Core 1 — Practice Case 1

Solution

The following solution is a "best" response, demonstrating a level much higher than competent. However, there may be additional acceptable and reasonable points that are not reflected in this response.

In addition, candidates are not expected to prepare a response of this level given the time constraints involved and, if applicable, page limits/word counts provided.

Memo

To: Partner
From: CPA
Subject: Plant Power Inc. (PPI) accounting issues and planning memo

Assessment Opportunity #1

The candidate discusses the appropriate accounting treatment for the long-lived asset.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Impairment of long-lived asset — Rent Some Green

Issue

PPI purchased a large plot of land and constructed a greenhouse on it during the year. The land was divided into separate gardening plots that are rented to "tenants" for an annual fee. The issue is whether the carrying value of the land and greenhouse should be written down as a result of the indicators of impairment identified.

Handbook and analysis

ASPE Section 3063 *Impairment of Long-lived Assets* should be consulted to analyze whether the long-lived asset is impaired.

ASPE 3063.09 states "a long-lived asset shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable." Given that PPI's tenants have been disappointed by their plots and the soil is deemed to be low quality, the long-lived asset should be tested for recoverability.

For purposes of recognition and measurement of an impairment loss, ASPE 3063.12 indicates a long-lived asset should be grouped with other assets and liabilities to form an asset group at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Given that the greenhouse cannot generate cash on its own, the land and greenhouse should be grouped together in assessing impairment.

The carrying amount of a long-lived asset is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. ASPE 3063.05 states that this assessment is based on the carrying amount of the asset at the date it is tested for recoverability, whether it is in use or under development.

If it is determined that the carrying value of a long-lived asset is not recoverable, then the impairment loss should be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. ASPE 3063.A1 indicates that the fair value can be characterized as the amount at which an item could be bought or sold in a current transaction between willing parties.

In calculating the undiscounted cash flows, PPI expects to rent the land at $3,000 per year for 15 years, now that it has invested the necessary funds to till and fertilize the land. Assuming the land can be sold for its original cost and the greenhouse has no additional value, the eventual disposition would amount to $50,000.

From an undiscounted future cash flow perspective, the recoverable amount of the land and greenhouse is $75,000, as calculated below:

Rental income ($3,000 × 15 years)	$ 45,000
Eventual land disposition	50,000
Total future cash inflow	$ 95,000
Less: Tilling and fertilizing	(20,000)
Recoverable amount	$ 75,000
Carrying amount at year end	85,000

The carrying value of the asset exceeds the recoverable amount; therefore, the land and greenhouse should be written down to their fair value. Since it appears that the land and greenhouse can be sold for $50,000, this amount would approximate the long-lived asset's fair value. The impairment loss is calculated as follows:

Carrying amount at year end	$ 85,000
Fair value	50,000
Impairment loss	$ 35,000

Recommendation

The asset group should be written down to $50,000, resulting in a one-time impairment charge to income. As there is no resale value for the greenhouse, the land should remain at $50,000 and the greenhouse should be written down to nil.

This adjustment will not impact PPI's current ratio covenant.

Assessment Opportunity #2

The candidate discusses the appropriate accounting treatment for the revenue related to the Total Towers contract.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Revenue recognition — Total Towers

Issue

PPI has recognized revenue for a contract at Total Towers in the 2024 financial statements. The inventory has been received and set aside, but it has not been planted yet. The issue is whether the revenue associated with the contract should be recognized in the 2024 financial statements.

Handbook and analysis

ASPE 3400 *Revenue* should be consulted to analyze when revenue can be recognized. It states that revenue should be recognized when the following criteria have been met:

1. *Performance has been achieved — in other words, the risks and rewards of ownership have transferred to the buyer.*

   In this transaction, the shrubs have yet to be planted, or even delivered, to the client. Generally, performance for revenue recognition is not achieved if delivery has not occurred. However, pursuant to ASPE 3400.09, delivery may be deemed to have occurred for revenue recognition purposes if a bill-and-hold arrangement exists. Specifically, when delivery has not occurred in a bill-and-hold arrangement, ASPE 3400.A43 has expanded criteria with respect to the performance achievement and specifically states revenue can only be recognized when the following criteria are met:

   (a) *the risks of ownership must have passed to the buyer;*
   (b) *the customer must have made a fixed commitment to purchase the goods;*
   (c) *the buyer, not the seller, must request that the transaction be on a bill and hold basis, and the buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;*
   (d) *there must be a schedule for delivery of the goods that is reasonable and consistent with the buyer's business purpose (e.g. storage periods are customary in the industry);*
   (e) *the seller must not have retained any specific performance obligations such that the earning process is not complete;*
   (f) *the ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and*
   (g) *the product must be complete and ready for shipment.*

   The client seems to have made the commitment to purchase the shrubs because they were specifically ordered and set aside for him at his request. He is aware of their arrival and he has made an appointment to have them planted. However, the client has not inspected the goods yet and the invoice that was issued is conditional on his approval. There is a concern that the customer might not like the shrubs. Given the uncertainty around customer acceptance, the risks and rewards of ownership likely have not transferred in this instance, so the criteria for the bill-and-hold arrangement are not met and performance has not been achieved.

2. *Reasonable assurance exists regarding the measurement of the consideration.*

   When the shrubs arrived from Italy, PPI invoiced Total Towers $27,000, so there is no indication that there is an issue with the measurement of the consideration. This criterion is met.

3. *Ultimate collection is reasonably assured.*

   Total Towers is PPI's largest commercial customer, so there is no indication that there will be an issue with collection. This criterion is met.

Recommendation

Although the measurement of the revenue is known ($27,000) and collectability does not appear to be an issue, risks and rewards have not transferred because PPI still has the shrubs on its property.

The revenue should be recognized when the shrubs are planted and accepted by the customer. This will result in a decrease in net income by the amount of the gross profit of $13,000 ($27,000 – $14,000), an increase in inventory of $14,000 and a decrease in accounts receivable of $27,000 as shown in Exhibit I. This will have a negative impact on the current ratio covenant.

Assessment Opportunity #3

The candidate discusses the appropriate accounting treatment for the inventory.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Inventory valuation

Issue

PPI has $12,000 of inventory that has been banned by the municipality. The issue is whether a write-down of the inventory is required.

Handbook and analysis

ASPE 3031 *Inventories* should be consulted to analyze the measurement of inventory. ASPE 3031 requires that inventory be measured at the lower of cost and net realizable value (NRV). NRV is the estimated selling price in the ordinary sale of the inventory. It equals proceeds less selling costs.

When measuring inventory, it is typical to write it down to NRV on an item-by-item basis because it should be evaluated at the most detailed level possible. However, grouping similar or related product lines is permissible.

Under the new bylaw, the pesticides and weed killers cannot be used, so the NRV of these products will be nil, as they cannot be sold or used. Furthermore, it is possible that there will be costs associated with their disposal.

Recommendation

Given the current status of the municipality rules, PPI should write off the cost of the affected pesticides and weed killers entirely. This will decrease inventory and net income by the original cost of the inventory, $12,000.

This will have a negative impact on the current ratio covenant.

Assessment Opportunity #4
The candidate calculates the current ratio for the purpose of compliance with the debt covenant after the financial statement adjustments.
The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:
1.4.4 Interprets financial reporting results for stakeholders (external or internal) (Core – Level A)

Covenant

As calculated in Exhibit I, PPI is in compliance with the current ratio covenant (2.08 compared to a required 2.0) prior to any adjustments. However, this will not be the case after the proposed adjustments are made, as the ratio worsens to 1.92. PPI will need to contact the bank immediately. Given PPI's long-standing relationship with Nordic Bank, it may be able to work out a temporary solution. If the bank does not intend to call the loan, a waiver letter should be obtained.

If Nordic Bank does plan to call the loan, it is possible that PPI would no longer be considered a going concern. This would need to be disclosed in the notes to the financial statements and, if PPI is deemed not to be a going concern, the statements would have to be presented at liquidation value.

Assessment Opportunity #5

The candidate assesses the overall financial statement risk for the 2024 financial statement review.

The candidate demonstrates competence in Assurance.

CPA Map Competencies:

4.3.1 Assesses issues related to the undertaking of the engagement or project (Core – Level B)

4.3.5 Assesses the risks of the project, or, for audit engagements, assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures (Core – Level B)

Overall financial statement level risk

In the prior year, the overall financial statement risk was assessed as low. This assessment must be completed for each engagement to consider new circumstances.

Factors that impact the risk of material misstatement at the overall financial statement level (OFSL) are as follows:

- There are accounting issues present at year end that will require judgment and use of estimates, including revenue recognition for new projects and impairment of inventory and long-lived assets. These issues are complex and more likely to result in errors. This increases OFSL risk.
- PPI has increased its borrowing from Nordic Bank in the current period. Given the bank's increased exposure, it is likely to place a higher reliance on PPI's financial statements. This could result in a bias for management to manipulate the financial results in order to meet the bank's covenants. This increases OFSL risk.
- There is a new bookkeeper in the year who is part-time and has been identified as having weak technical knowledge. The bookkeeper's lack of familiarity with both the company and complex financial reporting, as well as the limited hours available to complete the bookkeeping tasks, has the potential to result in increased errors. This increases OFSL risk.
- Joan is less involved in the day-to-day operations because she has had to take on outside employment. This decrease in oversight increases the likelihood of fraud and/or errors going unidentified. This increases OFSL risk.
- Because PPI has been a client for several years, Cumby and Menchions is familiar with the owner-operated business and the issues it typically faces. This decreases OFSL risk.

There are several accounting issues identified during the current period that require the use of estimates. In addition, the worsening financial results, combined with the bank's increased reliance on the financial statements, put additional pressure on the owners to manipulate results. As a result, the OFSL risk is set as high for this engagement.

Assessment Opportunity #6

The candidate calculates materiality and discusses the approach for the engagement.

The candidate demonstrates competence in Assurance.

CPA Map Competencies:

4.3.1 Assesses issues related to the undertaking of the engagement or project (Core – Level B)

4.3.4 Assesses materiality for the assurance engagement or project (Core – Level B)

Materiality

In calculating materiality, the first step is to identify the users of the financial statements. The main users of PPI's financial statements are the Nordic Bank, Joan, and Ellen. We then need to identify each user's objective. The bank's concern is whether PPI can make the payments on the line of credit. Joan and Ellen would be concerned about the profitability of PPI.

As a benchmark, income is a proxy for cash flow and is therefore a good indication of whether PPI will be able to repay the loan. Therefore, as PPI remains profitable, a materiality based on pre-tax net income from continuing operations would satisfy all of the users' objectives. CAS 320 does not specify exact percentages to be used when calculating materiality, but it does indicate that professional judgment should be applied. In practice, a range of 3% to 7% of income from continuing operations (before tax) is reasonable when calculating materiality. Due to the anticipated sensitivity of the bank to changes in the financial statements, materiality should be set in the lower range of 3%-5%. We will use 4%.

Unadjusted pre-tax net income	$ 23,500
Greenhouse impairment (Note 1)	—
Revenue recognition (Note 2)	(13,000)
Inventory writeoff (Note 1)	—
Adjusted normalized pre-tax net income	$ 10,500
Materiality (4%)	$ 420

We will need to update net income for the adjustments identified below:

Notes:

1. Although an adjustment has been suggested, the amounts are non-recurring and would be normalized for purposes of materiality.
2. Adjustment for net revenue recognition related to plants not yet sold, discussed below.

After adjustments, PPI's pre-tax net income is $10,500 and materiality is calculated as $420. We should also keep in mind that any amount that would result in a violation of the current ratio covenant would be considered material to the bank.

Approach

As this is a review engagement, we do not assess whether a substantive or combined approach is appropriate, as we would not perform tests of controls and are required to obtain limited assurance primarily through inquiry and analytical procedures. This will enable us to conclude that nothing has come to our attention that causes us to believe that the financial statements are not prepared, in all material respects, in accordance with ASPE.

Exhibit I

Debt covenant

Purpose: To calculate compliance with debt covenants.

	Notes	Current assets	Current liabilities	Current ratio
Per draft financial statements		$ 320,000	$ 154,000	**2.08**
Accounts receivable — Total Towers	1	(27,000)		
Inventory — Total Towers	2	14,000		
Banned inventory products	3	(12,000)		
		$ 295,000	$ 154,000	**1.92**

Conclusion: PPI is offside with the current ratio covenant after adjustments.

Notes:

1. Accounts receivable for Total Towers contract not yet earned: $27,000
2. Inventory for Total Towers contract not yet sold: $14,000
3. Write-off of banned products: $12,000