PROFILE AT C: The candidate discusses some of the tax issues raised by Gale. Candidates were asked to look at some tax issues when they were told the following: “You meet with Gale to discuss DI's financial reporting processes, draft financial statements, and some tax related matters (Appendix II).” In Appendix II, candidates were provided with hints that Dogani Inc. had corporate tax issues that needed to be addressed with Gale. Candidates were told that Gale was not sure how paying for exhibition expenses for Louis and his wife would affect Dogani Inc.'s corporate income taxes. In addition, Gale raised another corporate tax issue related to a researcher hired in 2015, since the researcher was provided with an interest-free home relocation loan and a leased luxury sport utility vehicle, at a cost of $1,500, for the researcher to use for business purposes. In order to demonstrate competence, candidates had to address several of the tax issues raised by Gale.

COMMENTS ON PERFORMANCE FROM MESSAGE TO CANDIDATES in CFE Report:

SAMPLE RESPONSE #1: This candidate correctly identified 2 of the 4 tax issues that there were in the case, missing the land exchange which was an important issue (integrated with accounting discussion). The analysis of the “exhibitions” - knows the rules to a degree but some technical weakness (misses convention rule and meals rule), and doesn’t do a very good job of integrating the detailed case facts provided. The lease discussion is incorrect (no value). So this response has “not enough breadth” and technical weakness.

“E. Tax issues:

I have identified the following tax issues:

1. Exhibitions

Under ITA rules, expenses incurred to attend exhibitions and conferences can be deducted so long as they are for business purposes, are put on by a business or professional organization and are within the territorial scope of DI's business. Furthermore, travel expenses incurred for business purposes can also be deducted so long as they are reasonable. Although Louise's wife did attend some exhibitions, the remainder of her time was spent sightseeing. As a result, a portion of the travel expenses incurred will not be deductible to DI.

2. Leased vehicle

A leased vehicle provided by the employer are subject to a stand-by charge which must be included in the employer's income in order for the employer to claim a deduction. The stand-by charge is equal to the following:

\[
\frac{2}{3} \times \text{lease costs per month} = \frac{2}{3} \times 1,500 \times 12 = \$12,000
\]
The above charge can be reduced so long as the personal km driven are below those driven for business purposes.”

**SAMPLE RESPONSE#2: GOOD!**

**“Response to Gail's Email**

**Tax Considerations**

- Per the income tax act, expenses may only be deducted by a business and not included in the person's taxable income when they are for legitimate business purposes.

- As it does not appear that Louis' wife works for the company and she was not there fore a business purpose, she will have to include the cost of her trip (food, meals, accommodation, etc) in her taxable income for the year.

- Further, DI will not be able to deduct these expenses to arrive at taxable income. Therefore, the business expense will be denied for the wife's portion of the expenses.

- It appears that Louis was there fore legitimate reasons so his expenses will be deductible by the company and not taxable to Louis.

- For the sport utility vehicle, there will be no taxable benefit for the employee as it is used 100% for business purposes. If this was not the case, he would have to claim a taxable benefit through a standby charge and operating benefit.

- The interest free home relocation loan is a taxable benefit to the employee so he will have to claim an imputed benefit based on CRA applicable rates,. Note that as this loan was for a new location and a new job (I assume he relocated for the job), there is an exemption; he will not have to pay tax on an interest benefit on 25,000 of the loan.
The luxury vehicle lease costs can be expensed for DI as a company as it is a valid business expense for the new employee as it is 100% used for business purposes.

The home relocation loan has no impact on DI’s taxable income for the year.”

**VS SOLUTION:**

Travel Expenses Related to Exhibitions in Europe

The Income Tax Act (ITA) allows for the deduction of expenses to the extent that they were incurred to earn business income and were reasonable in the circumstances. It is unclear if the exhibitions would be considered conventions. Since the purpose of these exhibitions appears to be promotion of DI’s products, rather than a professional meeting, it is possible that these are not conventions. If this is the case, there is nothing in the information provided by Gale to suggest that the expenses paid by DI were unreasonable. However, if these are in fact conventions, then subsection 20(10) of the ITA limits the deduction of expenses incurred for attending conventions to two a year, provided that the conventions were (a) held by a business or professional organization; (b) attended in connection with the taxpayer’s business or professional practice; and (c) held at a location that may reasonably be regarded as consistent with the territorial scope of the organization. Although it may appear that exhibitions in Europe may not be within the territorial scope of the organization, since it operates in Canada, it can be argued that DI is planning to expand to Europe, which would cause that area to be consistent with the territorial scope of the organization. If criteria (a) and (b) are also met, all costs discussed below would only be deductible for two of the events attended. In either circumstance, the expenses incurred by Louis’s wife would not be deductible unless she was an employee of DI and the costs were incurred for business purposes. If there is a business purpose, the exhibitions in which she participated could be deducted. Any expenses incurred for trips when she chose to go sightseeing rather than participate in the exhibitions would not be deductible and would become a taxable benefit to either Louis, if his wife is not a DI employee, or to her, if she is a DI employee.

Regarding the meals paid for by DI, under section 67.1 of the ITA, only 50% of the actual costs incurred can be deducted, and only to the extent they were incurred for business purposes. Any meals paid for by DI for Louis’s wife while sightseeing would not be deductible at all and would become a taxable benefit, similar to the above analysis. The costs incurred for airfare, hotels, and taxis would be considered deductible on the corporate income tax return subject to the two-conference limit, as well as the requirement that they be for business purposes, as discussed above. Costs related to Louis’s travel would not be a taxable benefit to him, since the primary beneficiary of these costs would be DI.

Lease of Luxury Sport Utility Vehicle

Regarding the lease of the luxury sport utility vehicle, the ITA restricts the deductibility of the lease payments. The maximum deduction currently allowed is $800 per month plus non-recoverable GST, HST, and PST, subject to an adjustment based on the manufacturer’s suggested list price of the vehicle.
Given that no personal use is allowed, the employee will have no taxable benefits assessed as a result of this vehicle.

**NOTE:** Two additional issues in solution, not addressed by candidate #1: Interest-Free Employee Loan AND Exchange of Land (details not shown here-see CFE report)

### III-2 (Dogani) AO#3 (Breadth Test-Audit and Assurance) The candidate assesses the risks related to the audit of DI’s financial statements for the year ended December 31, 2015.

**PROFILE AT C:** The candidate discusses several of the risks related to the audit. Candidates were asked by the engagement partner to assess the risks related to the audit. The case provided information in many areas that pointed to factors that affected the risk of material misstatement for the audit. In order to demonstrate competence, candidates had to address several of the factors and explain why these factors affected the risk of the audit.

**COMMENTS ON PERFORMANCE FROM MESSAGE TO CANDIDATES in CFE Report:**

SAMPLE RESPONSE: This candidate “hits” points but fails to explain WHY. Response is too brief/ lacking support (so really never goes beyond “ID” level).

“**Risk:**

- new controller started at the company recently which increases the risk of the audit.
- no errors noted in the financial statements which reduces the risk of the audit.
- first time audit of financial statements which increases risk of audit.
- management is trying to get approval for a financing loan that will increase the risk of the audit as management will be biased to show results that result in the bank providing financing.
- slow collection of AR compared to prior year increases risk of audit.
- the risk for the audit is high.”

**VS SOLUTION:**
Risk of Material Misstatement
CAS 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, requires that, as auditors, we assess the risk of material misstatement for the audit of DI’s financial statements. A number of factors must be considered when assessing the risk of material misstatement at the financial statement level, including the following:

- DI has had a new controller since September 2015. The controller may lack familiarity with DI, and there is, therefore, a risk that some transactions have not been recorded properly. We also do not know what happened to the previous controller. We should enquire about the circumstances to see if there is an increased risk due to this departure.
- As discussed previously, the exchange of the land was not accounted for appropriately, since the treatment does not comply with IFRS. This error may be the result of a lack of familiarity with the guidance provided by IFRS and also the complexity of the transaction entered into during the year under audit. This increases the risk that other errors might be present in the financial statements.
- 2015 is also the first year for which DI is required to have its financial statements audited in order to obtain the bank’s financing for the construction of its new manufacturing facility and warehouse. There may be undetected errors in the opening balances due to the fact that the financial statements have never been audited.
- The bank is a new user of the financial statements. Thus, there will be higher scrutiny on the financial statements compared to previous years since the bank will be more sensitive to errors in the financial statements. In addition, given the fact that the bank will likely require DI to meet some covenants, there is an incentive for DI’s management to manipulate results. Management may have acted on this bias in the preparation of the financial statements, since the error that was found improved DI’s bottom line.
- The control environment at DI may be lacking. In the past, DI engaged a professional services firm to design and document its processes and controls. Although Gale is generally satisfied that these processes are being followed, such documentation has not been updated since 2010 and may be out of date. Gale mentioned that she found a few exceptions in which the processes and controls were not followed. This is further evidence that the control environment is lacking. Management has engaged the same professional services firm to update the control documentation, but this will not be completed until after the audit engagement. Therefore, a lack of controls could result in additional misstatements in the financial statements. Gale also mentioned that the accounts receivable collection has slowed down. This might be further evidence that the controls are lacking, which leads to an increased audit risk.

Given these risk factors and the absence of factors that suggest a reduced level of risk, the risk of material misstatement at the financial statement level is assessed as high.

PROFILE AT C: The candidate prepares a reasonable quantitative and qualitative analysis of the make-versus-buy decision and provides a recommendation.

Candidates were asked to address Gale’s email (Appendix III), which detailed Dogani Inc.’s current manufacturing costs for body rhythm monitors and a proposal from Sensit Inc. to manufacture the monitors for a price of $38 per monitor. The email also mentioned that the customers of Sensit Inc. commented that there were no quality concerns and that all orders were filled on time. In order to demonstrate competence, candidates had to prepare a reasonable
quantitative and qualitative analysis of the make-versus-buy decision and provide a recommendation.

**COMMENTS ON PERFORMANCE FROM MESSAGE TO CANDIDATES** in CFE Report:

SAMPLE RESPONSE: This candidate does a calculation in the word part (rather than use the spreadsheet, which is fine), but provides NO explanation as to where #’s come from (poor supporting documentation). Markers are left to try to decipher/figure out what they are and what the candidate is going. In addition, the candidate does not really conclude on whether to make or buy (no conclusion).

“Gales Email

The offer to purchase the monitors from SI instead of producing them in house will increase the profitability of the company $227,500. (38x75000= 2850000) - (3187500-75000-35000)

Gale checked the references and saw no concerns but the company would not give her any customers that would give negative feedback so she is relying on their references. The risk is high that there could be quality control issues. We should require and obtain more than three references to check. This will avoid other issues down the road.”

**VS SOLUTION:**

Re: Make-versus-Buy Decision

To determine whether to continue to manufacture the body rhythm monitors or to purchase them from Sensit Inc. (SI), it is necessary to consider relevant costs, or those costs that could be avoided by purchasing from SI. The relevant costs associated with the annual volume of 75,000 monitors are as follows:

<table>
<thead>
<tr>
<th>Total Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
</tr>
<tr>
<td>$1,875,000</td>
</tr>
<tr>
<td>Direct labour</td>
</tr>
<tr>
<td>937,500</td>
</tr>
<tr>
<td>Overhead (Note 1)</td>
</tr>
<tr>
<td>110,000</td>
</tr>
<tr>
<td>$2,922,500</td>
</tr>
</tbody>
</table>

Note 1: Total overhead costs of $375,000 are expected in the production of 75,000 monitors. However, the only amounts that can be avoided are the $75,000 paid to the product line supervisor, who could be laid off, and the $35,000 in utilities that could be saved by shutting down this portion of the manufacturing facility. Therefore, the total relevant overhead costs are $110,000.

Should DI choose to purchase from SI, it would be possible to acquire the 75,000 monitors for a total cost of $2,850,000 ($38 x 75,000).

We should also consider the cost of the space used to manufacture the body rhythm monitors. If the manufacturing of the body rhythm monitors is outsourced, it will free up space in the warehouse. There might be an opportunity cost related to this space that should be taken into account in the decision to make or buy.
Any opportunity cost would increase the cost of making the units, so, regardless, it would be cheaper to purchase them. Therefore, ignoring any opportunity cost, from a strictly quantitative perspective it would cost DI $72,500 ($2,922,500 − $2,850,000) less to purchase from SI.

It is important to also consider qualitative factors in your decision. DI needs to consider the ability to control the quality of the monitors purchased and the risk of stock outs that would delay the production of SB and SB2 units. According to the reference checks you performed, there were no concerns with quality and all orders were filled on time. These are positive signs that also support the decision to outsource. However, the references you checked were from customers selected by SI. I advise you to obtain a complete customer list and perform additional reference checks. The price is currently favourable. You should consider that if you outsource, you lose control over the future cost of the unit. I recommend that if you decide to outsource, you should ensure your price is set for an extended time frame. The decision to outsource will require laying off the product line supervisor. You should consider the impact this will have on DI’s reputation and employee morale. Lastly, you should consider the fact that DI’s bank might not advance the funds necessary to allow for DI’s expansion. If this is the case, you may be able to repurpose the production space freed up from outsourcing to expand capacity.

Based on the quantitative and qualitative analyses associated with the make-versus-buy decision, I recommend that you pursue purchasing the required monitors from SI. However, to protect DI, you should have a detailed agreement that stipulates requirements like quality specifications and delivery time frames, as well as significant penalties should SI not fulfill these requirements.