

Day 3-2 Case**(Suggested time 80 minutes)**

Chang ESL Academy Inc. (the Academy) is a private company that reports under accounting standards for private enterprises (ASPE). Located in downtown Toronto, the Academy offers English as a second language (ESL) programs and courses to students who wish to improve their English for personal or professional purposes.

The Academy has been an audit client of the accounting firm, Aderman LLP (Aderman), for many years, and has been audited annually to reassure Michael Chang, the president and sole shareholder of the Academy. It is now January 29, 2016, and you, CPA, have been called into the office of the audit partner, Evelyn Aderman. She informs you that you will be leading the audit engagement for the Academy for the year ended December 31, 2015.

Evelyn tells you the following: “The Academy has had an eventful year. In October, it started offering courses online, which is a significant change from its traditional classroom setting. Here is a summary of my discussion with Michael Chang, which provides information on the new online courses (see Appendix I). Please prepare a memo that includes an analysis of any financial reporting issues resulting from this change. You should consider the impact of this change on the risk assessment, materiality level and approach to this year’s audit.

“After a number of years of profitability, Michael is considering opportunities to further grow the business. He is unsure whether it should offer additional online courses or more of its traditional classroom courses. Michael has asked for a quantitative and qualitative assessment of the two opportunities (see Appendix II). I will use the information as a basis for my discussion with Michael next week. You should also consider any strategic and governance implications.”

APPENDIX I
NOTES FROM DISCUSSION WITH MICHAEL CHANG, ACADEMY PRESIDENT

Annual results

The Academy's preliminary results for the year ended December 31, 2015, include revenues of \$3.7 million and income before taxes of \$750,000.

New online courses

In October 2015, the Academy launched four online courses. Students access the courses online via the Academy's learning website, which then redirects them to an external website. Online courses use a combination of video, audio and written material. Each online course is comprised of eight modules, with a short quiz at the end of every module. Each quiz must be completed successfully before students can proceed to the next module. After completing all eight modules, students are granted a certificate of completion.

The content of these online courses is similar to the Academy's introductory classroom courses. Classroom courses typically run for eight weeks, delivering one module each week. The online format, however, allows students to complete each module at their own pace. Students are given a username and password for each course, which is valid for 90 days. While taking the course, students can view all the course materials for their current module and from all previously completed modules. To assist students when needed, online tutor support is available throughout the course. After 90 days or the completion of the course, whichever is sooner, students no longer have access to the material, as the course is deemed to have "expired."

The registration process for the online courses is the same as for the classroom courses, and students pay for each course, in advance, via the Academy's website.

Students can register for an online course at any time, and receive their course username and password upon registration. Tuition for each online course is \$150. All payments are non-refundable once a student accesses the online course for the first time.

APPENDIX I (continued)
NOTES FROM DISCUSSION WITH MICHAEL CHANG, ACADEMY PRESIDENT

Registration and completion statistics

From October to December 2015, there were a total of 500 online course registrations, distributed evenly within the month: 100 in October; 150 in November; and 250 in December. As of December 31, all registered online courses had been accessed, and 5 students did not complete the courses before the expiry date. By December 31, 2015, students had completed 80% of unexpired October registrations, 30% of November registrations and 20% of December registrations.

The Academy's financial statements include \$75,000 in revenue from online courses.

Michael was surprised to learn that many of the students registered for online courses have Toronto mailing addresses.

Cost of online course and platform development

In January 2015, Michael commissioned a market research study into the demand for online ESL courses. The study cost \$30,000, and indicated that there is a significant demand for online learning, which would allow the Academy to expand its customer base outside of Toronto. With tuition of \$150 per online course, the study projected that annual online registration would start at 400 registrants per course and would increase by 40% in each of years two and three, and then stabilize.

Based on the results of the study, the Academy developed a detailed plan and budget for a fall launch of online courses. The Academy's projections on the profitability of the online courses were based on the market research, which supported recovering development costs within one year. The Academy contracted a programmer to work with its instructional designer and teachers in order to develop the course content and related IT platform for delivery of four online courses.

APPENDIX I (continued)
NOTES FROM DISCUSSION WITH MICHAEL CHANG, ACADEMY PRESIDENT

The costs incurred are as follows:

Market research study	\$ 30,000
Programming for IT platform development	75,000
Allocation of salaries of designer and teachers for development of content	105,000
Production costs of online course content	35,000
Marketing costs	10,000
Web hosting and IT support*	<u>3,000</u>
	<u>\$ 258,000</u>

*Web hosting and IT support for the online courses are outsourced at a cost of \$6 per course registration. These costs will continue to be incurred based on the number of total registrants.

At December 31, 2015, the Academy recognized an asset of \$258,000 on its balance sheet with respect to the online courses and related IT platform. Michael is pleased to have the value of the courses reflected on the Academy's balance sheet, as he believes they represent a significant and valuable asset.

Michael has already confirmed with Canada Revenue Agency that the cost does not qualify for scientific research and experimental development (SR&ED) treatment. However, he is wondering whether any of the online course and IT platform development costs can be deducted or if capital cost allowance can be claimed on the income tax return.

APPENDIX II GROWTH OPPORTUNITIES

Michael has indicated that the Academy has budgeted \$300,000 for growth, and that he is considering two possibilities.

Additional online courses

Michael is extremely pleased with the revenues from the four online courses, which have slightly exceeded the market research projections in the first quarter.

Although not all courses are suitable for online delivery, he believes that an additional six of the Academy's classroom courses could be converted and delivered online, in addition to being offered at the Academy. Development costs on a per-course basis would be similar to those incurred for the courses developed in 2015. Michael hopes courses will only need to be updated every five years.

Tuition would remain at \$150 per online course, and Michael believes that the registration and growth rate projected by the market research study would apply to these new courses.

Additional classroom courses

In 2015, the Academy offered 40 different classroom courses over 12 different sessions for a total of 480 offerings. Each classroom offering runs for eight weeks and costs \$400 in tuition. Each classroom can hold a maximum of 20 students.

Historically, most classroom offerings have operated at 100% capacity. For the first time in years, however, registration levels of entry-level classroom offerings averaged only 80% in November and December; to date, January registrations levels are similar. Michael wonders what triggered this drop in registrants and whether it will continue. At current tuition rates, Michael believes that there is market demand to support up to 80 additional offerings annually, and he believes these offerings would be full.

Additional offerings would require the rental of an additional classroom. The only lease opportunity within the Academy's current location is for a three-year period, at \$8,500 per month. This additional classroom would provide space for up to 160 offerings annually, but Michael does not believe that there is sufficient demand for this many offerings at this time. Additional instructor time would cost approximately \$2,400 per offering.