MARKING GUIDE
ATOMIC EXCELLENCE INC.
ASSESSMENT OPPORTUNITIES

To: Joel Cross
From: CPA
Subject: Atomic Excellence Inc. (AEI) memo

Attached is my memo outlining the risk assessment and materiality for this audit, as well as the analysis of the new accounting issues in 2021.

Assessment Opportunity #1

The candidate evaluates the accounting treatment of the new revenue stream.

The candidate demonstrates competence in Financial Reporting.

Competencies
1.2.2 Evaluates treatment for routine transactions (Core - Level A)

Module revenue – Telephone Support

(The candidates should identify the new stream of providing telephone support as a revenue recognition issue, apply the relevant IFRS criteria, and conclude on the accounting treatment. Candidates should apply general revenue recognition criteria focusing only on the telephone support program. Candidates should also consider whether the sale of the module and the telephone support are distinct or should be combined.)

AEI offered a new service in relation with the licence of software (modules) in 2021. Customers now obtain a three-year telephone support program with every module they purchase. Anna has recognized all of the revenue related to the three-year telephone support program in the current year. However, step 2 of *IFRS 15 – Revenue from contracts with customers*, requires analyzing the promised goods and services in a contract with a customer to determine whether the promised goods and services are distinct or should be combined:

IFRS 15.27:
A good or service that is promised to a customer is distinct if both of the following criteria are met:

(a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service iscapable of being distinct); and

(b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good orservice is distinct within the context of the contract).

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In this case, the modules are delivered before the telephone support program and remain functional without the telephone support, as deduced by the fact that in previous years, no telephone support was provided. Moreover, customers can benefit from the telephone support with the software licence(the modules) transferred at the start of the contract and the telephone support could be purchased separately. Thus, customers can benefit from the modules and the telephone supporteither on their own (for the modules) or together with the other good that is already available (forthe telephone support) and as such, the criterion in paragraph 27 (a) of IFRS 15 is met.

The modules and the telephone support do not significantly affecteach other and, therefore, are not highly interdependent or highly interrelated. This is because AEI would be able to fulfil its promise to transfer the modules independently from its promise to subsequently provide the telephone support. Hence, the promise to transfer the modules and theservice of the telephone support is separately identifiable from each other promise. Thus, the criterion in paragraph 27 (b) of IFRS 15 is met.

On the basis of this assessment, two performance obligations are identified:

1) The modules (the software licence); and
2) The telephone support.

Step 4 of IFRS 15, allocation of the transaction price, should also be considered.IFRS 15.74:
To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative stand-alone selling price basis in accordance with paragraphs 76–80, except as specified in paragraphs 81–83 (for allocating discounts) and paragraphs 84–86 (for allocating consideration that includes variable amounts).

IFRS 15.77:
The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. […].

IFRS 15.78:
If a stand-alone selling price is not directly observable, an entity shall estimate the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 73. […].

IFRS 15.79:
Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:

(a) Adjusted market assessment approach — an entity could evaluate the market in which itsells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. […].

Using the adjusted market assessment approach, the stand-alone selling price of the modules

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could be estimated at $1,300,000. The observable stand-alone selling price of the telephone support is $130,000. As the total transaction price is also $1,430,000, no further calculation is required.

Lastly, step 5 of IFRS 15 needs to be considered in order to determine when the revenues related to the telephone support should be recognized.

IFRS 15.31:
An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

IFRS 15.35:
An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3–B4);
(b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
(c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

For the three-year telephone support program, the performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of AEI’s performance (rendering available the telephone helpline). Hence, during three years, customers will be able to seek advice from a qualified statistician, 7 days a week, 24 hours a day.

Customers benefit from AEI’s telephone support evenly throughout the year (that is, customers benefit from having the helpline available, regardless of whether customers use it or not). Consequently, the best measure of progress towards complete satisfaction of the service of the telephone support is time-based measure.
AEI should recognize revenue allocated to the telephone support on a straight-line basis throughout the three-year period. For the first year,2021, that means that revenue of $43,333 ($130,000 / 3 years = $43,333) should have been recognized instead of the whole $130,000. [Note: $130,000 is $1,430,000-$1,300,000.] Thus, therevenue are currently overstated by $86,667 ($130,000 - $43,333 = $86,667). Therefore, $86,667should be removed from revenue, and the amount deferred and subsequently recognized evenlyover the remaining two-year period.
Note: Since the sales are even throughout the year, not all ofthe Year 1 support sales should be recognized. Candidates may defer another half a year, in which case the deferral would be $108,334 (($43,333 x 6/12) + $86,667).

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Assessment Opportunity #2

The candidate evaluates the accounting treatment of the research and development costs.

The candidate demonstrates competence in Financial Reporting.

Competencies
1.2.2 Evaluates treatment for routine transactions (Level A)

Module Nuclear

(Candidates should identify that Module Nuclear went from the research phase to the development phase in 2021, and thus not all costs can be capitalized. They should apply the relevant IFRS criteria, and conclude on the accounting treatment. Candidates should apply the R&D deferred costs criteria and use the appropriate case facts. Candidates could also recognize that a portion of the planned costs in 2022 cannot be capitalized.)

Approximately $120,000 has been spent at year-end on Module Nuclear. This is an internally generated intangible asset, as AEI will be able to sell the module to various clients in the new year and thus will provide future economic benefit for AEI.

Costs for this project need to be separated into research costs, and development costs, as *IAS 38 – Intangible assets* does not allow the capitalization of research costs. Development costs can only be recognized when the following criteria have been met:

(a) *the technical feasibility of completing the intangible asset so that it will be availablefor use or sale.*
(b) *its intention to complete the intangible asset and use or sell it.*
(c) *its ability to use or sell the intangible asset.*
(d) *how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally,the usefulness of the intangible asset.*
(e) *the availability of adequate technical, financial and other resources to complete thedevelopment and to use or sell the intangible asset.*
(f) *its ability to measure reliably the expenditure attributable to the intangible assetduring its development.*

At the end of October 2021 was when all the above criteria were met. At that point, they have finished the programming of the module without any crashing when used. There is clearly a market for the product as several clients have requested this module. Given that AEI had net income of $550,000 ($463,333 considering the above adjustment on revenue recognition of the telephone support) in the current year, there are sufficient resources to finish the module. Therefore, all costs before that date cannot be capitalized, and $100,000 of costs will have to be expensed, as AEI has currently capitalized these costs.

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In addition, it should be noted that the $5,000 of advertising and the client reception (expected to be incurred in 2022) cannot be capitalized, as IAS 38 paragraph 67 specifically prohibits “selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use”.

Assessment Opportunity #3

The candidate evaluates the accounting treatment of the impairment issue.

The candidate demonstrates competence in Financial Reporting.

Competencies
1.2.2 Evaluates treatment for routine transactions (Level A)

Genetic Network Module

(The candidates should identify that there is an impairment issue associated with the Genetic Network Module, apply the relevant IFRS criteria, and conclude on the accounting treatment. Candidates are expected to recognize the trigger for impairment and calculate the impairment amount based on the independent valuation. Candidates could also consider the fact that recoverable amount could also be calculated through value-in-use, but that it is unlikely that value-in-use would be higher than fair value less costs of disposal.)

AEI currently has deferred R&D costs related to the Genetic Network Module of $95,000.

IAS 36 – Impairment of assets paragraph 9 requires that an entity “assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists,the entity shall estimate the recoverable amount of the asset.”

There is an indicator of impairmentat year-end as a competitor has come out with a similar product that can be faster while doing thesame task. In addition, sales have decreased 90% in 2021 related to the product.

As there is an indicator of impairment, IAS 36 requires the entity to calculate the impairment loss, which is the amount by which the carrying amount of an asset or a cash-generating unit exceeds

its recoverable amount. An asset’s recoverable amount is the higher of its fair value less costs of disposal and its value in use. The asset’s value in use (present value of future cash flows) has significantly declined as sales have decreased 90%. Therefore, the fair value less costs of disposal for the asset is likely higher. BGC offered $50,000 for the purchase of the module. Therefore, an impairment loss of $45,000 ($95,000 - $50,000) should be recorded in the financial statements.

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Assessment Opportunity #4

The candidate assesses the risk of material misstatement.

The candidate demonstrates competence in Assurance.

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

Risk of material misstatement

(The candidates should identify some risk factors that would support a higher risk assessment, and conclude on the overall risk of the audit. Candidates should discuss generic risks associated with a high-tech public company. Candidate could also consider the additional case facts that would confirm the generic risks, e.g., the Genetic Network Module was improved upon by a competitor, so the industry is highly competitive.)

I recommend that the risk of material misstatement for the AEI audit be assessed as high. The following are factors that support this assessment:

- AEI is a public company. This increases risk due to the increased number of users of the financial statements, and the pressure to increase earnings as stock price is often dependenton financial results.
- The software industry for scientists is extremely competitive. There are very few barriers to entry due to the low cost to start a software company. Clients will often switch software providers if another company can deliver the same analysis more quickly, or provide better analysis. For example, a software similar to the Genetic Network Module was offered by a competitor in early 2021, and it can perform the work in half the time. This increases risk.
- There have been several new transactions during 2021, including a new business model withthe telephone support program component of sales, as well as expenditures made on ModuleNuclear. This increases risk as they are new to AEI and they may not be familiar with how to account for these items.
- This is a new client for the firm. Although you have not noted any areas of concern in reviewingthe prior year audit file, this increases risk, as we are not familiar with the client and their business. Therefore, we may not notice anomalies as it pertains to their industry.
- There have been several accounting errors noted with the treatment of accounting issues, as noted above. This increases the risk of material misstatement, as there may be additional errors in the financial statements.

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Assessment Opportunity #5

The candidate assesses materiality for the engagement.

The candidate demonstrates competence in Assurance.

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

Materiality

(Candidates should calculate materiality and discuss related implications. Candidates should calculate materiality on original net income or only include one or two accounting issues. Candidates could also consider the performance materiality, or the fact that a decreased materiality has implications on the amount of testing to be performed.)

Given that this is a public company, the main users of the financial statements would be the shareholders of the company. Thus, they will be mainly interested in the profitability of the company. Therefore, profit before tax would be the most appropriate benchmark for the calculation of materiality. For profit-oriented entities, 5% is a common percentage to apply to profit before taxes to determine materiality.

However, there have been some accounting issues that have not been considered in the preliminary profit before taxes. Therefore, these adjustments should be included:

Preliminary profit before taxes	$ 550,000
Less: Revenue related to the telephone support program	(86,667)
Less: Module Nuclear R&D costs	(100,000)
Less: Impairment of Genetic Network Module	(45,000)
Adjusted profit before taxes	318,333
Materiality @ 5%	5%
Planning materiality	$ 15,917

Therefore, planning materiality should be set at $15,917.

In addition, we should consider performance materiality for individual account balances, to ensure that the aggregate of uncorrected and undetected misstatements does not exceed materiality for the financial statements as a whole. Performance materiality is subject to professional judgment, but is typically set at around 70%. I recommend performance materiality be lower than this for AEI, based on the fact that this is a new client for us, so we have limited understanding of the entity and limited experience, as we have not performed the prior year audits. In addition, the overall risk assessment is high, so a lower performance materiality is appropriate. The lower

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performance materiality could be applied to line items of higher risk, such as revenue and R&D costs, as we have already identified several errors in the accounting.

The decrease in materiality will impact the amount of work we will need to perform, as additional testing will be required. We should plan to increase the amount of fieldwork time to ensure we can complete the audit within the required public company reporting deadlines.

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