Case 14-6
Making Connections

Social Konnections Inc. (SKI or the "Company") is a global Internet company that runs Social Konnections, a large social media networking Web site. SKI has experienced steep growth since its launch in 2005, and the Company went public in 2010. SKI currently has over 500 million active users who visit the site to connect with others, express themselves, and play games.

Last year, substantially all of SKI's revenue came from advertisers who market their products and services to SKI's active users through advertisements placed on the Web site or its various mobile platforms. The Company's remaining immaterial revenue was received from fees associated with the sale of virtual goods and services by third-party application developers using SKI's various platforms.

In Q1 of the current fiscal year, SKI acquired Corporate Collaborations (CC), an entity that manages private and public social media networks for corporations. CC's customers are primarily national and global companies whose employees connect over its platform. In addition to hosting private social media networks for corporations, CC provides services to develop the networks it manages. CC's revenues are earned through the performance of multiyear revenue contracts with its customers. In the current year, CC is expected to produce approximately 20 percent of SKI's consolidated revenue.

SKI's investors are focused on the growth prospects of the Company's legacy open social media platform operations and its new corporate revenue unit. The Company's MD&A disclosures include (1) various user and revenue metrics to help financial statement users assess its traditional operations and (2) backlog information to help users assess CC's operations.

Audit

Because of SKI's continued growth, the audit committee has requested that the Company choose a new audit firm with experience in auditing public technology companies. A new firm was selected and has performed each of the interim reviews in the current year.

Kristine Drew, a senior auditor, is the in-charge accountant on the SKI audit. In addition to her supervisory and administrative responsibilities, Ms. Drew is responsible for auditing revenue. Ms. Drew has read the Company's disclosed accounting policies and is interviewing the revenue controller, Bill Cook, and various sales personnel to develop in-depth process flow documentation that will serve as the basis for the team's risk assessment.

Advertising Revenue

SKI creates advertising space on its Web site and mobile applications and sells the space to advertisers either directly, or through advertising agencies. According to Mr. Cook, the amount an advertiser pays is dependent on the number of views the ad receives or the number of user clicks (depending on the type of advertisement defined in the underlying contract) and the revenue is recorded in the period in which the views or clicks are made.

Ms. Drew has learned that simple advertising can be purchased directly from SKI through SKI's advertising Web site at standard rates, with the advertisements and terms input directly into the Company's ad delivery platform. However, most advertising revenue is generated directly through the advertising sales team, which has the ability to help advertisers develop more sophisticated advertising campaigns. Management has established minimum pricing and volume thresholds for these advertisements; however, the sales staff is given significant latitude in securing contracts with customers. Extra commissions are paid to sales individuals who sign longer-term contracts that meet minimum revenue targets.

Once a contract is signed, the ad development department creates the ad content and obtains the customer's approval. The approved ad and the contract are electronically sent to the ad scheduling department, and the advertisement is uploaded into the Company's ad delivery platform. The ad delivery platform is a robust system and is designed to capture all the nuances associated with the contract. For example, an advertiser may wish to have its ads displayed only to users whose IP addresses are from a specific geographic location, or the contract may be structured to provide the advertiser with variable pricing or incentives (such as a set of free advertisements) once a certain level has been paid for. In summary, the delivery platform captures all the relevant pricing information associated with the contract to allow for real-time revenue recognition according to the terms of the contract. After the contract is entered into the system, a summary of the contract setup is provided to the sales manager that worked with the customer. The sales manager then reviews the contract setup for accuracy.

The Company's ad delivery platform automatically tracks the advertising activity each day and reports the activity to its customers, who are then billed weekly for the aggregate ad activity.

Corporate Social Network Development and Hosting Revenue

As part of its new corporate services program from the acquisition of CC, the Company earns revenues by providing corporate social network development and hosting services. For new customers, a contract will typically require an up-front fee to SKI for the development of the customer's specific social media network; the contract will also include a separate multiyear hosting agreement. The customized social media networks only operate on the Company's hosting platform and customers do not have the option to take possession of the software used to run the networks. Revenues for the up-front fee associated with the development are recognized as the development is completed and the system is available to the customer. Hosting revenues are automatically recognized by the system, based on the invoicing cycle outlined within the customer's contract. According to Mr. Cook, this invoicing cycle is fairly uniform throughout the hosting period; therefore, from a materiality perspective, the Company will disclose that hosting fees are recognized ratably throughout the hosting contract period.

In Q4, during an interview with one of the new members of the corporate sales team, Ms. Drew was told that the corporate sales director had established a goal of increasing the length of the average hosting contract. Before SKI acquired CC, most of the multiyear hosting agreements were for three-year terms. In Q4, the corporate sales director implemented a strategy shift that would increase the contracted hosting period to five years. To accomplish this goal, the sales team was able to offer its customers three months of free service, to be added at the end of any new five-year agreement signed. In addition, the sales director offered an additional commission for converting existing contracts to five-year agreements. To accelerate the implementation of this plan, the sales commission is doubled if the contract modification occurs before the end of the fiscal year.

Ms. Drew's Concern

Ms. Drew is concerned about several things she has learned regarding the appropriateness of management's revenue recognition policies.

Required:

1. Identify the potential revenue recognition issues related to each of the Company's sources of revenue.
2. On the basis of the information Ms. Drew has learned, what fraud risk factors should she consider discussing with her team at the next fraud brainstorming meeting?
3. What potential audit procedures could the team consider to evaluate management's revenue recognition policies and determine whether those policies are appropriately applied?