

## Rosetta Inc.

Rosetta Inc. (RI) is a new corporation that just acquired the assets of an unincorporated technology business on September 1, 2019, from Jess Stone. Extracts from the purchase and sale agreement entered into by RI and Jess Stone are provided in [Exhibit I](#). RI is owned by three shareholders: Carlos Guevara, the CEO of RI, who owns 20% of the shares of RI; and two investors, who each own 40% of the shares. Jess Stone is not a shareholder of RI.

### Exhibit I

#### **Extracts from the Purchase and Sale Agreement Between RI and Jess Stone**

##### **Purchase and Sale of the Business Assets of Jess Stone**

- RI will purchase the technology and the research findings of Jess Stone as at September 1, 2019
- RI agrees to purchase the equipment owned by Jess Stone as at September 1, 2019
- Jess Stone agrees to be responsible for all liabilities as at September 1, 2019

##### **Purchase and Sale Price**

- RI will pay to Jess Stone an amount of \$3.5 million for the technology and the research findings
- RI agrees to pay to Jess Stone the appraised value of \$420,000 for the equipment

##### **Contingent Consideration**

- RI agrees to pay to Jess Stone an amount equal to 50% of net income (determined in accordance with generally accepted accounting principles) in excess of \$500,000 for the fiscal year ending August 31, 2020

##### **Employment Contract with Jess Stone**

- RI and Jess Stone agree to enter into a two-year employment contract, and RI agrees to pay to Jess Stone an annual salary of \$200,000
- Jess Stone agrees that all research findings during the employment are the property of RI

Jess Stone developed new touch screen technology but lacked the financial resources necessary to benefit commercially from this technology. The touch screen technology is far superior to the current technology and has many potential uses, ranging from mobile devices, computer screens, and laptops.

RI put the technology it purchased to work immediately by entering into a licensing agreement with Mica Inc. (Exhibit II). In addition, RI has developed a new PC computer monitor with the touch screen and entered into an agreement with Ferrous Inc. to distribute the technology.

## Exhibit II

### Extracts from the Licensing Agreement Between RI and MICA Inc.

#### Licensing Arrangement

- RI agrees to provide to Mica the exclusive right to use the touch screen technology referred to as FeldsparX for a term of three years commencing on December 1, 2019
- RI agrees to deliver the technology to Mica on December 1, 2019
- Mica agrees to pay to RI a licensing fee in the amount of \$900,000, with the first payment of \$300,000 due on December 1, 2019; and agrees to make payments in the amount of \$300,000 plus interest of \$36,000 on December 1, 2020, and \$300,000 plus interest of \$18,000 on December 1, 2021

#### Royalty

- Mica agrees to pay to RI a royalty fee in the amount of 15% of the gross margin (determined in accordance with generally accepted accounting principles) realized by Mica from sales of goods that use the FeldsparX technology
- Mica agrees to provide to RI a quarterly statement of gross margin realized by Mica that is subject to the royalty payable to RI
- RI, or its representative, has the right of access to the records and information of Mica necessary to audit the gross margin reported by Mica to RI

You, CPA, have been recently employed by RI as the special assistant to Carlos Guevara. On July 3, 2020, Carlos calls you into his office and says he has an assignment for you:

“The financial statements of RI for the fiscal year ending August 31, 2020, are required to be audited. I want you to address the significant financial accounting issues pertaining to the preparation of RI’s financial statements for its first fiscal year ending August 31, 2020, and provide your recommendations on the accounting treatments to be used.”

As you leave Carlos’s office, he provides you with a file that includes some additional information about the operations of RI ([Exhibit III](#)).

### Exhibit III

#### Information Obtained About the Operations of RI

##### Licensing Arrangement with Mica

- Revenue in the amount of \$300,000 has been recognized in the accounting records
- Royalty revenue in the amount of \$135,000 has been recognized in the accounting records based on a gross margin of \$900,000 reported by Mica for the six months from December 1, 2019, to May 31, 2020
- Mica is a financially sound entity

##### Research and Development

RI acquired the following technology and research findings from Jess Stone:

Project Technology/Assigned Name	Fair Value	Current Status
FeldsparX	\$ 700,000	licensed to Mica for three years (see <a href="#">Note 1</a> )
QuartZ	1,500,000	used in the commercial production of goods (see <a href="#">Note 2</a> )
BasalT	900,000	used in the commercial production of goods (see <a href="#">Note 3</a> )
Grandiorite	400,000	testing use in a possible product
	\$3,500,000	

*Note 1—FeldsparX Technology:* Management of RI decided to license use of the FeldsparX technology rather than to produce goods using this technology itself. Management expects that this technology will have a useful life of three years.

*Note 2—QuartZ Technology:* Management of RI estimates that the QuartZ technology will generate total revenue in the amount of \$7.5 million over a four-year period commencing December 1, 2019.

*Note 3—BasalT Technology:* Management estimates that the BasalT technology will generate total revenue in the amount of \$2.7 million over a three-year period commencing March 1, 2020.

Jess Stone has started work on a new project, Kryptonite, after becoming an employee of RI and this project is presently in the conceptual formulation state of a possible product that uses the technology.

A research and development asset in the amount of \$3.5 million is reported on RI's statement of financial position as at May 31, 2020. All research and development costs incurred by RI have been expensed in the accounting records.

#### **Sales Arrangement with Ferrous Inc.**

Ferrous Inc. has placed a large order for PC touch screen monitors produced by RI that uses the QuartZ technology. The sales agreement requires RI to have the goods available for delivery to Ferrous by August 31, 2020 and to make deliveries to Ferrous as requested during September and October 2020. Ferrous will be holding a special sales event during these months. Ferrous has requested that the goods are not to be delivered until September and October as they do not have the warehouse space to store all of the items for the special sale. Revenue pertaining to this agreement is \$2,500,000 and the related direct production costs are estimated to total \$1,350,000. These goods will be covered by RI's inventory insurance.

Ferrous made the nonrefundable fee payment of \$1,250,000 required by this agreement on June 1, 2020. This amount has been recognized as sales revenue. The final \$1,250,000 is to be paid by Ferrous on October 31, 2020. Ferrous is a financially sound entity.

#### **Sales Arrangement with Mega Mart Ltd.**

RI entered into an agreement with Mega Mart Ltd., a large global retailer, to distribute a lower-end touch screen for price-sensitive customers. This touch screen makes use of the BasalT technology. The sales agreement requires RI to deliver units of the touch screen to Mega Mart. Mega Mart will display the screens in a prime location and retain 20% of the per-unit sales price (\$50 per unit), with the remaining 80% of the sales price to be sent to RI. Any unsold touch screens that are not sold by Mega Mart will be returned to RI. In addition, Mega Mart will provide RI an upfront payment of \$250,000 in order to help offset working capital requirements.

According to the sales **agreement**, RI shipped 30,000 units to Mega Mart Ltd. in April 2020. At the time of delivery, RI recorded revenue of \$1.2 million, debited cash for \$250,000, and set up an accounts receivable for the remaining \$950,000.

### **Required**

Prepare a report that addresses the requests of Carlos Guevara.

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