

5 pgs – 25 read/ plan (5 min per page), 55 write

**Question 2** (80 minutes)

Sue Kowalski owns and operates a retail art store, Kowalski Gallery Inc. (KGI), that sells paintings of Canadian artists on a consignment basis. Sue spends her time managing KGI. KGI has provided Sue with a salary of \$75,000 annually for the past two fiscal years which end on December 31, and has reported minimal net income.

>1 entities – draw parties on outline

Could be a rev rec issue – will depend whether asked for acctg issues

Sue is also the sole shareholder of Picture Perfect Inc. (PPI). PPI operates a small chain of three retail artwork and picture framing stores. PPI has developed a reputation for the high quality of its framing services. PPI reported net income in the amount of \$125,000 for the fiscal year ended December 31, 2006.

Could be quant info but need to i.d. real req'd

Sue has developed a new business plan whereby PPI will establish an Internet store division (ISD) and customers can upload digital pictures, select the desired frames, and have the framed pictures mailed to them. ISD will commence operations on January 1, 2008. Sue will hire her brother, Shawn Kowalski, to manage the PPI retail stores and ISD.

Track dates on outline

Role – take to outline

Sue has approached the bank to obtain the financing needed to start up ISD. The bank has requested the information described in Exhibit I before it will make its loan decision.

Real req'd – take to outline – trigger for S4

You, CA, have been recently hired by Sue as a special consultant and she has asked you to prepare the information required by the bank and to prepare an after-tax cash flow projection to evaluate the financial prospects for ISD. Sue has also asked you to determine the number of annual sales that ISD needs to make so that she will not lose money as a result of this business plan. Notes prepared during your meeting with Sue are provided in Exhibit II.

Real req'd – take to outline – trigger for D1, S5

Real req'd – take to outline – trigger for D3

Sue has asked you to explain to her if there is any benefit for income tax purposes of operating the ISD as a separate corporation.

Real req'd – take to outline – trigger for S5

Sue has also asked you to evaluate PPI's risk environment, including internal control pertaining to the retail stores, and to describe the significant risks that PPI is exposed to and to provide practical recommendations to mitigate these risks. She emphasized to you that she does not want an oppressive control environment because she trusts her employees; however, she wants a risk and control environment that will effectively prevent and detect errors and misappropriation.

Real req'd – take to outline – trigger for S9

You have obtained the information about PPI's operations and systems that is provided in Exhibit III.

Client objective to consider when giving sol'ns

She also asked you to evaluate the options of purchasing or leasing the printer required by ISD.

It is July 3, 2007 and you are preparing your report to Sue Kowalski.

**Required:**

Req'd looks like 2 reports but only asked for 1

Prepare the information required by the bank and respond to the requests made by Sue Kowalski.

Real req'd – take to outline – trigger for S10

**Exhibit I**

**EXCERPTS FROM THE BANK'S CORRESPONDENCE  
PERTAINING TO PPI'S LOAN REQUEST**

*Need to  
prepare  
info  
req'd  
by bank*

*Info for  
after-  
tax cash  
flow  
quant*

We require the following information for considering your request for a \$250,000 loan which would have an interest rate of 8% and would require annual payments of \$50,000 on the anniversary date of the loan plus interest on the outstanding principal for the year:

*Quant  
needed  
- can  
use to  
calc.  
after-  
tax cash  
flow*

- (1) projected income before interest and income taxes for the first two years of operations of ISD; and,
- (2) projections that support that the financial results of ISD will be in compliance with a minimum interest coverage ratio of 3 times (defined as income before interest and income taxes divided by interest expense) and will be in compliance with a minimum loan service ratio of 1.5 times (defined as income before interest and income taxes divided by the principal and interest loan payment amount payable in the same fiscal year as that pertaining to the determination of net income before interest and income taxes).

*Need to  
use  
income  
forecast  
to calc.  
coven-  
ants &  
see if  
meet  
them*

**Exhibit II**

NOTES PREPARED DURING YOUR MEETING WITH SUE KOWALSKI

Need to do B/E analysis so look for variable vs. fixed costs

Quant info – 3,650 orders in year 1, 4,380 in year 2

**Internet Store Division (ISD)**

Quant info – sales price photo = \$10, sales price framing = \$140

Sue estimates that ISD will receive, on average, 10 orders a day during the first year of operation (3,650 orders in total), and that, on average, 12 orders a day will be received during the second year. PPI will print the uploaded digital picture and Sue estimates that the price charged to the customer, which will depend on size, will be, on average \$10. The current picture framing sales price is, on average, \$140. Sue will offer a 20% discount for online orders for the first six months.

Need to include 20% disc. off sales price

The total price to the customer will include the price for printing the digital picture, the price for framing, and the cost of shipping. Customers will pay in full at the time the order is placed and will pay by credit card.

No collection issue – no bad debt expense

PPI currently earns a 60% gross margin on framing sales (revenue less cost of materials and direct labour because Sue considers all other cost to be fixed overhead). Sue expects the cost of framing the pictures to be the same as experienced by her retail stores. Overhead costs for the retail stores are currently, on average, \$25.60 per framing sale that is paid for by credit card, which includes: \$10 rent, \$3 store manager salary, \$5 advertising, \$5.60 debit card or credit card processing charge (4% of the average sale price of \$140), and \$2 other fixed costs.

VC for framing = 40% of \$140

PPI has capacity – no need for other space

VC since customers using credit card = 4% revenue

All framing is done at the largest retail store, and there is sufficient capacity at this location to meet the estimated framing needs for ISD.

**Advertising and Promotion Costs**

FC = \$12K year 1, \$7.2K year 2

Sue plans to spend \$1,000 per month on media advertising to promote ISD in the first year of operation, which will be reduced to \$600 per month in the second year of operation. She also plans to promote the ISD using an external sales referral organization that will charge a fee of 10% of the sales revenue generated by ISD. Sue estimates that 25% of the ISD sales revenue will result from these referrals.

VC = 25% of revenue x 10% referral fee

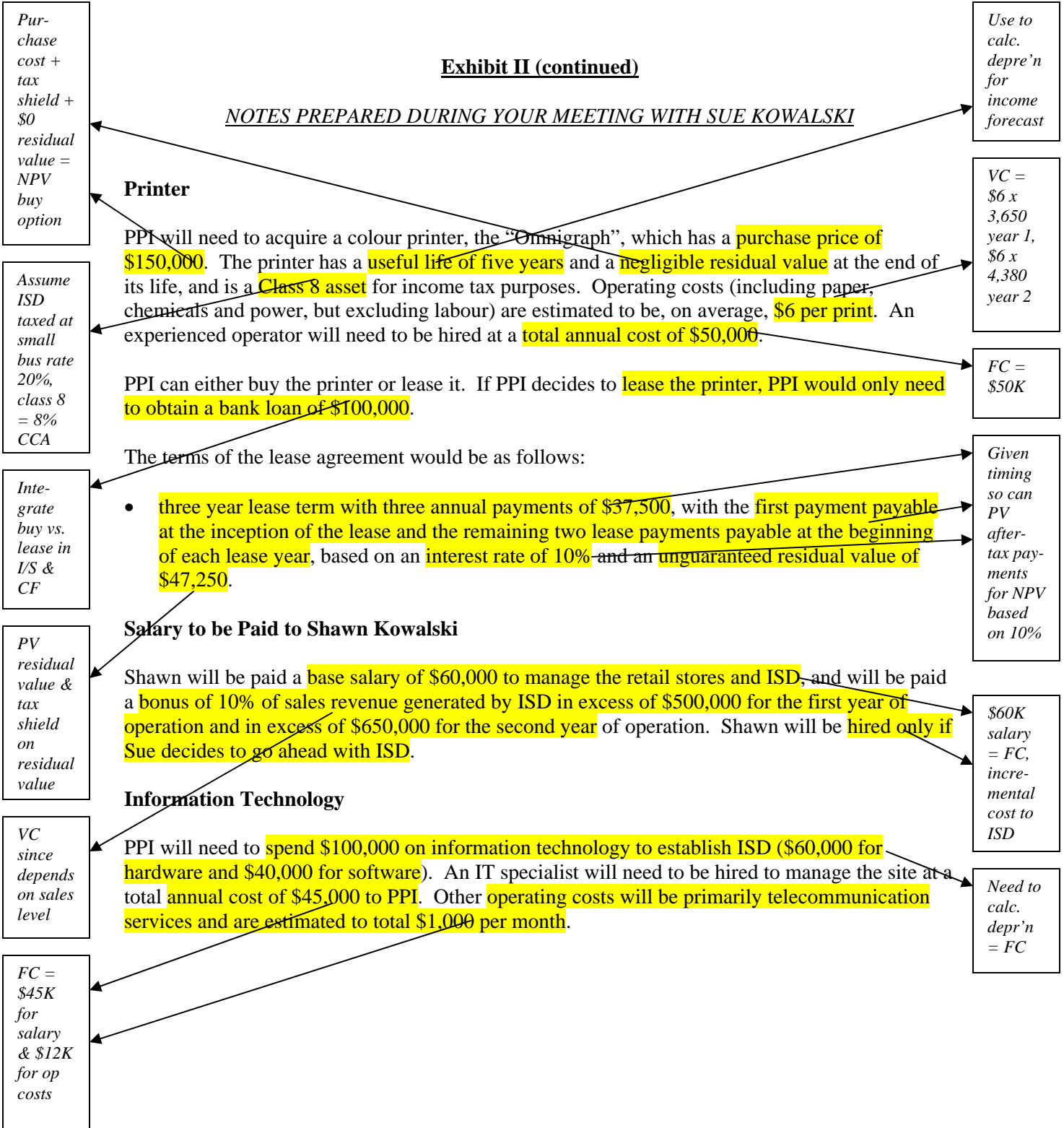
**Shipping Costs**

VC = \$15 x 3,650 year 1, \$15 x 4,380 year 2

The framed pictures will be shipped by courier at a cost, on average, of \$15 for each framed picture and the shipping cost will be charged to the customer.

**Exhibit II (continued)**

*NOTES PREPARED DURING YOUR MEETING WITH SUE KOWALSKI*



**Printer**

PPI will need to acquire a colour printer, the "Omnigraph", which has a purchase price of \$150,000. The printer has a useful life of five years and a negligible residual value at the end of its life, and is a Class 8 asset for income tax purposes. Operating costs (including paper, chemicals and power, but excluding labour) are estimated to be, on average, \$6 per print. An experienced operator will need to be hired at a total annual cost of \$50,000.

PPI can either buy the printer or lease it. If PPI decides to lease the printer, PPI would only need to obtain a bank loan of \$100,000.

The terms of the lease agreement would be as follows:

- three year lease term with three annual payments of \$37,500, with the first payment payable at the inception of the lease and the remaining two lease payments payable at the beginning of each lease year, based on an interest rate of 10% and an unguaranteed residual value of \$47,250.

**Salary to be Paid to Shawn Kowalski**

Shawn will be paid a base salary of \$60,000 to manage the retail stores and ISD, and will be paid a bonus of 10% of sales revenue generated by ISD in excess of \$500,000 for the first year of operation and in excess of \$650,000 for the second year of operation. Shawn will be hired only if Sue decides to go ahead with ISD.

**Information Technology**

PPI will need to spend \$100,000 on information technology to establish ISD (\$60,000 for hardware and \$40,000 for software). An IT specialist will need to be hired to manage the site at a total annual cost of \$45,000 to PPI. Other operating costs will be primarily telecommunication services and are estimated to total \$1,000 per month.

**Exhibit III**

**INFORMATION OBTAINED ABOUT PPI'S OPERATIONS AND SYSTEMS**

No check to see if disc. OK, could be stealing cash b/c also make daily deposit, no check of weekly reports prepare

Need to i.d. risks facing PPI & how to fix them

**Sales**

Selling prices are to be based on set prices for the frames and the framing of artwork and pictures. The total price for the frame and for the framing is based on the framing materials used, the labour time required, and the related overhead costs. Customers are required to pay 25% of the total sales price when the order is placed and to pay the remainder upon receipt of the framed artwork or picture. Customer payments include cash, debit cards, and credit cards (Visa, MasterCard, and American Express). Store managers have the authority to give special discounts if considered necessary to make a significant sale. Approximately 70% of the sales are paid for by debit card or credit card. The store manager prepares the daily bank deposit that is deposited to PPI's head office bank account.

No check that picking best supplier & risk could collude with supplier or approve false invoices

Could order too much, tying up cash in inv

**Purchases**

Purchases of framing materials (e.g., metal, wood, glass, etc.) are initiated at PPI's head office (which is located in the largest and first retail store) by the "head of framing" employee based on the quantities of inventories physically on hand. His purchasing policy is that PPI should always have "more than enough" inventory on hand so that "we never run short". The "head of framing" employee selects the suppliers and approves the suppliers' invoices for payment.

No formal records - inv. items could be stolen

Beg. inv + items bought - items used = end. inv, use to assess if inv being stolen

**Inventories**

Inventory is physically counted on January 2 each year (PPI is closed from December 30 to January 2) and the physical count quantities are used to determine the inventory balance that is reported on PPI's December 31 balance sheet. PPI does not maintain any formal inventory records.

**Financial Reporting**

PPI's accountant updates the accounting records using the weekly operating reports prepared by the store managers which provide sales revenue and operating expenses amounts. PPI uses generic accounting software programs. A balance sheet and income statement are prepared annually for review by Sue. No financial budgets are prepared.

No one over-seeing accuracy of acctg data - F/S only checked on annual basis, no budgets

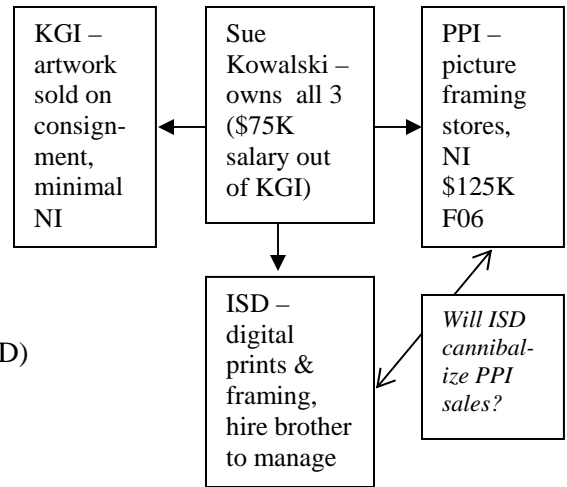
**2007 ICAO SOA Final Exam – Question 2**  
**Sample Outline**

**Time:** 25 min read/plan, 55 min write

**Role:** Special Consultant (advisor)

**Dates:** Dec 31/06 = Y/E  
 July 3/07 = Now  
 Jan 1/08 = Opening new Internet store division (ISD)

**Required:** Report to Sue Kowalski



**QUANT #2**

**15 MIN**

- Projected income before interest & inc taxes – first 2 yrs ops
  - # of orders & sales price (discount 1<sup>st</sup> 6 mth) – p3
  - VC = framing cost (p3), credit card fee (p3) referral fee (p3), courier (p3), print cost (p4), Shawn bonus (p4),
  - FC = advertising (p3), operator salary (p4), Shawn salary (p4), IT depr'n (p4), IT salary & op costs (p4)

**5 MIN**

- Calc interest coverage (min 3x) & loan service (min 1.5x) – meet Y/N? **QUANT #4**

**8 MIN**

**Prepare after-tax cash flow projection to evaluate financial prospects for ISD to evaluate financial prospects** **QUANT #5**

- Need to recommend – Y/N
- Interest (p2)
- Capital expenditures in yr 1 = printer, IT (p4) – add back depreciation, deduct CCA

**5 MIN**

**# of annual sales ISD to break-even** **QUANT #3**

- Given sales volume year 1 & 2 – calculate B/E both years (FC / CM)

**5 MIN**

**Any benefit for tax purposes of operating ISD as separate corporation**

- If ISD profitable – no difference b/w division or corporation
- If not profitable – better to be division so can use losses
- Associated for tax purposes – both owned by Sue, share SBD

**12 MIN**

**Evaluate PPI's risk environment & describe significant risks PPI exposed to & recommendations to mitigate risks (incl. retail stores)**

- Client objective = not want oppressive control environment but prevent/detect errors/misappropriations
- Store managers – no one checking discs or weekly reports & daily bank deposits (p5)
- Purchasing policy – “more than enough” inventory, could be too much (p5)
- Head of framing – no check over supplier choices/invoices approved (p5)
- Inventory – no formal records, rely on Y/E physical count (p5)
- Financial records – Sue only looks at annual F/S, no budgets (p5)

**5 MIN**

**Evaluate options of purchasing vs. leasing printer required by ISD** **QUANT #1**

- p4 – need to calc NPV for both options
- Purchase – \$150K, Class 8 = 8%, \$0 residual value
- Lease – \$37.5K 3 yrs, 10% int rate, unguar. Residual value \$47.25

**5 QUANTS – CAN'T GET TRAPPED HERE – DON'T NEED TO BE PERFECT - DO IN LOGICAL ORDER TO MAKE SAVE TIME, KEY IS BREADTH**

**DON'T HAVE TIME TO DO ALL 5 – DO AT LEAST 3, BUT TRY TO DO 4 W/IN TIME**