

**Nanyang Technological University
Nanyang Business School**

**AC3104 Risk Management and Advanced Auditing
Semester 1, 2022-2023**

Seminar 10.2 – Auditing Complex Revenue Recognition Issues I

Learning Objectives

- Describe the challenges in auditing the five-step approach to revenue recognition
- Design appropriate audit procedures to test the primary financial statement assertions involving complex revenue recognition transactions
- Evaluate the complexity in the audit of lease transactions

Required Reading

- SFRS(I) 15 - Revenue from Contracts with Customers
 - SFRS(I) 16 - Leases
- (Students are expected to apply auditing concepts covered in AC2104 on complex areas of accounting for revenue covered in AC2101 and other accounting modules)

Further Readings

- The following sections of ACRA Practice Monitoring Programme Public Reports that can be downloaded at: <https://www.acra.gov.sg/training-and-resources/publications/reports/practice-monitoring-programme-public-reports>
 - 14th PMP Public Report (2020) Section 4 Engagement Inspection Findings Theme 3: Revenue Recognition from pages 24 to 25.
 - 13th PMP Public Report (2019) Appendix 1 Case Study 4 from pages 30 to 32 and Case Study 6 from pages 35 to 36.
 - ISCA Practical Guidance 11 “Audit of Long-Term Construction Contracts”.
- (Note: These readings were written under the previous FRS 11. The challenges and shortcomings of recognizing revenue over time and associated costs are largely still applicable).

Seminar Requirements

Team Presentation 7

Answer both questions 1 and 2.

Question 1

As a newly promoted audit manager, you are assigned to the audit of Life Long Learning Pte Ltd (LLL) for the year ending 31 December 2022. LLL is a leading enrichment centres that has developed a customised learning program, X’plore, to help primary and secondary students develop curiosity in learning.

Part I

Based on the prior audit files, you noted that LLL had successfully moved its in-person classroom learning to online learning during the COVID-19 pandemic without any significant

loss in quality as shown by many of its students still achieving their desired school results at end of 2021. Boosted by the success of its online learning program, LLL launched its X'plore online learning program (XO'plore) in January 2022, with the introduction of the following new terms for the XO'plore program:

1. A one-time non-refundable registration fee of S\$2,700 per child for the registration and setup of the student's learning profile in the XO'plore system.
2. Parents can opt for interest-free deferred payment of the registration fee payable within 12 months.
3. Monthly fees are based on a 20% discount off the rates for the X'plore program.
4. Money-back guarantee if a child does not achieve a higher grade after attending the program each year, subject to certain minimum attendance requirements.

XO'plore proves to be a success and LLL managed to sign up 50% more students as compared to its in-person classes. Management estimates its fair value to be S\$5m. During your planning discussion with the founder, Mr Shawn Smart, you understand the following new terms for the XO'plore program:

1. As the registration fee is non-refundable, it is recognised as revenue upon the registration of the student.
2. As the deferred payment period is for 12 months or less, the interest element is not considered significant and hence it is not separately allocated.
3. The 20% discount is an estimated amount based on savings from the rental and overheads of the physical classroom.
4. From their past 20 years' track record, less than 5% of students on average did not achieve a higher grade at the end of each program year. The refunds will be recorded when incurred.

Required:

- (a) For each of the **four (4)** new terms for the XO'plore program, evaluate whether there is a risk of material misstatement in the revenue recognition.
- (b) For **two (2)** new terms above with the highest level of risk of material misstatement, describe the appropriate audit procedures to evaluate the extent of each of the risks of material misstatement. Assume that you have verified and are satisfied that the contract terms are as described above.

Part II

On 1 July 2022, LLL signed a S\$9 million contract with a leading preschool learning group, USKids Inc (USK) in the USA, to help USK develop a similar online learning system like XO'plore, with relevant customisations to migrate USK's existing classroom learning materials into the new system.

The key terms of the USK contract are as follows:

1. USK will make a monthly payment of S\$150,000 starting from 1 July 2022 and upon final payment in 1 May 2027, LLL will transfer the legal title of the learning system to USK.

2. The system development and material conversion project are expected to take 10 months to complete, thereafter LLL will be responsible for the maintenance and upkeep of the online learning system for the next 50 months, i.e., till 1 May 2027.
3. To ensure the timely completion of the conversion project, LLL will commit at least 50 staff to the USK project for 10 months.

Based on your discussion with Mr Shawn Smart, you noted that given the following the long financing period provided to USK, revenue from USK will be recognised by LLL as lease income on a straight-line monthly basis, i.e., S\$900,000 by 31 December 2022.

After the discussion with Mr Shawn Smart, you performed additional independent verification work and arrived at the following conclusion:

1. The USK contractual terms are as described above.
2. Given the knowledge and experience of LLL, the risk of system development and material conversion project for the USK contract not being completed on time is assessed as low.
3. The maintenance and upkeep of the new online learning system for the USK contract are simple and require only two skilled staff.

Required:

- (c) Evaluate whether there is a risk of material misstatement in the revenue recognition of the contract with USK and describe the appropriate audit procedures to address the risk of material misstatement.

Question 2

As the audit manager of an accounting firm in Singapore, you have just been assigned to the audit of Asia Diversified Group Pte Ltd (ADG) for the year ended 31 March 2022. ADG is in the business of manufacturing and sale of health equipment. It sells wearable health trackers (WHT) that are regularly upgraded with new features and historical patient records loaded for greater diagnostic power. Customers often trade in their old models for the latest model at a discounted price to take advantage of the latest diagnostic features. ADG also sells a PatientCare service separately that provides the customers unlimited virtual health consulting by trained professionals for two years.

ADG started a new Free Two-year Upgrade (F2G) program during the year. Under the F2G program, the customer receives the latest WHT, which comes with the prevailing diagnostic software, PatientCare service and a right to trade-in the WHT for the latest model within two years at no additional charge.

The standalone selling prices for ADG's WHT and PatientCare service are S\$800 and S\$400 each respectively, and the customer pays S\$1,200 for the F2G program to qualify for free trade-ins during the two years. ADG assures its customers who have purchased its F2G program one free trade-in within two years. The WHT traded in are fully written off.

ADG recognises the fees of S\$1,200 from its F2G program systematically over 24 months.

Planned audit responses:

- Review the F2G program and PatientCare service agreements to verify the above terms.
- Verify the standalone selling prices of the WHT and PatientCare service to historical sales and receipts of AGD.
- Recompute management's allocation of the S\$1,200 fee from the F2G program and ensure that the portions that have expired and unexpired as at 31 March 2022 have been correctly recognised as revenue and contract liability respectively.

Required:

Critically evaluate the revenue recognition of the wearable health trackers and describe additional audit procedures to address the risk.

End of Team 7 Presentation Question

Question 3

Power Building Constructions Pte Ltd (PBC) is in the business of construction and trading in construction materials. PBC bills its customers progressively based on the work certified by independent architects. It recognizes project revenue progressively over time using total costs as an input. PBC subcontracts some of its piling, electrical and mechanical works to a pool of subcontractors.

PBC purchases construction materials in bulk and allows most of its subcontractors ready access to construction materials that have been delivered to them onsite. At each month-end, PBC's quantity surveyors, together with the subcontractors, will perform a stock count and quantify the construction materials utilized onsite. PBC then raises invoices to the subcontractors at the end of each month for the construction materials used and recognizes them as trading revenue.

Your firm has recently been appointed as the external auditor of PBC for the financial year ended 31 December 20x1 and you are the audit manager assigned to the audit engagement. The audit senior in your audit team has provided you with an extract of the audit work performed as follows:

PBC's Projects and Trading Sales for the year ended 31 Dec 20x1

	Bayan Project S\$	Crescent Project S\$	Trading Sales S\$
Revenue	B 5,178,800	B 3,120,000	B 1,982,700
Modifications in 20x1	na	Δ 250,000	na
Total	c 5,178,800	c 3,370,000	c 1,982,700
Progress billings	↑ 4,574,000	↑ 1,300,000	na
Costs			
Actual costs incurred to date as at 31 Dec 20x1 (a)	μ 3,080,300	μ 1,860,000	μ 1,428,240
Estimated costs to completion as at 31 Dec 20x1	∩ 2,022,000	∩ 1,608,000	na
Estimated total project costs as at 31 Dec 20x1 (b)	c 5,102,300	c 3,468,000	c 1,428,240
Estimated total project costs as at 31 Dec 20x0	√ 5,652,300	√ 3,468,000	na
Input ratio (a)/(b)	c 60%	c 54%	na
Profit	c 76,500	c (98,000)	c 554,460

*na = not applicable

Key to Audit Work Performed

- B** - Verified to delivery orders and acknowledgement of receipt of goods by customers.
- Δ** - Reviewed approval of contract modification to contract/correspondence for evidence of customer's approval. Review management's estimate based on either the expected value or most likely amount
- ↑** - Agreed amounts to sales invoices with acknowledged delivery orders.
- μ** - Vouched to suppliers' invoices and third parties' shipping documents.
- ∩** - Performed analytical review.
- √** - Agreed to prior year's audit working papers.
- c** - Checked footing and cross-footing.

Required:

- (a) Do you agree that Banyan is a project with a high risk of material misstatement? Justify with reasons.
- (b) Identify the audit deficiencies in the work performed by the audit senior. Describe the additional audit procedures required to address **each** audit deficiency identified.

Question 4

Superior Building Leader Pte Ltd (SBL) is in the business of construction and trading in construction materials, which is very competitive. You are the audit engagement manager assigned to the audit of SBL for the year ending 30 June 20x1. During the audit planning, you identified the following significant audit issue relating to the Sports Hub Contract.

SBL entered into a contract with the Koala Sports Academy in October 20x0 to construct an indoor stadium and provide customized sports equipment for a contract sum of \$120 million

over a duration of three years. The contract includes an additional incentive of \$5 million if the stadium attains the Green Mark Award upon its completion. SBL decided to recognize the whole contract sum of \$125 million over the contract duration of 36 months as it concludes that it is “most likely” to receive the additional incentive.

The breakdown of the total estimated costs to complete the contract and the costs incurred for the period up to 31 March 20x1 are as follow:

	Total	Period up to
	\$ million	31 March 20x1
		\$ million
Direct material	34.0	16.0
Direct labour	32.0	3.2
Cost of equipment payable to the third party	30.0	-
Total incurred costs		19.2
Further costs to complete		76.8
Total estimated costs	96.0	96.0
Percentage of completion based on the input method using total costs (\$19.2/\$96.0 million)		20%

You concur with management that the revenue from the contract should be recognized over time based on your preliminary review of the contract. SBL billed the customer \$12.5 million, based on independent architect certifications on the value of work done.

Required:

Identify the significant risks of material misstatement in the revenue recognition of the Sports Hub contract and describe the audit procedure(s) that should be performed to address each of the risks identified.