DAY 2 COMP

CAMERON EXAM

ALL ROLES

Cameron Distributors

Examination Details

The examination consists of:

Booklet #1 – Case (this booklet)

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

The case should be answered in regular word and excel. The main body of your response should be in the word file. Only supporting calculation should appear in the spreadsheet file, in **Sheet 1**. You are responsible for clearly explaining all your calculations.

Answers or part answers will not be evaluated if they are recorded on anything other than word and excel.

The CPA Canada Handbooks and the *Income Tax Act* are available in Knotia throughout the entire examination. Knotia provide the standards in effect and tax laws enacted at December 31, 2022.

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

Rough notes, and any other notations made in the exam booklet will not be evaluated.

Candidates are instructed to consider and respond to the case as presented and ignore the potential impacts of COVID-19.

Professional Accounting Supplementary School
300 Sheppard Ave. W., Ste. 100
Toronto, Ontario M2N 1N5

Case

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

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

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BACKGROUND
COMMON INFORMATION FOR ALL ROLES

Cameron Distributors Limited (CDL) is a Canadian corporation, located in Toronto, founded and managed by Roy Cameron. CDL imports and distributes baby cribs, manufactured in Hong Kong, which are sold to retail stores across Canada. CDL's year end is June 30, 2023. It is now August 2, 2023. CDL has numerous competitors in the baby furniture industry most of whom are larger than CDL.

Lately, Roy has become very concerned about Cameron's ability to compete with companies who sell North American made furniture. Roy believes that some of his competitors who are selling North American made cribs, may be in a better position to compete. He believes that these competitors are becoming more aggressive in their bids because they may now have a cost advantage over importers. He therefore feels that it may be prudent to source the cribs from North America rather than importing from Asia. One possibility he would consider for CDL, is manufacturing the company's cribs.

At an industry convention Roy met Bill Drake, the owner of Drake Manufacturing Inc. (DMI). Bill has been the majority shareholder of DMI for the past 16 years. Roy believes that a relationship with DMI could provide an opportunity for CDL to get involved in manufacturing. DMI operates a job order shop located in Vancouver. DMI obtains contracts from department store chains to manufacture specific goods labeled "Manufactured Exclusively For ....". In recent years, the company has manufactured dressers, beds and cabinets, toy boxes and car seats. They have never manufactured cribs but given the company's experience with beds, Bill indicated that manufacturing cribs would not be difficult for the company.

A couple of weeks after Bill provided the cost estimate to Roy, he phoned Roy and mentioned the possibility of DMI and CDL working together. Bill and Roy had a lengthy telephone conversation in which Roy learned more about DMI. Following the conversation, in order to "test the waters" Roy sent Bill an informal proposal concerning a possible acquisition of a majority interest in DMI. Roy also made an informal oral presentation regarding the company entering a relationship with DMI to CDL's board of directors (Appendix I).

At the same convention in which Roy met Bill Drake, he met with John Holis, who is a vice president of Big Furniture Inc. (BFI), one of the largest and most successful manufacturers in the United States. BFI is a multinational furniture manufacturer with plants all over the world including Buffalo, New York, which is about 200 kilometres from CDL's operations. It is well known as a manufacturer of quality furniture. BFI manufactures various types of furniture including cribs. Roy would also consider using BFI to manufacture the company's cribs.

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

ASSURANCE REQUIREMENTS

You, CPA, are a senior accountant, employed by Kraft and Kraft LLP. Kraft and Kraft are the auditors of CDL. Dan Kraft, an audit partner in the firm, has just finished a meeting with Roy Cameron the president of CDL. Following the meeting, Dan meets with you.

Dan explains that Roy has asked Kraft and Kraft to help him determine whether he should consider selling cribs manufactured in North America rather than importing from Asia. Although CDL has internal managers with the necessary expertise to perform this analysis, he is still interested in Kraft and Kraft doing the analysis as he believes that an objective second opinion would be useful.

Dan asks you to prepare the necessary quantitative and qualitative analysis to help CDL make an optimal decision. He would like you to consider three options: continue to import from Asia, manufacture through DMI or purchase the cribs from BFI. After performing your analysis he would like you to make a recommendation.

Dan also mentions that there is some concern with respect to the accounting for revenue recognition in the DMI May 31, 2023 financial statements; Roy would therefore like you to take a look at this issue and determine whether the company's treatment of revenue is appropriate. Jim would also like you to discuss the appropriate accounting treatment for the legal suit as well as the product recall that DMI is currently facing. CDL prepares its financial statements based on Accounting Standards for Private Enterprises (ASPE)

Dan then asks you prepare an audit plan for the 2023 year end of CDL for his review, which includes an assessment of risk, and a discussion of materiality as well as audit approach. Dan emphasizes that the plan should address analytical procedures to be used as part of the risk assessment.

It will be important that the audit plan address the audit impact of CDL purchasing a majority interest in DMI given that this acquisition may take place. CDL is intending to consolidate DMI in the event that the acquisition takes place.

You have also been asked to discuss procedures that will have to be done in connection with the audit of consolidated financial statements which include DMI. Although if the acquisition takes place, it will be in the 2024 fiscal year and will therefore not impact the 2023 statements, the partner is interested in how the acquisition would have impacted the audit had the acquisition taken place in fiscal 2023. Accordingly for the purpose of this memorandum, you should work with DMI's 2023 financial statements.

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

ASSURANCE REQUIREMENTS (continued)

You have been asked to give particular attention to high risk financial items. Dan has informed you that Roy is considering more than one option in connection with the financing of the possible DMI acquisition. Given that a definite decision has not yet been made with regard to which option to pursue, your procedures should take into account both of the possible financing options.

You have also been asked to address any special reports that may be required to meet CDL's needs, based on the terms of the proposals DMI and BFI have made with regard to possible business relationships. In addition to discussing possible reports that could be provided that would meet the client's needs, you are also asked to prepare an audit strategy including a risk analysis, a discussion of whether a lower materiality will be required for the special engagement than was used on the financial statements, the approach to be used for the engagement and any other engagement issues. You have also been asked to consider the criteria that should be used in determining what costs should be included for the purpose of computing the markup. In addition you are asked to describe the procedures that will need to be performed for the variable and annual fixed costs DMI expects to incur to manufacture the cribs.

Your audit strategy and procedures should consider both the possibility of a review level or audit level of assurance being provided.

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

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

FINANCE REQUIREMENTS

You, CPA are an analyst at the financial consulting firm Dubois and Chabib (D & B). CDL is a client of D & B. Jim Harrigon, a partner at D & B, has just finished a meeting with Roy Cameron the president of CDL in which Roy raised various issues that the Company is currently facing. Following the meeting, Jim meets with you.

Jim explains that Roy has asked D & B to help him determine whether he should consider selling cribs manufactured in North America rather than importing from Asia. Although CDL has internal managers with the necessary expertise to perform this type of analysis, he is still interested in D & B doing the analysis as he believes that an objective second opinion would be useful.

Jim asks you to prepare the necessary quantitative and qualitative analysis to help CDL make an optimal decision. He would like you to consider three options: continue to import from Asia, manufacture through DMI or purchase the cribs from BFI. After performing your analysis he would like you to make a recommendation.

Jim also mentions that there is some concern with respect to the accounting for revenue recognition in the DMI May 31, 2023 financial statements; Roy would therefore like you to take a look at this issue and determine whether the company's treatment of revenue is appropriate. Jim would also like you to discuss the appropriate accounting treatment for the legal suit as well as the product recall that DMI is currently facing. CDL prepares its financial statements based on Accounting Standards for Private Enterprises (ASPE)

Jim then goes on to explain some additional issues Roy would like the firm to deal with. Roy is seriously considering acquiring DMI and claims that DMI is a financially stable and profitable entity, which could be counted on to generate strong cash flows in the future even before considering the impact of DMI selling cribs to CDL. Jim however has some serious doubts about this, particularly in light of the fluctuations in some of the balances in the balance sheet. He therefore asks you to assess the strength of DMI's balance sheet as well as the company's liquidity after considering significant balance sheets fluctuations. In addition he would like you to prepare a 5 year forecasted cash flow for DMI before considering the impact of sales to CDL on DMI's cash flows.

Before giving serious consideration to purchasing a majority interest in DMI, Roy would like D & B to perform due diligence work. Jim asks you to outline in detail the due diligence work that should be performed including the major areas that should be focused upon. Jim also asks you to assess the two financing options CDL is considering in the event that DMI is acquired.

Should the acquisition go through, the current plan is for DMI to manufacture the cribs for CDL

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

FINANCE REQUIREMENTS (continued)

using leased machinery. Jim asks you to consider both quantitatively as well as qualitatively whether this is optimal or whether it would make more sense to purchase the machines. Also while initially the plan is to transport the cribs from DMI's location in Vancouver to CDL's location in Toronto by train, Roy is considering having CDL purchase trucks to transport the goods. As a preliminary step for making this decision, Jim has asked you to calculate CDL's cost of capital.

Despite Roy's interest in acquiring DMI, Roy is still keeping an open mind to other possibilities. Jim therefore asks you to assess the financial and other risks associated with continuing to import from Hong Kong versus purchasing from BFI versus manufacturing the cribs. For the case of manufacturing, Jim asks that you consider the risks of manufacturing both through CDL acquiring DMI or starting up its own manufacturing facility. Jim would also like you to discuss how to mitigate risk where possible.

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

PERFORMANCE MANAGEMENT REQUIREMENTS

You, CPA are a senior management consultant, employed by the consulting firm Kraft and Kraft LLP. CDL is a client of Kraft and Kraft. The firm has been engaged to provide consulting services to assess various issues that CDL is facing, and to assess CDL's strategic options. Karen Higgins, a partner in the firm, has just finished a meeting with Roy Cameron the president of CDL. Following the meeting, Karen meets with you.

Karen explains that Roy has asked Kraft and Kraft to help him determine whether he should consider selling cribs manufactured in North America rather than importing from Asia. Although CDL has internal managers with the necessary expertise to perform this type of analysis, he is still interested in Kraft and Kraft doing the analysis as he believes that an objective second opinion would be useful.

Karen asks you to prepare the necessary quantitative and qualitative analysis to help CDL make an optimal decision. He would like you to consider three options: continue to import from Asia, manufacture through DMI or purchase the cribs from BFI. After performing your analysis he would like you to make a recommendation.

Karen also mentions that there is some concern with respect to the accounting for revenue recognition in the DMI May 31, 2023 financial statements; Roy would therefore like you to take a look at this issue and determine whether the company's treatment of revenue is appropriate. Jim would also like you to discuss the appropriate accounting treatment for the legal suit as well as the product recall that DMI is currently facing. CDL prepares its financial statements based on Accounting Standards for Private Enterprises (ASPE)

Karen asks you to provide a situational analysis for CDL which would include a SWOT analysis, a discussion of any relevant stakeholders, and the identification of any constraints. She would also like you to quantitatively consider the company's current situation by comparing the company's performance and current financial condition to its historical performance, and benchmarking against industry statistics. In addition Karen would also like you to consider the appropriateness of CDL's mission and vision.

Karen also asks you to assess the risks associated with continuing to import from Hong Kong versus purchasing from BFI versus manufacturing through DMI, as well where possible, how the risks could be mitigated.

From an operational standpoint, there are a number of areas that Karen asks you to review. Corporate Governance is very important to CDL, as part of the continuing evolution of the company. Karen therefore asks you to address the effectiveness of the Company's Board. She also asks you to consider an effective bonus plan that could incentivize employees to help grow the company. She specifically asks that you address in your analysis how CDL could utilize a

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

PERFORMANCE MANAGEMENT REQUIREMENTS (continued)

balanced score card as a performance metric.

As part of a due diligence exercise in connection with the possible acquisition of DMI, Roy has asked Bill to perform a detailed variance analysis for costs and sales for one of DMI's main products over the last year, the toy boxes. No budgeted sales price has been provided, however you have been told to assume that the contribution margin for the toy boxes will be similar to the company's contribution margin on its other products. As well, should you find there to be any variances from budget, Roy has asked you to consider pricing on the toy boxes going forward both quantitatively and qualitatively given that it is important to attain at least DMI's average contribution margin (as available per 2023 financial statements) on this product.

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

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

TAXATION REQUIREMENTS

You, CPA, are a senior accountant, employed by Kraft and Kraft LLP. Kraft and Kraft has been engaged to provide tax consulting services to CDL. Michael Peroga, a tax partner in the firm, met with Roy Cameron, the president of CDL, a few days ago to discuss the Company's tax needs, as well as some other issues the company is facing.

Michael explains that Roy has asked Kraft and Kraft to help him determine whether he should consider selling cribs manufactured in North America rather than importing from Asia. Although CDL has internal managers with the necessary expertise to perform this analysis, he is still interested in Kraft and Kraft doing the analysis as he believes that an objective second opinion would be useful.

Michael asks you to prepare the necessary quantitative and qualitative analysis to help CDL make an optimal decision. He would like you to consider three options: continue to import from Asia, manufacture through DMI or purchase the cribs from BFI. After performing your analysis he would like you to make a recommendation.

Michael also mentions that there is some concern with respect to the accounting for revenue recognition in the DMI May 31, 2023 financial statements; Roy would therefore like you to take a look at this issue and determine whether the company's treatment of revenue is appropriate. Jim would also like you to discuss the appropriate accounting treatment for the legal suit as well as the product recall that DMI is currently facing. CDL prepares its financial statements based on Accounting Standards for Private Enterprises (ASPE)

Michael explains that there are various tax areas that need to be addressed. He asks you to prepare a calculation of DMI's corporate tax payable for its May 31, 2023 year-end. He also asks you to outline corporate tax issues arising from the acquisition that could impact CDL, considering among other things interaction between CDL and DMI post acquisition. During their meeting, Roy also told Michael that Bill had been ranting and raving about his accountant's tax planning, which he claims enabled him and DMI's Vice President, John Simons to withdraw money from DMI "without paying any taxes" by using shareholder loans. Michael asks you to address the personal tax consequences associated with Bill and John's shareholder loans including whether the loans would be taxable in the year the loans were made. He also asks you to consider the tax impact of CDL making a shareholder loan to Roy.

CDL recently received a notice from Canada Revenue Agency ("CRA") indicating they will be performing an audit to assess whether CDL's sales staff are considered employees or independent contractors. Roy asks you to prepare an analysis of areas the CRA will likely look at and how they would apply to CDL's situation.

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

TAXATION REQUIREMENTS (continued)

With respect to the possible acquisition of CDL, although Roy has informally offered to purchase DMI's shares, he has contemplated presenting Bill with an asset purchase option as well. Michael asks you to explain the advantages and disadvantages of purchasing either shares or assets. In addition, he'd like you to address any important considerations Bill will take into account when deciding whether to sell assets or shares including eligibility for the LCGE, since it will provide him with a better idea of Bill's position for negotiation purposes. He'd like you to include any calculations relating to LCGE eligibility. Further, since Roy is currently leaning more towards a share purchase, Michael would also like you to perform a detailed analysis of the tax implications of CDL purchasing a majority ownership in the shares of DMI, along with any tax planning that could be utilized at the time of the acquisition to save taxes going forward, assuming that shares are purchased.

Finally, Michael asks you to outline the tax implications associated with manufacturing cribs in Canada versus continuing to import including the impact of the imported cribs being purchased in US dollars.

APPENDIX I - COMMON
EXCERPTS OF ORAL PRESENTATION MADE BY ROY CAMERON TO CAMERON DISTRIBUTORS INC. BOARD OF DIRECTORS

“I must tell you about a chance meeting at a convention with Bill Drake, the majority owner of Drake Manufacturing Inc. (DMI), as I think that it could lead to an opportunity for CDL to get involved in manufacturing.

“At the end of the convention Bill offered to provide an estimate of what it would cost DMI to manufacture a typical crib that CDL currently imports from Asia (Appendix III). Bill has indicated that his costs are quite representative of the cost of manufacturing cribs in Canada. Bill’s figures should therefore give us a good idea of what it would cost CDL to manufacture in North America; this should help us determine whether it would be profitable to manufacture rather than import.

“A couple of weeks after Bill sent the cost estimate to me, he phoned me to ask whether I had reviewed the figures and at the same time, he mentioned the possibility of DMI and CDL working together. I expressed interest in the idea and sent him over an informal proposal concerning a possible acquisition of DMI (Appendix II). I am working quickly on this as I think that getting involved with DMI provides a wonderful opportunity for CDL.

“At the same convention I also met with John Holis, who is a vice president of Big Furniture Inc. (BFI), one of the largest and most successful manufacturers in the United States. I would also consider using BFI to manufacture our cribs; they have proposed prices for providing cribs to CDL (Appendix II). I have done some research and the proposed prices are definitely comparable to other high quality North American manufacturers.

APPENDIX II - COMMON
RELATIONSHIPS WITH DRAKE MANUFACTURING INC. (DMI) AND BIG FURNITURE INC. (BFI) UNDER CONSIDERATION

Possible Relationship with DMI

The following are excerpts from an informal proposal Roy Cameron sent Bill Drake in connection with acquiring DMI.

"Cameron Distributors Ltd. (CDL) would be prepared to purchase 51% of the shares of DMI, based on a fair price to be determined by a professional business valuator. I would undertake to keep you on as president and let you run the show for a minimum of two years. I would then consider having CDL purchase the remaining shares of DMI for their fair value at that time, if you wish, and run the show myself.

"I will undertake to consult with you before dividends are paid out by DMI.

"CDL would purchase the cribs from DMI at a 7% markup over DMI's costs, which would allow DMI to earn a reasonable profit on sales to CDL. It is assumed that the proposed pricing is in accordance with taxation laws, but your accountants would be free to review this.

"CDL will have its auditors confirm DMI's costs of producing the cribs.

"DMI would be willing to conduct a test run if necessary."

Possible Relationship with BFI

BFI has proposed the following relationship with CDL.

(1) CDL will guarantee to give BFI a minimum amount of business per year to be established by mutual agreement. While the minimum is negotiable, BFI would prefer a minimum of 275,000 units per year.

(2) The fee charged by BFI for the average crib (similar to the average crib CDL is currently importing) would be based on the costs (all inclusive) plus 20%. CDL's auditors would be welcome to verify the cost figures on a semi-annual basis. The costs would be determined based on mutually agreed accounting principles.

(3) Anticipated price per crib including the 20% mark up is as follows: $83 for annual production below 350,000 units and $76 for annual production of 350,000 units or greater*.

* The price will be charged in US dollars. The above prices have been translated into Canadian dollars based on the exchange rate at the date the proposal was made, which was $1 US = $1.25 Canadian.

APPENDIX III - COMMON
DMI'S ESTIMATE OF COSTS TO MANUFACTURE A CRIB

Variable Costs per 1000 Units

Direct materials	$15,300
Direct labour (note 2)	35,000
	$50,300
Variable overhead	30% of labour and material costs

Annual Fixed Costs	
Foreman and other salaries (note 3)	$1,890,000
Rent (note 4)	400,000
Leasing of equipment (note 5)	see note
Maintenance costs per machine (Note 5)	11,700
Allocation of DMI's Corporate Costs (note 6)	440,000
Start-up Costs (note 7)	
Design set-up	$200,000
Training	100,000
	$300,000

Notes

(1) The estimate is for an average crib similar to the average crib, CDL is currently importing.

(2) The labour costs are based on the current average hourly wage rate of $20 per hour. It is expected that wage rates will increase by about 5% next year. The average hourly wage rate is representative of the job classifications of the type of employees who would be required for the manufacturing of cribs. Depending on the job classification assigned by the union, the hourly wage rate at DMI can be up to $40 per hour.

(3) Total salaries are based upon a production level of under 350,000 units. An additional supervisor at a cost of $75,000 is required if 350,000 units or more are produced. Some employees are not union workers and therefore work for an annual salary.

(4) The rent estimate is based on renting additional space in the same complex as our current operations; assumed rental rate of $10 per square metre.

(5) Two machines are required.

APPENDIX III – COMMON (continued)
DMI'S ESTIMATE OF COSTS TO MANUFACTURE A CRIB

The lease payments per machine, which are payable at the beginning of each year are as follows:

Year 1: $37,500 per year
Year 2: $45,000 per year
Year 3: $50,000 per year

The life of the machines is approximately 3 years.

The lessor is responsible for maintenance of the machines. The lease costs do not include maintenance. Maintenance costs are charged by lessor separately from the lease payment as per the above schedule.

Technology for furniture manufacturing is always improving. If technology improves over the next 3 years it will be possible to switch to a new lease for more technologically advanced machines at no additional cost.

(6) Thirty percent of DMI's total corporate overhead costs are being allocated to the manufacturing of cribs. Total corporate costs are expected to increase by $100,000 as a result of manufacturing the cribs due to the need to hire additional personnel. Corporate overhead includes legal, accounting, human resources, and executive management salaries, in addition to the corporate facility costs. Corporate allocation rates take into account the level of relative job production for jobs done for CDL, to overall company production.

(7) Start-up costs are expected to recur every 3 years due to necessary design changes in styles of baby furniture. The design changes are in addition to the cost of the two manufacturing machines. Employees also undergo an in-house training program which provides updated training on changes in safety, machine handling etc.

APPENDIX IV- COMMON
GENERAL INFORMATION ON CDL

Description of Company

Cameron Distributors Limited (CDL) is a Canadian corporation founded by Roy Cameron. CDL imports and distributes baby cribs, manufactured in Hong Kong, which are sold to retail stores across Canada. Most of the cribs are purchased from a Hong Kong subsidiary of a European company. All purchases of furniture from Hong Kong are made in US dollars.

The cribs that CDL imports from Hong Kong are designed by well-known designers with international reputations.

CDL is fortunate in that - unlike the case of certain other products - baby furniture produced in Hong Kong currently meets Canadian safety requirements. This is an important factor in selling baby furniture, as safety requirements are very strict and are continually being made more stringent. Also for parents, the safety of the crib is paramount in making a purchase decision.

The political situation in Hong Kong is unstable.

Projected Sales of Cribs

The company is expecting major growth in the next few years. The company is projecting the following unit sales over the next 3 years.

2024	2025	2026
200,000	300,000	350,000

After 2026, Roy is hopeful that the company will be able to continue to sell at least 350,000 units a year.

APPENDIX IV – COMMON (continued)
GENERAL INFORMATION ON CDL

CDL's 2023 Cost of Importing the Average Crib

Cost per 1,000 units	Cdn. $
Cost FOB Hong Kong	$99,800
Freight (to Canada)	700
Insurance	400
	$100,900
Other costs	
Traveling costs	$12,000
Administration costs	380,000
	$392,000

The freight is based upon less than 300,000 units transported over the course of the year. Freight costs decline to $650 per 1,000 units, if the number of units is 300,000 or more.

Other Information

The furniture is transported from Hong Kong by ship. The trip generally requires about 2 months.

Roy believes that if the deal with DMI goes through and manufacturing is done in Vancouver, freight costs will be substantially reduced. Based on his research, the cost of transporting cribs from Vancouver to Toronto by train should cost $450 per 1,000 units. If CDL purchases from BFI, transportation costs would be $100 (Cdn) per 1,000 units.

CDL endeavors to maintain as low a debt to equity ratio as possible as a higher ratio could impact future financing costs. The company would also like to continue to maintain a current ratio of 2 or greater. The company pays close attention to its return on equity.

APPENDIX V - COMMON
EXTRACTS FROM DMI UNAUDITED FINANCIAL STATEMENTS

DRAKE MANUFACTURING INC.
BALANCE SHEET
as at May 31, 2023

	2023	2022
Assets		
Current Assets		
Short-term deposits and bonds (note 2)	$ 281,610	$ 305,190
Accounts receivable (note 3)	3,298,300	2,066,890
Inventory (note 4)	771,030	560,250
Prepaid expenses	203,920	56,470
	4,554,860	2,988,800
Long-Term Investment	77,500	77,500
Capital Assets (less accumulated dep'n.) (note 5)	1,141,070	943,610
Goodwill, at cost (note 6)	1,125,000	1,125,000
Organization expenses	9,000	9,000
Deferred interest (note 7)	276,440	103,100
	1,410,440	1,237,100
Loans to shareholders	448,420	-
	$7,632,290	$5,247,010
Liabilities and Shareholders' Equity		
Current Liabilities		
Bank advances	$ 620,650	$ 136,600
Accounts payable and accrued liabilities	2,688,790	964,820
Principal on term loan	560,000	600,000
Income taxes payable	340,140	44,070
	4,209,580	1,745,490
Non-Current Liabilities		
Term loan	2,240,000	2,800,000
Capital Stock	47,000	47,000
Retained earnings	1,135,710	654,520
	1,182,710	701,520
	$7,632,290	$5,247,010

APPENDIX V - COMMON (continued)
EXTRACTS FROM DMI UNAUDITED FINANCIAL STATEMENTS

DRAKE MANUFACTURING INC.
STATEMENT OF INCOME AND RETAINED EARNINGS
for the year ended May 31, 2023

	2023	2022
Revenue	$17,759,560	$15,440,490
Cost of sales	13,817,260	11,992,530
Gross profit	3,942,300	3,447,960
Gain on sale of land	84,000	-
Other expenses		
Rent	600,000	600,000
Freight	173,170	153,310
Travel	350,000	350,000
Admin and management salaries and expenses (note 8)	1,078,390	780,170
Interest expense	162,100	129,130
Depreciation	204,350	164,560
Lease payments (note 9)	917,500	585,050
	3,485,510	2,762,220
Income before income taxes	540,790	685,740
Income taxes	59,600	75,600
Net income	481,190	610,140
Retained earnings, beginning of year	654,520	44,380
Retained earnings, end of year	$ 1,135,710	$ 654,520

APPENDIX V COMMON (continued)
EXTRACTS FROM DMI UNAUDITED FINANCIAL STATEMENTS

DRAKE MANUFACTURING INC.
NOTES TO THE FINANCIAL STATEMENTS
for the year ended May 31, 2023

(1) *Revenue Recognition*
Revenue is recorded when manufacturing is complete and goods are ready for shipment to the customer; the cost of manufacturing the goods is charged at that time to direct expenses.

(2) *Short-term Deposits*
Comprised primarily of very short-term, liquid money-market investments to ensure cash is readily available for operations; also includes $42,500 of longer-term bond holdings, which mature in the next 12 months.

(3) Accounts Receivable
A provision of 1% of receivables was taken in order to take into account possible bad debts.

(4) *Inventory*
Inventory includes primarily raw materials to be used in production. The amount includes a provision for damaged inventory of $230,000, or 80% of the cost.

(5) *Capital Assets*
Fixed assets are depreciated on a straight-line basis over the estimated useful life of 5 years.

(6) *Goodwill*
Goodwill resulted from the purchase of the assets of Top Furniture Company, a company involved in manufacturing book shelves, in 1994. The goodwill is allocable primarily to the strong management team at Top Furniture Company, most of whom have since retired.

(7) *Deferred Interest*
Interest is expensed for periods during which production is taking place on the basis of percentage of plant utilization. The portion of interest relating to unused production capacity during the year (computed on a per square footage basis) is deferred.

(8) *Administrative Expenses*
Includes $22,500 for brokerage and legal fees on re-financing of the term loan at the 2023 year-end.

(9) *Commitments*
Certain manufacturing equipment is leased by the company under long-term contracts for periods up to 10 years. The lease payments for subsequent years are $1,032,100 per year for 2024 and 2025 and $1,450,000 each year thereafter until 2029.

APPENDIX VI - COMMON
NOTES ON DMI PREPARED BY CPA

Orders

In the past, DMI has dealt primarily with two chains, National Chain Stores Ltd. and Province Wide Chain Stores Ltd. Typically the retailers sign a job order contract which stipulates the type of product DMI will produce on their behalf, the number of units to be produced, the price per unit as well as specific dates when the goods will be delivered.

In some instances there may be a period of a number of months between the time the order is made and production is completed. Even when production is complete, retailers regularly choose not to take immediate delivery in order to conserve space in the store for other products.

Once the contract is signed, the retailer is committed and cannot rescind the contract even if their demand for the product changes between the time that the order is made and the goods are produced. The retailers do not take title to the goods until they are delivered. Payment is due 30 days after delivery.

The only basis for refusing to take receipt of the goods or returning goods is if DMI does not meet the very specific design standards stipulated in the contract. In such cases, unless the deficiency is very minor, the retailer has the option to either terminate the contract, in which case DMI must find a new buyer for the goods or demand that the deficiencies be corrected

Legal suit

During 2023 Janie Horn, aged 4, seriously injured herself in a car accident due to a problem with the model A car seat, manufactured by DMI. The car seat was purchased by the parents of the injured girl at Retail Limited (RL), one of DMI's smaller customers. In May 2023, council for the injured party sued RL for $2 million. RL has in turn counter-sued DMI.

Based on a letter from DMI's council dated June 25, 2023, due to the paucity of recent case decisions in similar situations, it is unclear at this stage whether the retailer or DMI will be held responsible. However, the letter indicated that it is likely that DMI and RL could be jointly liable. The letter also indicated that there may be contributory negligence on the part of the girl's parents, given that they may not have properly fastened the car seat to their automobile seat. Council was therefore unable to offer any opinion as to what the suit is likely to cost DMI.

There is also a letter from the Safety Branch of the Department of Consumer and Corporate Affairs dated May 16 which requires that DMI recall all units of the model A car seat which have been sold to date. They also required that DMI recall all units of similar car seat models. DMI was far more concerned about the recall of the similar models than the recall of the model involved in the accident. The model involved in the accident was a new model and only a small number of seats had been sold to date and all seats had gone to one customer, RL.

APPENDIX VI – COMMON (continued)
NOTES ON DMI PREPARED BY CPA

DMI had however sold a significant number of seats of a similar model to many of the company's major customers in the last few months. DMI therefore immediately petitioned the Department to rescind their requirement to recall the seats of a similar model on the basis that there are some design differences between the model involved in the accident and the similar models. The Department has agreed to consider the company's petition and the company

is now awaiting a Decision. To be conservative, DMI recorded a small accrual of $20,000 to account for possible recall costs in its latest year-end financial statements.

Although normally DMI only manufactures on a job order basis and would therefore not normally hold inventory, DMI does have some small inventory of the model A car seat sold to RL. This occurred as the order from RL for the model A was quite small and it was not economical to produce such a small production run. DMI was quite confident at the time they produced the seats that they could unload the inventory at some point in the next few months by simply putting a new label on it and selling it to another retailer.

Bankruptcy

In April 2023, DMI was informed in writing that one of its retail client's had declared bankruptcy. At the time, they owed $86,500 to DMI. No adjustment was made upon hearing of the bankruptcy as the 1% bad debt provision the company takes is assumed to cover situations such as customer bankruptcies.

ASSURANCE ROLE
ADDITIONAL INFORMATION

APPENDIX VII
ASSURANCE – ADDITIONAL INFORMATION

FINANCAL INFORMATION ON CDL FOR THE LAST 3 FISCAL YEARS
(in thousands of dollars)

	2023	**2022**	**2021**
Sales	$26,250	$23,220	$20,900
Cost of sales	17,950	16,254	14,839
Interest expense	375	325	309
Income before tax	1,564	1,324	1,107
Assets			
Current	8,462	8,123	6,985
Non- current	15,100	13,259	13,579
Liabilities			
Current	4,123	3,798	3,356
Non – current*	6,056	4,614	4,285
Equity	$13,383	$12,970	$12,923

* Non-current liabilities as at the end of 2023, consist of a term loan from the bank in the amount of $2,056,000 as well as a loan from a consortium of 20 investors in the amount of $4,000,000. The bank loan is due on May 1, 2027 and the loan from the consortium is due on August 31, 2029.

APPENDIX VII (continued)
ASSURANCE – ADDITIONAL INFORMATION

Further Information on DMI

General

DMI presently employs about 65 people, of whom about 60 work in the factory. Other personnel include Bill, the controller, a designer who is also the purchasing agent, and two clerks who perform accounting and secretarial work. Bill has no accounting background and therefore does not get involved with the accounting function. He leaves that to the controller who closely supervises the accounting work performed by the accountants. All cheques have to be signed by Bill, unless an urgent cheque is required and Bill is not available, in which case the controller can sign the cheque, provided the cheque is for an amount under $100,000.

During fiscal 2023, DMI worked on three orders: an order for beds, an order for toy boxes, and an order for car seats. The plant was closed during the year for two months due to lack of work. One of the orders was delivered to the customer about three weeks before year end.

Bank reconciliations

The controller picks up the bank statements directly from the bank, and prepares the bank reconciliation. Separate chequing accounts are maintained for payroll and cash disbursements.

I examined the bank reconciliation for May 31, 2023 and noted that one cancelled cheque for $85,000 was missing. The controller said the cheque was for a promotion expense and was unfortunately lost.

Raw materials

If excess raw materials are on hand at the end of a job and cannot be used on other jobs, they are sold back to the supplier for whatever price Bill can negotiate. At year-end, he estimated there was approximately $55,000 of excess raw materials on hand and included a 75% reserve for this in expenses. He is often able to recoup most of the costs, depending on the type of raw materials, but tries to be conservative for accounting purposes.

Notes on DMI's manufacturing process

A standard bill of materials outlining the quantity of each raw material and labour hours at each stage of production has been prepared by the production supervisor and approved by Bill. All variable costs will be tracked on a job cost sheet and follow a similar process to that of other customers' orders manufactured by DMI. Raw material components will be purchased from DMI's existing suppliers. All raw materials requisitioned from inventory are tracked. Factory workers usually work on designated production lines assigned by job order, however, they make

APPENDIX VII (continued)
ASSURANCE – ADDITIONAL INFORMATION

Further Information on DMI

additional notes to their time cards when pulled to work on another job. Workers are unionized so DMI is meticulous in scheduling its workers – as regardless of the task being performed, workers are paid based on their employee job classification. The production manager has been with DMI for many years and has made many improvements to streamlining DMI's ability to track costs accurately per job and client. Based on historical results, most new jobs are charged a 30% allocation for variable overhead and then adjusted accordingly once more data on the actual job has been collected.

Other information

At the 2023 year end, the term loan was renegotiated and the new interest rate is prime + 3.5%, or approximately 6.5% as rates presently stand. Previously, the rate charged was 1% above prime. The bank is also requiring for the first time a personal guarantee from Bill of DMI's indebtedness to them and the pledging of accounts receivable and inventory as security. In addition the bank is demanding that the term loan be paid off over 5 years, with one fifth of the amount due at the beginning of each fiscal year starting with the 2024 fiscal year. The company also has bank advances owing to another bank. Interest on the advances is 5%.

In early May 2023, DMI signed a deal with a local refurbishing and clearance retailer to purchase all of DMI's damaged inventory for $130,000. The retailer picked up and paid for the goods in July.

DMI has unused net capital losses from 2018 of $85,000.

The company's accountants are the public accounting firm, Ritchie & Co LLP.

APPENDIX VII (continued)
ASSURANCE – ADDITIONAL INFORMATION

Financing alternatives – Private financing

Option 1: Issue Retractable Preferred Shares

Shares would be issued at a price of $50 per share on the following terms:

The shareholders would be entitled to receive quarterly cumulative dividends of 75 cents per share.

As the shares are retractable the shareholders would have the option to redeem the shares after 5 years have passed (i.e., starting at the beginning of year 6) on the following basis:

Year of Redemption	Redemption Price
6	$55.00
7	$59.50
8	$65.80
9	$70.90
10 or thereafter	$78.10

Any unpaid dividends would have to be paid at the date of redemption.

Option 2: Issue 10 year debt of up to $22,600,000

There are 2 sub options being considered:

1. Issue fixed rate debt due in 10 years, secured by 5 prime properties of CDL. The interest rate would be 6% per annum over the term to maturity. The debt can be settled in shares or cash at the option of the issuer. The number of shares required to repay the debt will be based on the total debt outstanding, divided by the price per share at the date of settlement. The current share price which is close to its historic high, is $167.50. All interest must be paid in cash.

2. Issue 10 year floating rate debt, secured by the same properties. The current interest rate would be 4% (prime rate is currently 3%). The debt would be repayable in 10 equal annual installments. There would be a debt covenant, which requires the company to maintain on a consolidated basis, a current ratio of at least 1.5.

APPENDIX VII (continued)
ASSURANCE – ADDITIONAL INFORMATION

Information on governance and the IT department at CDL

Roy has always had a good relationship with CDL’s Board of Directors. The current board, a diverse group of individuals with various accounting, legal, and manufacturing expertise, was assembled by Roy many years ago. Board members serve for a term of three years and are then up for re-election. Many of the board members have been re-elected numerous times and have an impressive tenure with CDL. However, just before year-end, three of CDL’s oldest serving members resigned, citing personal reasons. All three members were up for re-election at the end of the year. The general consensus from the members remaining is that there may have been a personal disagreement between Roy and the three members.

CDL’s IT department has also been extremely busy. They are currently investigating whether any data has been lost after its system was hacked this past spring. One of CDL’s IT employees was playing video games during his lunch hour while using his administrator log-in credentials and the network was compromised. The employee who was with CDL for many years, was fired. Just last year CDL implemented an enhanced security roll-out - a defense in-depth system with multiple layers of protection, including stronger firewalls and encryption. Security was designed to reduce the length of time before an external breach could be identified and even if access was compromised, stolen data would not be readable. The IT department is still working on combing through all the logs to ensure no files were compromised or stolen.

FINANCE ROLE
ADDITIONAL INFORMATION

APPENDIX VII
FINANCE – ADDITIONAL INFORMATION

Information on CDL and Furniture Industry

- Until now all of the cribs that the company sells have been imported from Hong Kong.
- One factor that has allowed for the high growth, is that to date there have never been import quotas in Canada on the types of products CDL imports, although in recent years quotas have been imposed on other products.
- Tariffs have increased somewhat in the last few years.
- Last year a sudden surge in the value of the US dollar right before the date a major invoice was due led to an unanticipated increase in the value of the order in Canadian dollars.
- When the British left Hong Kong, Roy was somewhat concerned that his business could be disrupted; he however received assurances from the Government that the importation of goods will continue as it had in the past. With the current unrest in Hong Kong, the Chinese government has in some cases interfered in private businesses although less so in businesses in which there is Chinese ownership.

Summarized CDL Balance Sheet

Assets	**($000s)**
Current	12,324
Non- current	11,238
Liabilities	
Current*	6,056
Non – current*	4,123
Equity	$13,383

*Current liabilities include a bank demand loan of $500 and the short term portion of long term debt of $5,625. Non-current liabilities include long term debt of $3,250.

- Recently a valuation was performed and it was determined that the market value of the equity was 1.2 times the book value
- Equity includes just one class of common shares. There are 500,000 shares outstanding; each share is entitled to one vote. Roy owns 62% of the common shares; there are currently no preferred shares outstanding. Currently Roy holds 5 out of the 6 seats on the Board of Directors.
- The interest on the long term and short term debt is 7% and 4% respectively. The long term debt consists of a bank loan which CDL recently assumed.

APPENDIX VII (continued)
FINANCE – ADDITIONAL INFORMATION

- CDL's combined federal and provincial tax rate is 19%

Economic and Market Information

Interest on a 10 year Canadian government Bond – 1.75%
Market rate of Return – 7%
Beta – Canadian Furniture Industry - .92
Beta – Canadian Baby Furniture Business – 1.08
Size premium - 5%

Notes on DMI

General

During fiscal 2023, DMI worked on three orders. One of the orders was delivered to the customer about three weeks before year end.

In 2024 DMI is expecting to work on at least 5 orders, assuming that the negotiations currently in progress are successful. This should lead to an increase in sales of about 30% in 2024. As one of the orders has a very high profit margin, DMI is hopeful that average profit margin for the company can be improved by about 20%. It will also be necessary to hire an assistant manager and an additional part time administrative assistant if the additional contracts are obtained at a cost of approximately $100,000 per year.

After 2024 DMI hopes to grow sales by about 10% per year. If the company is successful in growing sales by 30% in 2024, an additional 15,000 square meters will have to be rented in the company's current complex. Due to new orders, the company will have to invest $1,850,000 and $1,750,000 in new equipment in 2024 and 2025 respectively..

Costs of sale are generally paid in the year in which the costs are incurred.

Bill personally negotiates all of the major retail orders and has been doing so for quite some time. The industry is very competitive, however, Bill is very well respected in the industry and the purchasing agents representing the retail chains have continued to work with DMI because of his prominent reputation.

Purchase of Machines to Manufacture Cribs

Although the current plan is for DMI to lease the two machines that DMI will use to manufacture cribs for CDL, Bill would consider having DMI purchase the machines if it is more economical.

APPENDIX VII (continued)
FINANCE – ADDITIONAL INFORMATION

Each machine costs $200,000. The useful life of the machines is 3 years at which time it is expected that the machines could be be sold for approximately $7,500. Each machine can produce 14,600 units per month.

If the machines are purchased rather than leased:

- DMI would be responsible for maintenance rather than the lessor. However maintenance costs would be expected to be 30% lower than the maintenance costs charged by the lessor for maintenance.
- As wastage on the purchased machines is lower than on the leased machines, approximately 2% less material needs to be used on the purchased machines compared with the leased machines.

DMI - Raw materials

If excess raw materials are on hand at the end of a job and cannot be used on other jobs, they are sold back to the supplier for whatever price Bill can negotiate.

Information on BMI’s Debt and Lease

At the 2023 year end, the term loan was renegotiated and the new interest rate is prime + 3.5%, or approximately 6.5% as rates presently stand. They are also requiring for the first time a personal guarantee from Bill of DMI's indebtedness to them and the pledging of accounts receivable and inventory as security. In addition the bank is demanding that the term loan be paid of over 5 years, with one fifth of the amount due at the beginning of each fiscal year starting with the 2024 fiscal year. The bank advances constitute a demand loan. The bank to whom the bank advances are owed has now indicated that the balance as at May 31 2023 must be repaid in two equal instalments at the beginning of fiscal 2024 and 2025. Interest on the advances is 5%.

DMI’s 10-year lease on the plant expired on June 30, 2023. Upon renewal, the yearly rent will be $15 per square meter including, as before, all maintenance, property taxes, insurance, etc.

Additional Information on Purchasing Cribs in the US

BFI’s Vice President of the Children’s Furniture Division, pointed out that in light of the Canada-United States-Mexico Agreement (Cusma), which replaced the North American Free trade Agreement (NAFTA), duties and tariffs should not be a concern.

APPENDIX VII (continued)
FINANCE – ADDITIONAL INFORMATION

Financing Alternatives

Roy will be hiring a professional valuator to value DMI. In order to determine the amount of financing that would be required, Roy has told you to assume that the cost to acquire DMI will be somewhere between $2.5 million to $3.1 million.

Option 1: Issue between $2.5 million and $3.1 million of Retractable Preferred Shares

Shares would be issued at a price of $50 per share on the following terms:

The shareholders would be entitled to receive quarterly cumulative dividends of 50 cents per share.

As the shares are retractable the shareholders would have the option to redeem the shares after 5 years have passed (i.e., starting at the beginning of year 6) on the following basis:

Year of Redemption	Redemption Price
6	$55.00
7	$59.50
8	$65.80
9	$70.90
10 or thereafter	$78.10

Any unpaid dividends would have to be paid at the date of redemption.

Option 2: Issue between 2.5 million and $3.1 million of Convertible Preferred Shares

The issue price would be $25; therefore between 100,000 and 124,000 shares would be issued. The shares would be issued to one individual.

The terms of the shares would be as follows:

- The preferred shares could be converted at any time at the discretion of the holder of the shares if sales or income falls by more than 10% in any given year.
- Each preferred share can be converted into 1 common share.
- CDL would be required to provide quarterly financial statements within 15 days of the end of each quarter.
- The quarterly dividend is based upon the interest rate on a 10 year government of Canada bond plus 600 basis points. The rate will change every 5 years based on changes in the rate on 10 year government of Canada bonds, but will not fall below 7.5%.

PERFORMANCE MANAGEMENT ROLE
ADDITIONAL INFORMATION

APPENDIX VII
PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION

Consulting staff at Kraft and Kraft provided you with the following on the baby furniture industry:

Competition is fierce, particularly from large players. As raising a family is expensive, consumers tend to be very sensitive to pricing. Babies need cribs, so there are no options for families to use other products, but families do have the option of where to purchase. Research has found that branding does not often play a large role in decision-making for parents. There are also strict regulations and specifications that cribs sold in Canada must meet.

The major players in the baby furniture industry are Ashley Furniture, Bed, Bath and Beyond, Hudson Bay Company, as well as Ikea.

In Canada, the home furniture market is estimated to be approximately $10 billion dollars. 70% of that amount is attributed to bedroom, living room and dining room furniture. Approximately 390,000 babies were born in Canada in 2022, with an expected increase of 2,400 babies year over year.

Key Industry Ratios

Current Ratio: 2.01
Debt-to-Equity Ratio: 0.34
Asset Turnover: 1.04
Interest Coverage (Times Interest Earned): 13.26
Return on Assets: 5.0%
Return on Equity: 6.5%

CDL – Mission and Vision

The mission and vision at CDL has always been to provide safe cribs to Canadian families at affordable prices, and to be the “go-to” for cribs in Canada.

Further Information on CDL Provided by Roy Cameron:

CDL is a Canadian corporation founded by Roy Cameron. CDL imports and distributes baby cribs, manufactured in Hong Kong, which are sold to retail stores across Canada.

Roy has judged consumer preferences quite well. Consequently, he has been very successful in growing the company; one factor that has allowed for the high growth, is that to date there have never been import quotas in Canada on the types of products CDL imports, although they do exist on certain other products.

APPENDIX VII (continued)
PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION

CDL's successful performance is also largely attributable to Roy's skill in bidding for the exclusive Canadian distribution rights for certain baby cribs. The furniture is designed by well known designers in Hong Kong. Roy evaluates the popular designs and bids accordingly for distribution rights for cribs produced by these designers. He bids against other Canadian distributors who distribute either imported baby furniture as he does, or North American-made baby furniture. Currently standards for manufacturing cribs in Hong Kong are on par with Canadian Standards.

Typically the production run is very large as the same piece of furniture which is produced for CDL, would be produced for other non Canadian distributors who acquire the rights to sell the furniture in other parts of the world. Therefore, the manufacturers in the orient can provide a wide variation of models so that even if CDL only sells a few units of a particular model per year, the manufacturer can make that model available.

When the British left Hong Kong, Roy was somewhat concerned that his business could be disrupted; he however received assurances from the Government, that the importation of goods will continue as it had in the past. With the current unrest in Hong Kong, the Chinese government has in some cases interfered in private businesses although less so in businesses in which there is Chinese ownership.

Roy has mentioned that one of his long term goals is to have control over the manufacturing process for the products his company sells.

Financial Information on CDL for the Last 3 Fiscal Years
(in thousands of dollars)

	2023	**2022**	**2021**
Sales	$26,250	$23,220	$20,900
Cost of sales	17,950	16,254	14,839
Interest expense	375	325	309
Income before tax	1,564	1,324	1,107
Assets			
Current	8,462	8,123	6,985
Non-current	15,100	13,259	13,579

APPENDIX VII (continued)
PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION

Liabilities			
Current	4,123	3,798	3,356
Non – current*	6,056	4,614	4,285
Equity	$13,383	$12,970	$12,923

* Non-current liabilities as at the end of 2023 consist of a term loan from the bank as well as a loan from a consortium of 20 investors. The bank loan is due on May 1, 2027 and the loan from the consortium is due on August 31, 2029.

Excerpts from Covenants:

1. Upon request by the lender, audited financial statements will be provided, and will provide calculations of the covenants set out here:

   i. The borrower named above shall maintain a current ratio of at least 1.5:1
   ii. The borrower named above shall not exceed a debt-to-equity ratio of 1.2:1

2. Should the borrower find itself in violation or default of any of the lending agreement terms, an automatic 30-day remedy period will be triggered. Should the default or violation be remedied within the defined 30-day period, no action will be taken by the bank and the lending agreement shall remain in place. However, if no remedy is reached within that 30-day period, the term loan in its entirety will become payable on demand.

Information on Governance and the IT department at CDL

Roy has always had a good relationship with CDL's Board of Directors. The current board, a diverse group of individuals with various accounting, legal, and manufacturing expertise, was assembled by Roy many years ago. Members serve for a term of three years and are then up for re-election. Many of the board members have been re-elected numerous times and have an impressive tenure with CDL. However, just before year-end, three of CDL's oldest serving members resigned, citing personal reasons. All three members were up for re-election at the end of the year. The general consensus from the members remaining is that there may have been a personal disagreement between Roy and the three members.

CDL's IT department has also been extremely busy. They are currently investigating whether any data has been lost after its system was hacked this past spring.

APPENDIX VII (continued)
PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION

Notes on DMI Prepared by Kraft and Kraft

DMI presently employs about 85 people, of whom about 80 work in the factory. Other personnel include Bill, the controller, a designer who is also the purchasing agent, and two clerks who perform accounting and secretarial work. Bill has no accounting background and therefore does not get involved with the accounting function.

The industry is very competitive, however, Bill is very well respected in the industry and the purchasing agents representing the retail chains have continued to work with DMI because of his prominent reputation.

A large part of DMI's work force is unionized. Over the years labour relations have been tense and workers have come close to striking on a number of occasions.

At the 2023 year end, DMI's term loan was renegotiated and the new interest rate is prime + 3.5%, or approximately 6.5% as rates presently stand. Previously, the rate charged was 1% above prime. The bank is also requiring for the first time a personal guarantee from Bill of DMI's indebtedness to them and the pledging of accounts receivable and inventory as security.

DMI Due Diligence Related Information Sent to Roy by Bill for One Product:

The following budgeted information relates to the production of 50,000 toy boxes made from Canadian hardwood. There is fierce competition in the toy box market.

Direct labour - 70,000 direct labour hours at normal hourly rate
Direct material - $2,350,000

Variable overhead - 30% of direct material and direct labour

Fixed overhead - for DMI as a whole, is 10% of COGS per May 31, 2023 income statement plus 100% of the depreciation and lease payments per financial statements. Allocated to production based on direct labour hours.

Current budgeted direct labour hours/year = 160,000

The following was the actual information related to production and sales of 35,000 units of the product in 2023:

Sales	35,000 * $141.00=	$4,935,000	
Direct material		$1,905,000	
Direct labour		$1,023,000	

APPENDIX VII (continued)
PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION

Variable overhead		$ 858,000	
Fixed overhead		Per budget	

- Bill provided some additional insight - all of the possible material cost variance would relate to having to use maple hardwood instead of birch hardwood for 2/3 of the units produced given a shortage of birch. It appears that in the future production will be based on using maple only; any direct labour variance from budget is based on one-time training costs only.

Additional Information on BFI

BFI is well known as a manufacturer of quality furniture and according to Moody's is one of the few furniture factors with a double AA credit rating, which it has earned due to its strong balance sheet and consistent income growth. John Hollis, BFI's Vice President of the Children's Furniture Division, pointed out that in light of the Canada-United States-Mexico Agreement (Cusma)**,** which replaced the North American Free trade Agreement (NAFTA), duties and tariffs should not be a concern.

Additional Points on Relationship Proposed by BFI

BFI is proposing that:

- CDL will covenant not to have any goods manufactured in North America by anyone other than BFI, unless BFI agrees in writing to this, due to the unlikely event that the goods are such that BFI lacks the resources to manufacture the particular goods.
- The relationship can be dissolved at such time as either CDL or BFI decides, but CDL agrees to not dissolve the relationship for two years from its creation nor while a job order is in progress.

TAXATION ROLE
ADDITIONAL INFORMATION

APPENDIX VII
TAXATION – ADDITIONAL INFORMATION

Information on work terms for new sales staff at CDL

When CDL hired new sales staff a few years ago, they decided to utilize a different hiring process for these new salespeople than had been used previously. Similar to the existing salesperson on staff, Greg Hardy, each signed a formal letter labeled as an "Employment Contract", which defines their duties and work arrangements. However, their arrangements are structured differently than Greg's. To incentivize sales volume, their compensation is based on the level of sales produced from retailers, plus a small flat fee each time they come into the office, rather than a salary. They don't have fixed hours, but are essentially on-call, primarily based on when retailers decide to set up meetings. Since Greg is on site five days per week, new salespeople are utilized mostly during late summer and early fall (i.e. CDL's peak sales period). This arrangement is preferred by most of them.

The contract guarantees that the new salespeople will be contacted by CDL at least once per week during August to October to determine if they're available. CDL has vacant office space that the new salespeople use, with Wi-Fi connections available for their laptops and cell phones. Management establishes a formal sales quota and sales approach for Greg, which they review and discuss with him on a regular basis, but prefer to let new salespeople determine their own sales tactics, since many have broad experience dealing with a wide variety of clients. CDL deducts and withholds CPP and EI from all salesperson's pay and issues T4's to them.

<u>Information on DMI</u>

Sales and Accounts Receivable

Sales returns average about 2% over the long term, although they vary from year to year. This estimate of a 2% return rate is built into Bill's projections when he bids for a contract. The company does not record a provision for sales returns, as Bill states it is too difficult to estimate returns in advance.

To account for possible collection issues, Bill takes a bad debt provision for 1% of revenues at year-end, which is included under administrative expenses.

Raw Materials

If excess raw materials are on hand at the end of a job and can not be used on other jobs, they are sold back to the supplier for whatever price Bill can negotiate. At year-end, Bill estimated there was approximately $55,000 of excess raw materials on hand and included a 75% reserve for this

APPENDIX VII (continued)
TAXATION – ADDITIONAL INFORMATION

in expenses. Bill is often able to recoup most of the costs, depending on the type of raw materials, but tries to be conservative for accounting purposes.

Sale of Land

DMI sold a piece of land in April 2023, which was purchased a number of years ago as he was planning to build new headquarters on this land. In 2023 the company decided that they would continue to operate in their current headquarters and therefore decided to sell the land.

Shareholder Loans

The shareholder loans in the financial statements include $85,000 advanced in October 2022 to the Vice President of DMI, John Simmons, who owns a small percentage (2.5%) of the company. He used the funds to pay for his son's wedding. The other $363,420 was advanced in November 2022 to Bill Drake to help with the purchase of a house that is closer to work. Both loans are for three year-terms, though a formal repayment schedule was never established. John and Bill both intend on re-paying the loan in full at the end of 3 years. DMI does not have a formal policy on shareholder or employee loans as it has never before availed these to its staff.

DMI's Provincial Tax Rate

DMI's provincial corporate tax rate is 2% on income eligible for the small business deduction and 12% for income in excess of the small business deduction threshold.

Impact of Continuing to Import from Asia

Historically CDL has experienced foreign currency gains and losses due to fluctuations in the value of the US dollar. If CDL continues importing, in order to hedge exposure to movements in the US dollar, CDL may begin utilizing forward contracts. Also in the future, CDL will have to purchase licenses which are effective for 5 years in order to import from Hong Kong.

Roy believes that an advantage of importing is that they will pay less GST than if cribs are manufactured.

Roy also mentioned, due to the seasonality of his business in many instances the company will receive payment for a sale but not require funds for the purchase of cribs for a number of months. He therefore indicated that if the company continues to import he plans to take advantage of the additional funds and hire staff to do some day trading to generate some income using these funds. Roy really likes this idea as he has been told that only 50% of the gains from the day trading would be taxable.

APPENDIX VII (continued)
TAXATION – ADDITIONAL INFORMATION

Manufacturing Option

If CDL decides not to purchase DMI, it would consider manufacturing its own cribs. If this occurs, CDL would purchase the equipment used to produce the cribs.

APPENDIX VII (continued)
TAXATION – ADDITIONAL INFORMATION

Relevant financial and tax information regarding the acquisition of DMI

Information provided by Bill regarding DMI

Unused non-capital loss carryforward	nil
Unused net-capital losses from 2018	$85,000

The following are the assumed tax and fair market values of DMI's assets at the expected time of acquisition in 2024:

Asset	**FMV**	**Cost**	**UCC**	
Short term deposits and bonds				
- Money Market	236,515	232,200		
- Bonds (maturing in next 12 months)	49,450	42,500		
AR	3,107,640	3,255,650		
Inventory	721,660	802,400		
Prepaid Expenses	188,000	188,000		
Long-term Investment	428,550	77,500		*Note 1*
Capital Assets				
- Machinery & Equipment (Class 43)	714,600	1,015,500	522,720	*Note 2*
- Furniture & Fixtures (Class 8)	85,000	248,400	100,800	*Note 2*
Goodwill (Class 14.1)	0	1,125,000	183,800	*Note 2*
Organization Expenses	0	9,000	0	
Loans to Shareholders	448,420	448,420		
Total	5,979,835			

Note 1: Represents speculative investment in shares of public technology company in 2021.

Note 2: UCC balance is as at May 31, 2023. No CCA reflected above for period up to date of acquisition. In 2023 no additions or disposals in these classes and maximum CCA claimed.

End of Exam

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

1. PRESENT VALUE OF TAX SHIELD FOR AMORTIZABLE ASSETS

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

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

Notation for above formula:

C = net initial investment
T = corporate tax rate
k = discount rate or time value of money
d = maximum rate of capital cost allowance

2. SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

	2022	**2023**
Maximum depreciable cost — Class 10.1	\$34,000 + sales tax	\$36,000 + sales tax
Maximum depreciable cost — Class 54	\$59,000 + sales tax	\$61,000 + sales tax
Maximum monthly deductible lease cost	\$900 + sales tax	\$950 + sales tax
Maximum monthly deductible interest cost	\$300	\$300
Operating cost benefit — employee	29¢ per km of personal use	33¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	61¢ per km	68¢ per km
— balance	55¢ per km	62¢ per km

3. INDIVIDUAL FEDERAL INCOME TAX RATES

For 2022

If taxable income is between			Tax on base amount	Tax on excess
\$0	and	\$50,197	\$0	15%
\$50,198	and	\$100,392	\$7,530	20.5%
\$100,393	and	\$155,625	\$17,820	26%
\$155,626	and	\$221,708	\$32,180	29%
\$221,709	and	any amount	\$51,344	33%

For 2023

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

4. SELECTED INDEXED AMOUNTS FOR PURPOSES OF COMPUTING INCOME TAX

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

	2022	2023
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is greater than or equal to the amount at which the 33% tax bracket begins	$12,719	$13,521
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is less than or equal to the amount at which the 29% tax bracket begins	14,398	15,000
Age amount if 65 or over in the year	7,898	8,369
Net income threshold for age amount	39,826	42,335
Canada employment amount	1,287	1,368
Disability amount	8,870	9,428
Canada caregiver amount for children under age 18, and addition to spouse, common-law partner, or eligible dependant amount with respect to the Canada caregiver amount	2,350	2,499
Canada caregiver amount for other infirm dependants age 18 or older (maximum amount)	7,525	7,999
Net income threshold for Canada caregiver amount	17,670	18,783
Adoption expense credit limit	17,131	18,210

Other indexed amounts are as follows:

	2022	2023
Medical expense tax credit — 3% of net income ceiling	$ 2,479	$ 2,635
Old age security repayment threshold	81,761	86,912
Annual TFSA dollar limit	6,000	6,500
RRSP dollar limit	29,210	30,780
Lifetime capital gains exemption on qualified small business corporation shares	913,630	971,190

5. PRESCRIBED INTEREST RATES (base rates)

Year	Jan. 1 – Mar. 31	Apr. 1 – June 30	July 1 – Sep. 30	Oct. 1 – Dec. 31
2023	4			
2022	1	1	2	3
2021	1	1	1	1

This is the rate used for taxable benefits for employees and shareholders, low-interest loans, and other related-party transactions. The rate is 4 percentage points higher for late or deficient income tax payments and unremitted withholdings. The rate is 2 percentage points higher for tax refunds to taxpayers, with the exception of corporations, for which the base rate is used.

6. MAXIMUM CAPITAL COST ALLOWANCE RATES FOR SELECTED CLASSES

Class 1………………………	4%	for all buildings except those below
Class 1………………………	6%	for buildings acquired for first use after March 18, 2007 and ≥ 90% of the square footage is used for non-residential activities
Class 1………………………	10%	for buildings acquired for first use after March 18, 2007 and ≥ 90% of the square footage is used for manufacturing and processing activities
Class 8………………………	20%	
Class 10……………………	30%	
Class 10.1…………………..	30%	
Class 12……………………	100%	
Class 13……………………	n/a	Straight line over original lease period plus one renewal period (minimum 5 years and maximum 40 years)
Class 14……………………	n/a	Straight line over length of life of property
Class 14.1…………………..	5%	For property acquired after December 31, 2016
Class 17……………………	8%	
Class 29……………………	50%	Straight-line
Class 43……………………	30%	
Class 44……………………	25%	
Class 45……………………	45%	
Class 50……………………	55%	
Class 53……………………	50%	
Class 54……………………	30%	