found a new job that required him to relocate from Saskatoon to Edmonton. He incurred the following costs with respect to the move:

Cost of flight and cab fare for house-hunting trip to Edmonton (1)	$ 545
Lease cancellation costs on Saskatoon home	590
Cost of moving household effects	2,180
Legal fees and title transfer fees on Edmonton home	1,860

(1) Ed made a one-day trip to Edmonton to find a new home. He had done significant research prior to the trip, so with the help of a realtor, it took only one day to finalize the purchase of a home.

Assuming Ed earned sufficient employment income after the move, what is the maximum claim Ed may make for moving expenses?

a. $3,315

@ Answer a) is incorrect. $3,315 includes the cost of the house-hunting trip of $545, the lease cancellation costs on the Saskatoon home of $590, and the cost of moving household effects of $2,180. This answer is not correct because the cost of the house-hunting trip prior to the move is not a deductible moving expense.

b. $4,040

@ Answer b) is incorrect. $4,040 includes the legal fees and title transfer tax on the Edmonton home of $1,860 and the cost of moving household effects of $2,180. The lease cancellation costs on the Saskatoon home have not been included, although they are deductible, and the legal and title transfer fees on the purchase of the Edmonton home are not deductible because the Saskatoon home was rented, not owned.

c. $5,175

@ Answer c) is incorrect. $5,175 includes the cost of the house-hunting trip of $545, the lease cancellation costs on the Saskatoon home of $590, the legal fees and title transfer fees on the Edmonton home of $1,860, and the cost of moving household effects of $2,180. This answer is not correct because the cost of the house-hunting trip prior to the move is not a deductible moving expense and the legal and title transfer fees on the purchase of the Edmonton home are not deductible because the Saskatoon home was rented, not owned.

*d. $2,770

@ Answer d) is correct. The maximum deduction is $2,770, which includes the lease cancellation costs on the Saskatoon home of $590 and the cost of moving household effects of $2,180. The cost of the house-hunting trip is not deductible, and the legal fees and title transfer fees on the Edmonton home are not deductible because the Saskatoon home was not owned (it was rented).

91. Advises on specific tax-planning opportunities for individuals

Jack has $20,000 pre-tax income to invest in a plan. He will use the money to buy his first house in five years. Jack's current marginal tax rate is 35% and it will be 45% in five years. He expects a 4% rate of return on his investments. Which of the following statements is correct?

a. The TFSA is a better investment because the earnings on the investment will be tax-free.

@ Answer a) is incorrect. While the earnings are not taxed when funds are withdrawn from a TFSA, the amounts can be withdrawn tax-free from an RRSP under the Home Buyers' Plan.

*b. The RRSP is a better investment because he can withdraw the money tax-free but the funds will need to be repaid.

@ Answer b) is correct. With the Home Buyers' Plan, he can withdraw the money tax-free but the funds need to be repaid to the RRSP.

	TFSA	RRSP
Amount to invest	$20,000 × (1 – 0.35) = $13,000	$20,000
Amount compounded annually for five years @ 4%	$15,816	$24,333
Withdrawn amount	**$15,816**	**$24,333**

c. The amount withdrawn in five years will be higher for the TFSA than for the RRSP.

@ Answer c) is incorrect. After five years, the amount withdrawn from an RRSP is higher due to the fact that it can be deducted from income when it is initially invested and withdrawn tax-free because of the HBP ($24,333 > $15,816).

d. The amount withdrawn in five years will be the same for both TFSAs and RRSPs.

@ Answer c) is incorrect. After five years, the amounts withdrawn will not be the same. The amount withdrawn from an RRSP will be higher due the fact that it can be deducted from income when it is initially invested and withdrawn tax-free because of the HBP ($24,333 > $15,816).

92. Discuss deductibility of charitable donations

A personal tax client, Juliet, has asked you to explain the tax rules related to charitable donations made by her and her spouse, Ellis. Which one of the following statements is *false*?

a. Juliet and Ellis can include the total of their charitable donations on either of their tax returns.

@ Answer a) is incorrect. This statement is true. Juliet and Ellis can include the total of their charitable donations in either of their tax returns.

*b. The lower-income spouse, Ellis, must claim the charitable donations.

@ Answer b) is correct. This statement is false. Either Juliet or Ellis can claim the charitable donations on their tax return.

c. Either Juliet or Ellis can claim the charitable donations.

@ Answer c) is incorrect. This statement is true. Either Juliet or Ellis can claim the charitable donations on their tax return.

d. Any unclaimed charitable donations can be carried forward for a period of up to five years.

@ Answer d) is incorrect. This statement is true. Unclaimed charitable donations can be carried forward for a period of up to five years.

93. Identify qualified small business corporation share criteria

Which of the following statements is *false* when determining if shares are considered to be qualified small business corporation shares?

a. The corporation is a Canadian-controlled private corporation (CCPC).

@ Answer a is incorrect. This would be considered, as the corporation must be a CCPC for the shares to be qualified small business corporation shares.

b. Shares were owned by the taxpayer for 24 months before being sold.

@ Answer b) is incorrect. This would be considered, as the shares must not be owned by anyone other than the taxpayer or a related person for at least 24 months preceding disposition in order to be considered qualified small business corporation shares.

c. Over the 24 months preceding the sale, more than 50% of the fair value of the assets of the corporation must be used in an active business.

@ Answer c) is incorrect. This would be considered, as over 50% of the fair value of the assets is required to be used to carry on active business operations (more than 50% of the business must be in Canada).

*d. At the time the shares are sold, 90% of the book value of the assets must be used in an active business carried on primarily in Canada.

@ Answer d) is correct. This would not be considered. The criteria require that 90% of the *fair* value, not the book value, of assets be used in an active business carried on primarily in Canada.

94. Calculate taxable income for a corporation

Evergreen Co. has computed its net income for tax purposes for 2017 as follows:

Income from business	$200,000
Dividends from taxable Canadian corporations	30,000

Dividends from foreign corporations	15,000
Taxable capital gains	10,000
Net income for tax purposes	$255,000

Evergreen made charitable donations of $5,000 to registered charities in the year. In addition, the company has the following carryover balances at the beginning of the year:

Net capital loss (2013)	$12,000
Non-capital loss (2014)	13,000
Charitable donations (2016)	2,000

What is Evergreen's taxable income?

a. $180,000

@ Answer a) is incorrect. This was determined as follows:

Net income for tax purposes	$255,000
Current-year charitable donations	(5,000)
Charitable donation carryover	(2,000)
Dividends from taxable Canadian corporations	(30,000)
Dividends from foreign corporations	(15,000)
Net capital loss carryover	(10,000)
Non-capital loss carryover	(13,000)
Taxable income	$180,000

This is incorrect because the $15,000 of dividends from foreign corporations was deducted. Only dividends from taxable Canadian corporations are deductible in determining taxable income of a corporation

b. $178,000

@ Answer b) is incorrect. This was determined as follows:

Net income for tax purposes	$255,000
Current-year charitable donations	(5,000)
Charitable donation carryover	(2,000)
Dividends from taxable Canadian corporations	(30,000)
Dividends from foreign corporations	(15,000)
Net capital loss carryover	(12,000)
Non-capital loss carryover	(13,000)
Taxable income	$178,000

A net capital loss carryover of $12,000 was deducted. The amount of a net capital loss deductible in the year is the lesser of the net capital loss carryover and taxable capital gains included in net income. Taxable capital gains included in net income were $10,000; therefore, the net capital loss carryover available to be used in the current year is $10,000.

*c. $195,000

@ Answer c) is correct. It was determined as follows:

Net income for tax purposes	$255,000
Dividends from taxable Canadian corporations	(30,000)
Net capital loss carryover	(10,000)
Current-year charitable donations	(5,000)
Charitable donations carryover	(2,000)
Non-capital loss carryover	(13,000)
Taxable income	$195,000

d. $197,000

@ Answer d) is incorrect. This was determined as follows:

Net income for tax purposes	$255,000
Current-year charitable donations	(5,000)
Dividends from taxable Canadian corporations	(30,000)
Net capital loss carryover	(10,000)
Non-capital loss carryover	(13,000)
Taxable income	$197,000

Charitable donations carried forward were not deducted. The available deduction for charitable donations is the lesser of 75% of net income ($191,250) and the sum of current-period charitable donations of $5,000 and the charitable donation carryforward of $2,000 ($7,000).

95. Discuss employee taxable benefits

An employee will be required to include a taxable benefit in his return if:

a. The employee uses a company car for business purposes.

@ Answer a) is incorrect. Where an employee uses a company car for business purposes, there is not a taxable benefit for the employee. Where an employee uses a company car for personal purposes, the personal use of the vehicle is considered to be a taxable benefit for the employee.

b. The employee is a senior accountant with a public accounting firm, and the firm pays for the employee’s CPA membership dues.

@ Answer b) is incorrect. Where an employer pays the professional membership dues for an employee and the employer is the primary beneficiary of the payment, there is no taxable benefit to the employee.

*c. The employee has a loan from his employer at a rate that is below the prescribed rate but pays the interest within 30 days of the end of the calendar year.

@ Answer c) is correct. Any benefit that an employee receives as a result of an interest-free or low-interest loan because of employment must be included in the employee's taxable income.

d. The employee uses his own automobile for company business, and the company reimburses him at a reasonable rate acceptable to the Canada Revenue Agency (CRA).

@ Answer d) is incorrect. A reimbursement for automobile expenses is not a taxable benefit for the employee receiving it unless the reimbursement represents payment of the employee's personal automobile expenses.

96. Discuss taxation of employee benefits

Cleanco Supply Ltd. sells cleaning supplies. The company is considering implementing new employee benefits. Which of the following statements about the taxation of the proposed benefits to the employees is true?

a. If Cleanco Supply paid premiums under a private health services plan for the employee, a taxable benefit would result.

@ Answer a) is incorrect. Premiums paid under a private health services plan are not a taxable benefit to the employee.

*b. Cleanco Supply could supply a built-in vacuum system worth $400 to an employee in recognition of a five-year term of service every five years without this being considered a taxable benefit.

@ Answer b) is correct. Cleanco Supply can provide a non-cash term of service award if the term of service is greater than five years. The value of the gift must not exceed $500. The vacuum system meets these criteria since it is less than $500, it is not cash or a gift certificate, and the gift is given in recognition of five years of service. Term of service awards can only be given every five years.

c. Cleanco Supply could supply a fitness club membership worth $600 to all employees without this being considered a taxable benefit.

@ Answer c) is incorrect. A fitness club membership primarily benefits the employee and is therefore considered a taxable benefit. Physical fitness of employees is not a direct benefit to the employer selling cleaning supplies.

d. If Cleanco Supply offers loans at rates below the CRA's prescribed rates, the loans are not considered a taxable benefit to the employee.

@ Answer d) is incorrect. If an employer offers loans to employees at rates lower than the CRA's prescribed rates, then a taxable benefit is calculated based on prescribed rates less the actual interest paid.

97. Determine the optimal allocation of the medical expense credit

Harry and Vera are married. Harry's net income for the year was $65,000 and Vera's net income was $10,500. Assume the maximum threshold for medical expenses for 2017 is the lesser of 3% of net income and $2,268. Both Harry and Vera had a significant amount of dental work completed in 2017, with receipts totalling $2,300 for Harry and $1,100 for Vera.

Based on the information provided, on whose tax return would you include the medical expenses in order to optimize the tax benefit for Harry and Vera?

*a. Both Harry's and Vera's medical expenses should be claimed on Harry's tax return.

@ Answer a) is correct. All of the medical expenses should be included in Harry's tax return. Vera cannot use the medical expense tax credit because her income is only $10,500, and after claiming the basic personal tax credit, she will have no tax payable to deduct a medical expense tax credit against.

b. Both Harry's and Vera's medical expenses should be claimed on Vera's tax return.

@ Answer b) is incorrect. Vera cannot use the medical expense tax credit because her income is only $10,500, and after claiming the basic personal tax credit, she will have no tax payable.

c. Harry's medical expenses should be claimed on Harry's return and Vera's medical expenses should be claimed on her return.

@ Answer c) is incorrect. The taxpayer may claim a medical expense tax credit for the medical expenses of the taxpayer, the taxpayer's spouse, or a dependent individual. Although the medical expenses can be split between the two returns, it is usually more beneficial for the lower-income spouse to claim all of the expenses, as the 3% threshold will be lower.

d. Harry and Vera will be indifferent between including the total of the medical expenses on either taxpayer's return.

@ Answer d) is incorrect. The taxpayer may claim a medical expense tax credit for the medical expenses of the taxpayer, the taxpayer's spouse, or a dependent individual. Although the medical expenses can be split between the two returns, it is usually more beneficial for the lower-income spouse to claim all of the expenses, as the 3% threshold will be lower.

98. Inputs into determining cash requirements

SunnyBrook Inc. is currently reviewing its cash balance and making plans for how much of this amount will be required in the next six months for transactions.

Which of the following planned transactions should **NOT** be taken into consideration in determining the amount of the cash on hand?

a. The delivery of a large piece of equipment which will be paid for on delivery

@ Answer a) is incorrect. The capital disbursement will reduce the cash on hand.

b. Annual dividends declared at the end of last month to be paid within 30 days of declaration

@ Answer b) is incorrect. The dividends have been declared and will be paid within the six-month period being examined, thus reducing the cash on hand.

*c. The granting of stock options to the CEO of the organization

@ Answer c) is correct. Granting stock options to the CEO has no immediate impact on the firm's cash levels; therefore, it will not impact the cash on hand over the next six months.

d. Payment for the government-regulated inspection completed every five years for the elevators

@ Answer d) is incorrect. The payment of this government-regulated inspection will reduce cash on hand.

99. Source of financing — Leasing

Which of the following is a disadvantage of leasing for the lessee?

a. The implied lease interest rate is less than the lessee's incremental borrowing rate.

@ Answer a) is incorrect. This is an advantage for the lessee. If the implied lease interest rate is less than the lessee's incremental borrowing rate, it will be cheaper for the lessee to lease the asset rather than borrow to purchase the asset.

b. The lessee will have to pay the unguaranteed residual value of the asset at the end of the lease term.

@ Answer b) is incorrect. The lessee only has to pay the residual value if it is guaranteed; not if it is unguaranteed.

*c. The lessee loses the tax savings associated with the capital cost allowance deductions allowed for the asset.

@ Answer c) is correct. These tax benefits may be more advantageous earlier in the life of the asset in comparison to the deductible lease payments, which will be same for each year of the lease.

d. The lessee takes on the risk of selling or disposing of the asset at the end of the lease.

@ Answer d) is incorrect. This is the lessor's risk, not the lessee's risk. Thus, this is an advantage of a lease because the lessee can avoid this risk.

100. Capitalized cash flow approach — Equity value

You are calculating the value of a company using the capitalized cash flow approach. You have determined the following:

- The capitalized value of operations is $1,000,000.
- The current cash balance is $300,000 (management has informed you that it typically requires $100,000 to run the business).
- Other working capital is $200,000.
- Long-term debt is $300,000.

What is the equity value of the company?

a. $700,000

@ Answer a) is incorrect. The value of redundant cash ($200,000) has not been added to determine the equity value.

*b. $900,000

@ Answer b) is correct. The value of the company's equity using the capitalized cash flow approach = capitalized value of operations ($1,000,000) + redundant cash ($300,000 – $100,000 = $200,000) – interest-bearing debt ($300,000) = $900,000.

c. $1,000,000

@ Answer c) is incorrect. The full amount of cash of $300,000 has been added back, rather than just the redundant portion of $200,000.

d. $1,100,000

@ Answer d) is incorrect. The other working capital of the business should not have been added back to determine the equity value of the business; only redundant assets are added.