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BDO **FLASH** REPORT ASSURANCE

▶SUBJECT

PCAOB ISSUES STAFF AUDIT PRACTICE ALERT NO. 12, *MATTERS RELATED TO AUDITING REVENUE IN AN AUDIT OF FINANCIAL STATEMENTS*

On September 9, 2014 the PCAOB issued Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements*, (the "Alert"), to highlight certain PCAOB auditing requirements related to aspects of auditing revenue in which significant auditing deficiencies have been frequently observed by the PCAOB's Inspections staff. The matters discussed in the Alert are applicable to both planning and performing audit procedures with respect to revenue. Since revenue is often significant to a company's operating results, audit committees may find the matters discussed in the Alert of interest and might consider discussing with their auditors their approach to auditing revenue.

The following summarizes the more significant topics discussed in the Alert. The Alert contains reminders and considerations that may be applicable in the conduct of any audit, not just those of issuers. Moreover, the matters discussed in the Alert are likely to continue to have relevance to auditing revenue under the recently issued accounting standard on revenue recognition. The Alert can be viewed at: http://pcaobus.org/Standards/QandA/9-9-14_SAPA_12.pdf.

Testing Revenue Recognition, Presentation, and Disclosure

Testing the Recognition of Revenue from Contractual Arrangements

As it relates to construction-type or production-type contracts, Inspections staff identified instances in which auditors failed to perform audit procedures to: (1) test management's estimated costs to complete projects; (2) test the progress of the construction or production contracts; or (3) evaluate the reasonableness of the company's approach for applying the percentage-of-completion method of accounting. With respect to multiple-element arrangements, Inspections staff noted instances where auditors failed to (1) evaluate each of the deliverables to determine whether they represented separate units of accounting, and (2) test the value assigned to the undelivered elements.

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The Alert highlights the importance of gaining an understanding of the company, its environment, and internal control that includes understanding the company's key products and services and contractual terms of sales transactions, since such an understanding will assist auditors in determining the specific audit procedures to test whether revenue was properly reported. Furthermore, the Alert explains that revenue recognition often involves accounting estimates, such as estimates of future obligations under the terms of sale in the contract. Depending on whether the estimate is a fair value estimate or other type of estimate, the auditor should apply either AU sec. 328, *Auditing Fair Value Measurements and Disclosures,* or AU sec. 342, *Auditing Accounting Estimates*.

Evaluating the Presentation of Revenue – Gross versus Net Revenue

Inspections staff observed instances in which auditors failed to perform sufficient procedures to evaluate whether a company's presentation of revenue on a gross basis (the company has the primary obligation to the customer) versus a net basis (the company is acting in the capacity of an agent) was in conformity with the applicable financial reporting framework. The Alert emphasizes the importance of determining whether a company is a principal or agent in a transaction.

Testing Whether Revenue Was Recognized in the Correct Period

The risk of material misstatement involving revenue recognition in the incorrect period may be a risk of error or a risk of fraud. The Alert explains that when designing and performing cutoff procedures, the auditor should plan and perform audit procedures that address the risk of material misstatement, in particular, determining that the procedures are designed to (1) detect the type of potential misstatement related to the risk and (2) obtain sufficient relevant and reliable evidence. An example of a typical cutoff procedure is to test sales transactions by comparing sales data for a sufficient period before and after year-end to sales invoices, shipping documentation, or other appropriate evidence to determine that the revenue recognition criteria were met and the sales transactions were recorded in the proper period.

Evaluating Whether the Financial Statements Include the Required Disclosures Regarding Revenue

The Alert emphasizes that the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures. Specifically, when evaluating the disclosures, the auditor is required to perform the following, among other things:

- Evaluate whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation; and
- Consider the form, arrangement, and content of the financial statements (including accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Additionally, the Alert emphasizes that the evaluation of disclosures also involves the evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures.

Other Aspects of Testing Revenue

Responding to Fraud Risks Associated with Revenue

Inspections staff have observed deficiencies in some auditors' responses to fraud risks associated with revenue. Examples include failures to:

- Identify and respond to the presumed fraud risk related to improper revenue recognition or demonstrate how the presumption was overcome;
- Perform procedures to address an identified fraud risk; and
- Sufficiently address an identified fraud risk related to side agreements because the firm's planned response – confirmation procedures – resulted in a high percentage of nonresponses, for which the auditor's procedures were limited to inquiry.

PCAOB standards require the auditor to presume that there is a fraud risk involving improper revenue recognition and to evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks in the company being audited. The Alert emphasizes that auditors who merely identify revenue as having a general risk of improper revenue recognition without attempting to assess ways in which revenue could be intentionally misstated may find it difficult to develop meaningful responses to the identified fraud risks.

When responding to fraud risks, it is important to seek reliable evidence that would be difficult for potential perpetrators to manipulate and to incorporate an element of unpredictability in audit procedures.

Testing and Evaluating Controls over Revenue

When the auditor plans to assess control risk for a relevant assertion of a significant account and disclosure at less than the maximum by relying on controls, and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, PCAOB standards require the auditor to obtain evidence that the controls selected for testing are designed and operating effectively during the entire period of reliance. Inspections staff have observed instances in which auditors relied on controls to reduce substantive testing, but such reliance was unsupported because the testing of controls was insufficient (e.g., auditors failed to test controls for the entire period), the results of control tests identified deficiencies indicating controls were ineffective, or procedures to test the design and operating effectiveness of the company's controls were insufficient because they did not address the relevant assertions.

When deficiencies in controls over revenue on which the auditor plans to rely are detected, the PCAOB standards require the auditor to:

- Perform tests of other controls related to the same assertion as the ineffective controls; or
- Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased risk assessment.

Applying Audit Sampling Procedures to Test Revenue

Inspections staff observed deficiencies in the design and performance of sampling procedures used to test revenue transactions, including:

- Using samples that were too small to provide sufficient audit evidence;
- Failing to select a representative sample of items for testing that would allow auditors to extend their conclusions on the sample to the entire population; and
- Failing to apply audit procedures to all sample items selected and inappropriately evaluating the sample results as if the untested sample items were tested without exception.

When determining the number of items to test for a substantive test of details, PCAOB standards require consideration of the tolerable misstatement for the population, the allowable risk of incorrect acceptance, and the characteristics of the population. Although auditors may use either a statistical or nonstatistical sampling method, the size of a sample using a nonstatistical method will be comparable to, or larger than, the size of a statistically determined sample.

In selecting a representative sample, items may be selected randomly, systematically, or haphazardly. The following are NOT representative selection methods:

- Testing all revenue transactions over a specified amount or with specified characteristics;
- Testing only the unpaid revenue transactions that compose accounts receivable; and
- Limiting the sample selection to certain days, weeks, or months during the year.

Additionally, each sample item selected should be subject to the planned audit procedures. In circumstances where supporting documentation may be missing, the auditor's treatment of unexamined items will depend on their effect on the evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that revenue contains a material misstatement, the auditor should consider alternative procedures to obtain sufficient evidence to form a conclusion. Moreover, the auditor should consider the reasons for his or her inability to examine the items and its implications for the risk assessment, including fraud risk, the integrity of management, and other possible effects.

Performing Substantive Analytical Procedures to Test Revenue

It is important for auditors to design their substantive procedures to provide the necessary level of assurance regarding the assertion being tested. The level of assurance needed depends on (1) the risk of material misstatement, considering reliance on controls when appropriate; and (2) the assurance provided by other substantive procedures directed to the same assertion as the analytical procedure. As the assessed risk of material misstatement increases, the level of assurance needed from substantive procedures also increases. It is important to note that under PCAOB standards, substantive analytical procedures alone are not sufficient to respond to fraud risks or other significant risks; therefore, tests of details are also needed in such situations.

The Alert highlights the following areas where the substantive analytical procedures for testing revenue were insufficient in some instances, including:

- Failing to develop sufficiently precise expectations;
- Not determining whether a plausible and predictable relationship among the data used in the substantive analytical procedure existed;
- Not establishing an amount of difference from the expectation that could be accepted without further investigation;
- Failing to perform procedures to obtain evidence to corroborate management's responses regarding significant unexpected differences with other evidence; and
- Failing to test the completeness and accuracy of the information obtained from the company that was used in performing analytical procedures.

Testing Revenue in Companies with Multiple Locations

Inspections staff have observed instances in which auditors did not test, or test sufficiently, revenue at individual locations that had specific risks, including fraud risks, for which there was a reasonable possibility of a material misstatement. In one example, entity level controls were relied upon to reduce substantive testing of revenue at certain locations, but the effect of identified deficiencies in those controls was not considered. In another example, the auditor planned to use the work of internal auditors for certain locations, but the auditor failed to evaluate whether the work of the internal auditors addressed certain identified risks associated with those locations.

When a company has operations in multiple locations or has business units that generate or process revenue, the auditor is required to determine the extent to which audit procedures should be performed at selected locations or business units in gathering sufficient appropriate audit evidence. In determining the amount of audit attention to devote to a location or business unit, the auditor is required to correlate such audit attention with the degree of risk of material misstatement. Auditing Standard No. 9 lists the following factors that are relevant to assessing the risk of material misstatement associated with a location or business unit and the determination of audit procedures:

- The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including significant transactions outside the normal course of business or that otherwise appear unusual;
- The materiality of the location or business unit;
- The specific risks associated with the location or business unit that present a reasonable possibility of a material misstatement of the consolidated financial statements;
- Whether the risks of material misstatement associated with a location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement;
- The degree of centralization of records and information processing;
- The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and
- The frequency, timing, and scope of monitoring activities by the company or others at the locations or business unit.