Chang ESL Academy

Revenue Recognition issue

<u>Assess the situation</u>
Students pay $150 for an online course, which is non-refundable once a student accesses the online course for the first time. From October to December 2015, 500 students registered for online courses and the Academy has recognized all revenue for these online course registrations at year-end (500 x $150 = $75,000). The issue is whether or not performance has been achieved by the Academy with respect to online course revenue, which will affect whether it should be recognized at December 31.

<u>Analyze the issue</u>
For revenue to be recognized, the following criteria must be met:

- Collectability is reasonably assured
  The $150 is collected up front, before the course begins, so collectability is certain. MET.

- Consideration can be reliably measured
  The amount of consideration is known, as it is the course fee that is paid before the course begins. MET.

- Performance has been achieved
  In the case of providing services, performance is determined using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. For a service contract, performance is achieved when the following additional criteria are met:

- Persuasive evidence of an arrangement exists
    - This appears to have been met upon student registration. Because the arrangement is proven through the online registration documents, persuasive evidence exists. MET.

- The seller's price to the buyer is fixed and determinable
    - This also appears to have been met because the price is set at $150 per course and fees are not refundable after students access the course. MET.

- Delivery has occurred or services have been rendered – analyzed below.

Since the Academy has recognized revenue for all registrations, management likely believes that performance has been achieved, even though the courses have not all been completed.

It could be argued that performance has been achieved, since the measurement of the consideration from providing the online courses over a maximum of 90 days is reasonably assured, meeting the requirements of 3400.06. Specifically, the Academy could argue that the cost of offering the courses is essentially developing the course and making it available to students, which it has already done for all registrants who have accessed the course.

However, the Academy is obliged to ensure that the course continues to be available for students to access up until the earlier of course completion or 90 days. The Academy also offers an online tutor service that is available throughout the course. The Academy is obligated to provide the online tutor service as long as the course is running. There are additional costs associated with this, which include online tutor services as well as costs of hosting and supporting the course externally. In addition, there may be additional acts required, including dealing with any administrative issues and student queries and issuing a course completion certificate.

Since the service has not been fully rendered, the delivery criterion is NOT MET until the course is complete or the 90-day time period is up.

<u>Conclude and advise</u>
Since all the criteria are not met, it is not appropriate to recognize revenue at the time of registration. The criteria are met when the course is completed or the 90 days have expired.

Use of the percentage of completion method, is a better way to relate the revenue recognized to the work accomplished or the duty outstanding by the Academy, since the service is provided over time. As a result, revenue should be deferred upon receipt at registration and recognized evenly over the 90 days the course is available to the students. However, if students complete the course early, as many do, the full amount of revenue deferred should then be recognized, since no further obligation would remain on behalf of the Academy.

Please see Exhibit I for calculations.

$33K of the revenue for online courses should be deferred, with the remaining $42K ($75K − $33K) recognized as revenue at December 31.

Development cost issue

Assess the situation
At December 31, the Academy has recognized $258,000 in its balance sheet as an asset with respect to the development of its online courses. The issue is whether these costs meet the definition of an asset, and it so, which asset, and if they should be capitalized or expensed on the financial statements.

Analyze the issue
To be inventory, the online courses would need to meet the following criteria:

- Held for sale in the normal course of business; or
  The online courses themselves are not for sale. NOT MET.

- In the process of production of such sale; or
  The online courses are not in the process of production for sale – the courses themselves are not sold. NOT MET.

- Materials that would be consumed in the rendering of services
  The online courses do not represent materials that would be consumed – they are not "used up". NOT MET.

The online courses may be intangible assets – they would first need to meet the definition of an intangible asset:

- Identifiable
  - The courses are separable and could likely be sold to another school. MET.
  - and are non-monetary assets lacking physical substance (the courses are intellectual, not physical, property), as defined in ASPE 3064 *Goodwill and Intangible Assets*. As a result, the recognition and measurement criteria of Section 3064 must be applied.
- Control
  - The Academy has developed the courses and has the exclusive right to deliver the course. They enter into contracts with designers and teachers to develop the material for them. MET.
- Future economic benefits
  - Prior to commencing course development, the Academy commissioned a market research study on the demand for and pricing of online courses. The results of this external information supported the Academy's belief that the courses would be profitable, which also supports its recognition as an intangible asset on the balance sheet. MET.

Since the definition criteria are all met, the intangible asset must also meet the recognition criteria:

- Future benefit will flow to the Academy
  - MET as noted above.
- Cost of the asset can be measured reliably
  - The Academy developed a budget for the development of the courses and tracked costs for it separately. MET

Both the definition and recognition criteria are met for the online courses. Since the courses are internally generated, rather than purchased, additional criteria for recognition must be considered. The Academy classify the generation of these assets into both research and development phases. Costs in the research phase must be expensed whereas costs in the development phase may qualify for capitalization.

<u>Research Phase</u>

By their nature, it is clear that the market research costs of $30,000 with respect to the online courses represent research. As a result, the market research costs of $30,000 must be expensed. The Academy has recorded this incorrectly, so it must be adjusted.

<u>Development Phase</u>

The Academy has the option of either expensing expenditures incurred in the development phase or capitalizing them as an intangible asset. Although Michael has indicated that he would prefer to capitalize the online courses and the related IT platform, these costs can only be capitalized if the Academy demonstrates the requirements of ASPE 3064.41, as follows:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale — The completion of the course is technically feasible because the Academy has an instructional designer and ESL teacher on staff with the expertise to convert the content for online delivery. Although it does not have a programmer on staff, there are likely many such programmers available in Toronto on a contract basis. MET.

b. Its intention to complete the intangible and use or sell it — The Academy's intent has always been to offer the course online, as proven by its commission of a market research study and development of a detailed plan and budget. MET.

c. Its ability to use or sell the intangible asset — The Academy has existed for many years, and it had previously established a plan for launching the online courses and the related IT platform, giving it the ability to sell the online courses. MET.

d. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible assets — The Academy has technical resources, in terms of an instructional designer and teacher, in-house, and it was able to hire an external programmer to develop the IT platform and convert the course content for online delivery. Financial resources are available in the form of previous retained earnings. MET.

e. Its ability to measure reliably the expenditure attributable to the intangible asset during its development — The Academy has tracked all expenditures attributable to the conversion of the course and the development of the IT platform, including the allocation of internal time and the contract of external costs. MET.

f. How the intangible asset will generate probable future economic benefits — The generation of future economic benefits has been demonstrated by projections provided from the external market research study, indicating the number of registrants per course at specified price points. This is combined with the Academy's profitability projections, which indicated that the online courses would cover development costs within one year of launching. MET.

<u>Conclude and advise</u>
Overall, the Academy should be able to demonstrate the required criteria to recognize costs incurred in the development phase of the online courses and the related IT platform. However, the elements included in these costs must be examined more closely.

Of the $258,000, the only eligible costs are those directly attributable to creating the online courses and the related IT platform. The programming costs of $75,000 and production costs of $35,000 can likely be directly attributed to the online courses. As long as the $105,000 allocation of salaries of the instructional designer and teachers can be attributed to time spent developing the online content, including written material, quizzes, and videos, these would also be eligible for recognition.

The monthly costs of $3,000 to host and support the online courses, recognized to keep the site live, and the $10,000 marketing costs for online courses, however, cannot be attributed to preparing the courses for use. These are ongoing operating costs, and, as a result, these amounts must be expensed.

Overall, the Academy should be able to recognize only $215K (75K + 105K + 35K) with respect to the online courses on its balance sheet. The remaining $43K ($258K − $215K) must be expensed.

The Academy also has to determine the useful life of the courses, including whether it is definite or indefinite. If the useful life of the courses is definite, the intangible asset would be amortized over its useful life. Assuming Michael's estimate of courses being refreshed every five years is accurate, these costs could be amortized over five years. However, further analysis should be performed to determine this.