SC Limited (120 minutes)

Located in Waterloo, Ontario, SC Limited (SC) is a privately owned venture capital–funded company in its fifth year of operations. SC is in the business of providing software development services in the manufacturing industry, as well as developing and selling automated inventory count equipment. SC was founded by a married couple, Jan and Deani Irvine, who were both previously senior software designers. Jan and Deani are co-CEOs of SC and have a combined ownership of 48% of the company's shares. They have effective control through a close relationship with a senior manager who owns 3% of SC. The other shareholders are members of senior management and a venture capital investor.

The company has an August 31 year end and has been audited by Welkin Smith LLP (Welkin) for the past two years. The company follows accounting standards for private enterprises (ASPE).

SC's customers are located all over the world. They engage SC's highly regarded programmers to write customized code for their equipment. The company has also developed three lines of automated inventory count equipment and is currently working on new versions in response to customer requests.

SC also has a significant, growing business selling a new app. The CellarTracker app (CellarTracker) started out as a side project when a programmer came up with an idea that excited her colleagues. CellarTracker is a simple app for reviewing wine. With the app, users scan the barcode of any wine bottle and the app recognizes the product. Users can then review the description, make any tasting notes they want, and rate the wine. Users will have access to this information when they go to the liquor store and can ensure they are not buying items they did not like.

SC has recently hired a controller, Raymond Chan. He has been in this newly created position since the beginning of August 2017, with the accounting manager reporting to him.

Today is October 16, 2017. You, CPA, are the audit senior at Welkin in charge of the year-end audit. The partner, Harjit Sandhu, did the preliminary planning in July (Appendix I). At the partner's request, you met with Raymond last week to gather additional information on the current fiscal year. Your notes from that meeting can be found in Appendix II.

The partner asks you to update the preliminary audit planning that was done in July, in light of the additional information you have obtained and the items not yet considered. He would also like you to discuss any accounting issues identified and to quantify the adjustments where possible. He has also asked you to provide relevant procedures to address them. Lastly, he would like you to write a letter to the client highlighting any internal control weaknesses and providing recommendations to improve them.

Appendix I
Excerpts of Preliminary Audit Planning

Prepared by Harjit Sandhu, Partner

Risk Assessment

Based on my preliminary assessment, the risk of material misstatement is low to moderate, the same as it was last year. The factors I considered include the fact that SC is a young business and its revenues have been growing significantly. However, these factors are offset somewhat by the fact that the company has fairly simple revenue streams and few financial statement users.

Materiality

The primary users of the financial statements are Jan and Deani Irvine, management, and a venture capital investor, Watman Investments (WI). There are no lenders.

I used the same basis and percentage as in previous years to determine materiality (i.e., 2% of extrapolated revenue). Preliminary materiality has been set at \$196,000 (\$9,799,132 × 2%) and performance materiality has been set at \$147,000 (\$196,000 × 75%).

Approach

In previous years, our firm documented, tested, and relied on the company's internal controls over the employee time reporting system and related revenue calculations for the hourly software revenue contracts, which reduced the extent of substantive audit testing of revenue. I plan on doing the same thing this year. However, the work will be carried out at year end, since no interim audit work has been carried out to date because of scheduling difficulties — I couldn't get the staff I needed.

Other Information

Revenue information for the ten months ended June 30, 2017, was as follows:

	September 2016 to June 2017 (Actual)	July 2017 (Estimated)	August 2017 (Estimated)	Total for Fiscal 2017 (Estimated)	Total for Fiscal 2016 (Actual)
Custom software	\$5,648,555	\$ 688,848	\$ 647,517	\$6,984,920	\$2,666,660
Equipment sales	1,478,554	180,311	169,493	1,828,358	1,784,343
CellarTracker app	645,854	140,000	200,000	985,854	0
Total	\$7,772,963	\$1,009,159	\$1,017,010	\$9,799,132	\$4,451,003

For the ten months ended June 30, 2017, SC's internal financial statements showed pre-tax income of \$647,332. This amount is significant because it is SC's first profitable year. The company's financial position at June 30 was fairly strong, with no outside debt and no current liabilities on the balance sheet other than accounts payable and routine accruals.

CHARTERED PROFESSIONAL ACCOUNTANTS

Appendix I (continued)
Excerpts of Preliminary Audit Planning

Prepared by Harjit Sandhu, Partner

About two years ago, venture capital firm WI invested $1.6 million in SC to obtain a 28% ownership. WI mandated a share adjustment clause that requires SC to issue an additional 5% ownership to the venture capital firm if fiscal 2017 sales are less than $13 million.

Appendix II
Notes from Meeting with Raymond

Prepared by CPA

I met with Raymond today. He started by giving me a quick tour of the office and introducing me to some of the employees. As he led me around the building, I noticed there were numerous boxes of unfiled source documents randomly placed in closets and corridors. Raymond and I then sat down in his office to discuss changes in operations and any new transactions and events in the current year.

CellarTracker App Sales

The new CellarTracker app works on most of the smartphones made by the world's largest smartphone manufacturers, and it has already been translated into 10 major languages. The app has grown by word of mouth, particularly in the under-30 market segment, although there has also been some targeted advertising by SC. The developing programmer told Raymond that the July 2017 monthly app sales exploded, and furthermore, August app sales exceeded July levels. The programmer said she was surprised by the success of the app but was very pleased with the result. Raymond was also surprised by this performance, and he admitted he had not really been monitoring the CellarTracker app sales because it was such a small portion of total revenue to date.

The app is sold in the following ways:

- Download from the SC corporate website for $11 with payment by credit card (deposited in the company's bank account two days later).
- Download from the website of the distributing partner, Lars Distribution Inc. (Lars), for $11. This distribution deal was signed on June 12, 2017, by the developing programmer and commenced the next day. SC receives $8 on each sale made, and the distributor provides a quarterly report on its sales. The developing programmer receives the report and sends the amount to record as revenue to the accounting department. The distributor has not remitted payment for any of the downloads sold because it has agreed with the programmer to provide future custom marketing services in lieu of cash payment. There is no detail on what type of marketing services would be provided or when those services are to be rendered, except that they have to be provided before June 2018. The first quarterly sales report provided to SC by Lars was as follows:

Lars Distribution Inc. Download Report

Customer ID	104252	
Name	SC Headquarters Inc.	
Quarter ending	August 31, 2017	
Product	CellarTracker	
Downloads		144,452
Less: Cancellations		66
Promotional copies (Note 1)		1,244
Net downloads		143,142
Per unit		$ 8
Total owing		$ 1,145,136

Settlement: Service offset by June 2018

Note 1: Raymond is not sure what the promotional copies represent. He is not sure if Lars should still pay for those copies.

Appendix II (continued)
Notes from Meeting with Raymond

Prepared by CPA

CellarTracker receivables on SC's balance sheet as at August 31, 2017, were $301,548 from the website and $1,145,136 from Lars. Raymond was surprised to see a big receivable balance for the website sales, since all payments are made by credit card.

At the meeting, Raymond provided the following revenue information, based on actual figures, for July and August. This CellarTracker sales information came from the developing programmer, and the day he was preparing this information for me was the first time Raymond had looked at monthly figures for CellarTracker:

Sales	**July**	**August**
Custom software	$ 702,345	$ 641,098
Equipment sales	194,237	155,783
CellarTracker app	1,705,855	1,847,585
	$2,602,437	$2,644,466

The programmer mentioned that in September 2017, 63 customers complained that their first attempt to download from SC's website failed and, while their second attempt to download worked, they were charged twice for the app. He assumes that this situation only happened for those 63 customers, since they were the only ones who contacted SC.

Raymond informed me that shortly after joining SC, he noticed that the company was in an HST refund position. Upon investigation, he found that after an upgrade to the company website, HST billed during the month of July had been incorrectly posted by the system to the "CellarTracker website revenue" account. This error was fixed retroactively by the in-house webmaster, who is responsible for all website programming. The confusion in the HST amounts meant that the HST return was filed late, which resulted in penalties and interest.

The revenue figures above reflects the corrected values from the two errors found.

Contracts in 2017

During fiscal year 2017, the company worked on more than 300 contracts, most of them of 6 to 30 weeks in duration, with values ranging from $10,000 to $60,000. Services provided include four main steps: design, development, implementation, and testing. Customers also have the option to purchase maintenance services for the software developed by SC.

Until October 2016, all of the company's software contracts were priced on an hourly basis, with time spent for development and maintenance services billed on a monthly basis. At that time, the vice-president of sales tried a fixed-price model on a few projects for clients who said they preferred this model. Fixed-price contracts are becoming more prevalent in the industry and give customers more project cost certainty. Most of the fixed-price-contract customers chose to include maintenance services in their contracts. SC does not track which contracts are fixed-price contracts, hourly contracts, or hybrid fixed/hourly (for example, $35,000 plus $100 per hour for certain activities) contracts.

Appendix II (continued)
Notes from Meeting with Raymond

Prepared by CPA

SC recognizes revenue on the fixed-price contracts on a monthly basis, based on the percentage of the project revenue that the project coordinator feels is appropriate, but there is no formal methodology to determine the percentage to recognize. Virtually the only cost on the projects is labour, and there are rarely other costs.

On June 1, 2017, the company signed its largest ever fixed-price contract with PAB Limited, for a total of $60,210. The contract includes the development of software and maintenance services for three years after the implementation. PAB Limited could purchase the maintenance services at a later time for a cost of $275 per month. Development started on June 8, 2017, and management estimates it will take 30 weeks to develop the software if a consistent 15 billable hours are spent on the project each week. An amount of $30,000 was recorded as revenue for the year ending August 31, 2017.

I requested the contract, as well as copies of the invoices to date, for review, but the vice-president of sales does not think he saw the final version of the contract, and he was unable to find either a print or an electronic copy of it.

Inventory Count Equipment Development Costs

In response to customer requests, the company spent fiscal 2017 developing an updated version of its most popular line of automated inventory count equipment. Several customers mentioned they would like to be able to use their mobile devices as scanners, rather than the SC-developed scanners, which are harder to use. Customers would also like the interface to be easier to use, since the turnover of warehouse employees is high and they spend a lot of time training employees to use the scanners. Therefore, SC is developing a mini-scanner that can be attached to a user's mobile device and an app that would be used in conjunction with the mini-scanner. SC's sales department discussed the concept with several customers, and the staff are confident that they will be able to sell the new version as soon as it is ready.

Programmers spent approximately two months researching various types of scanners and the related programming, to get an idea of how to best develop the software for the mini-scanner. They spent the next eight months designing the scanner and programming the software to develop a workable prototype. The development process is almost complete and is now in the testing phase with two clients. So far the comments have been positive with regards to the app. However, the mini-scanner is very slow, and further work will need to be done to improve the speed. Programmers are confident they will be able to address the issue in the upcoming weeks. SC's sales department has already started a marketing campaign to promote the mini-scanners.

All $475,000 of the costs incurred to date related to the mini-scanners have been capitalized in fiscal 2017 as development costs. These costs include:

- market study on the size of the potential new market: $20,000;
- programmers: $245,000; and
- supplies and material for the mini-scanner prototypes: $210,000.

CHARTERED PROFESSIONAL ACCOUNTANTS

Appendix II (continued)
Notes from Meeting with Raymond

Prepared by CPA

Stock Option Plan

On June 1, 2017, the company put in place a stock option plan for key employees. Sixteen employees have received options, vesting after three years of services from the grant date. In total, 1.13 million stock options have been granted in fiscal year 2017.

The estimated value of each option using the Black-Scholes model is $1.022. Management estimates that 10% of the options issued will be forfeited before the end of the vesting period.

Raymond said he has no experience accounting for such plans. He said he wants to keep compensation expense low and is happy that he does not need to record any expense before the options are exercised.

Information Systems

Raymond provided me with a completed version of Welkin's information systems questionnaire. There were three items of note:

- The most recent successful data backup on the main corporate finance server was nearly two months ago, although the system is programmed to back up daily.
- The company website is developed in-house by the webmaster, who maintains and updates the website on his own with no other help. The firewall currently protecting the website has not been updated to the latest version.
- The company's disaster recovery plan, which covers the website and all internal IT infrastructure, has not been reviewed since early fiscal 2015.