AUDITING REVENUE
INTRODUCTION AND OVERVIEW
Auditing Revenue Recognition (MCAP 0680.00)

- Obtain an understanding of the entity’s products or services
- Obtain an understanding of the entity’s revenue recognition policies and related internal controls
- Assess the risks of material misstatement related to all relevant assertions related to significant revenue classes of transactions
- Perform substantive tests addressed at the related balance sheet accounts
- Apply substantive procedures (analytical or tests of details, or a combination of both) to respond to identified risks of material misstatement at the assertion level
Other revenue auditing guidance

- AICPA Industry Audit and Accounting Guides
- AICPA Audit and Accounting Guide, *Auditing Revenue in Certain Industries*
UNDERSTANDING REVENUE RECOGNITION POLICIES AND RELATED CONTROLS
Revenue recognition criteria

• Persuasive evidence of arrangement exists
• Earnings process is complete
• Sales price is fixed or determinable
• Collectability is reasonably assured

This course does not address ASU 2014-09, *Revenue from Contracts with Customers*
Accounting and auditing challenges

- Sales returns and allowances
- Rebates and incentives
- Percentage of completion
- Multiple element arrangements
- Gross vs. net reporting
- Evidence of an arrangement: Contract drafts and addendums
Identifying multiple element arrangements

• Delivered items are separate units of accounting if:
  – They have value on a standalone basis
  – Delivery of undelivered item is probable

• Allocate consideration based on relative selling price

• Determine selling price using the following hierarchy:
  1. Vendor-specific objective evidence (VSOE)
  2. Third-party evidence (TPE)
  3. Best estimate of selling price, if neither VSOE or TPE

• Example: Cell phone contract
Reading and understanding contracts

• Why is reading and understanding contracts important?
• What is the contract?
• What should you look for?
Battle of the forms

• Buyer sends purchase order (product, price and delivery date)
• Seller may confirm with different price in sales order (counter offer)
• Beware that that the buyer and seller documents each may contain their own standard boilerplate contractual language (possible incompatible provisions)
• Which provisions prevail?
Internal control understanding

• Cover the entire cycle related to revenue recognition, including processes and controls for recording:
  – Sales
  – Accounts receivable
  – Collections
  – Sales returns and allowances
  – Allowances for bad debts
• Understand each significant product line and service – each may have different controls
• Cover all relevant assertions
IDENTIFYING RISKS OF MATERIAL MISSTATEMENT AND DESIGNING FURTHER AUDIT PROCEDURES
Potential RMMs due to error

The following factors may be indicators of the presence of a significant risk:

- Unique operating characteristics of the business or industry
- Complexity of revenue recognition criteria, including use of estimates
- Competency of the entity’s personnel
Potential RMMs due to fraud (incentives/motivation)

- Sharp declines in customer demands
- Client having difficulty meeting cash flow projections
- Client is at risk to violate their debt covenants
- Compensation arrangements driven heavily by financial results
Potential RMMs due to fraud (opportunities)

- Bill and hold
- Side arrangements
- Channel stuffing
- Backdating agreements
- Related party transactions
- Management’s ability to override controls
Example: Bausch & Lomb

- Early 1990s, contact lens business undergoing substantial changes
  - Move to “disposable” contact lenses
  - B&L was late entrant to disposable lens market
- B&L’s contact lens division very successful
  - Met or exceeded sales goals for 48 consecutive months
  - Double-digit revenue growth every year since 1989
Bausch & Lomb: Background

• **Products**
  - Traditional lenses (wear for 6 months)
  - Disposable (wear for a few days)

• **Distribution channels**
  - Internal sales force
  - Authorized distributors

• In late 1993, shifted primary responsibility for sales of the traditional lens segment to authorized distributors
Incentive/motivation for fraud

- Fall 1993, management realized they were not going to meet Q3 sales forecasts
- In Q3, offered a promotion to authorized distributors
  - Sold large volume at steep discount (50% off)
  - As a result, substantially exceeded Q3 forecast
- As a result of Q3 promotion, distributors had enough inventory to meet or exceed their Q4 needs
The December program

- B&L had 1.8 million units of traditional lenses
  - Mgmt allocated all 1.8 units to distributors
- Distributors required to purchase their allocation to maintain their authorized distributor status
  - B&L estimated it could take up to two years for some of the distributors to sell their allotment
The December program (cont.)

• Extended credit limits significantly without analyzing creditworthiness or ability to repay
• Recognized revenue on lenses shipped after year-end
• Granted many distributors the right to return unsold lenses
• Shipped product to warehouses
Audit procedures

What audit procedure would have detected this:

B&L extended credit limits significantly without analyzing creditworthiness or ability to repay.
Audit procedures (cont.)

What audit procedure would have detected this:

B&L recognized revenue on lenses shipped after year-end.
What audit procedure would have detected this:

Granted many distributors the right to return unsold lenses.
Audit procedures (cont.)

What audit procedure would have detected this:

B&L shipped product to warehouses they had leased “on behalf of” various distributors.
Unpredictability

In determining overall responses to address risks of material misstatement due to fraud at the financial statement level, the auditor should... incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures.

AU-C 240.29c
Improper revenue recognition

• Maintain appropriate auditor skepticism and recognize potential signs

• AICPA Practice Alert 98-3: *Responding to the Risk of Improper Revenue Recognition*
Further audit procedures

- Substantive procedures
  - Tests of details
    - Nonstatistical sample
    - Attribute sample
    - Selection of items with specific risk characteristics
  - Substantive analytical procedures
- Tests of controls

Key points:
- Our objective is to perform an appropriate amount of testing that efficiently achieves reasonable assurance that revenues are free from material misstatement.
- One client may have multiple revenue streams that each require a different approach.
Attribute testing

- Use the following sample sizes:

<table>
<thead>
<tr>
<th>Significant Risk</th>
<th>Reliance on Control</th>
<th>Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>Yes</td>
<td>10</td>
</tr>
<tr>
<td>Yes</td>
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<td>25</td>
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<td>No</td>
<td>No</td>
<td>30</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>50</td>
</tr>
</tbody>
</table>

- Perform substantive analytical procedures to obtain a low level of assurance
- Not designed to allow the auditor to project misstatements
- Each revenue stream represents a separate population from which a sample should be drawn
NOTE: When there is a significant risk of material misstatement, PCAOB standards require the performance of tests of details (see paragraph 11 of PCAOB AS No. 13).

<table>
<thead>
<tr>
<th>Significant Risk</th>
<th>Reliance on Controls</th>
<th>Assurance Factors</th>
<th>Analytical Procedures Effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>High</td>
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<td></td>
<td>N/A</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td>N/A*</td>
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<tr>
<td>No</td>
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<td>N/A</td>
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<tr>
<td>Yes</td>
<td>No</td>
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<td>1.1</td>
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</table>
Tests of controls considerations

• Required when substantive procedures alone cannot provide sufficient appropriate audit evidence
• Testing information technology general controls (ITGCs)
• Management review controls
Test of controls sample sizes

<table>
<thead>
<tr>
<th>Significant Risk</th>
<th>Controls Tested</th>
<th>Expected (Allowed) Deviations</th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>2 or more</td>
<td>11</td>
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<tr>
<td>Yes</td>
<td>2 or more</td>
<td>25</td>
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<td>45</td>
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<tr>
<td>Yes</td>
<td>1</td>
<td>60</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Frequency</th>
<th>No Sig Risk</th>
<th>Sig Risk</th>
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<td>Annual</td>
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<td>1</td>
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<tr>
<td>Quarterly</td>
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<td>2</td>
</tr>
<tr>
<td>Monthly</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Bi-weekly</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Weekly</td>
<td>5</td>
<td>9</td>
</tr>
</tbody>
</table>
Dual purpose tests

- Nonstatistical sample + TOC
- Attribute test + TOC
- Use in your revenue samples transactions tested as part of:
  - Walkthrough procedures
  - A/R confirmations testing
  - Revenue/shipping cutoff testing
  - Detail testing on A/R rollforward (if applicable)
APPLYING TESTS OF CONTROLS AND SUBSTANTIVE PROCEDURES
PERFORMING TESTS OF CONTROLS

Applying Tests of Controls and Substantive Procedures
Tests of controls procedures

- Inquiry
- Inspection
- Observation
- Re-performance
Significant Risks – Controls

AU-C 315.28

As part of the risk assessment described in paragraph .26, the auditor should determine whether any of the risks identified are, in the auditor’s professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.

[emphasis added]
Tests of Controls

We will cover a few situations related to tests of controls that we have received questions on during the last year:

- How many controls do I need to test?
- Can I test controls over the significant risk and not the rest of the transaction cycle?
- Can I test controls if there is not evidence of the occurrence of the control to inspect?
Tests of Controls – How Many
Tests of Controls – How Many

- Remember from last year’s internal controls courses there are two types of controls:
  - Preventative
  - Detective
If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.
Tests of Controls – Significant Risks

• Earlier we identified the following as a possible delivery risk:
  - Shipments made to warehouse or intermediary location without customer instruction

• What control activities could we test related to this risk?
Tests of Controls – Evidence of Performance

**AU-C 330.10** In designing and performing tests of controls, the auditor should:

a. perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including
   
i. how the controls were applied at relevant times during the period under audit;
   
   ii. the consistency with which they were applied; and
   
   iii. by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively, and (Ref: par. .A28–.A32)

b. determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls. (Ref: par. .A33–.A34)
AU-C 330.A28 Other audit procedures in combination with inquiry (Ref: par. .10a). Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection, recalculation, or reperformance may provide more assurance than inquiry and observation because an observation is pertinent only at the point in time at which it is made.
AU-C 330.A29 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect such documentation to obtain audit evidence about operating effectiveness.
AU-C 330.A29 (cont.) For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures, such as observation or the use of CAATs.
Tests of Controls – Evidence of Performance

• What if we did want to test this control?
• From AU-C 330, we need to evidence:
  i. how the controls were applied at relevant times during the period under audit;
    • Inquiry – control operator(s), others
    • Observation – of the control being performed
    • Inspection – how are items presented to the control operator?
    • Reperformance – can we reperform and get the same results
Tests of Controls – Evidence of Performance

• What if we did want to test this control?
• From AU-C 330, we need to evidence:
  ii. the consistency with which they were applied; and
    • Inquiry – control operator(s), others
    • Inspection – how frequently are invoices entered into the system
What if we did want to test this control?

From AU-C 330, we need to evidence:

iii. by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively, and (Ref: par. .A28–.A32)

• Inquiry – control operator(s), others
• Inspection – performance evaluations
• Observation – performance of control, discrepancies
• Reperformance – we get different results
 Tests of Controls – Evidence of Performance

• So what would be in our workpapers?
  − Narrative documentation of our consideration of all the items on the last three slides (AU-C 330.10 criteria)
  − Documentation of everything we did to reperform the samples we selected
    • This should entail more work than we would do for detail testing these revenue transactions
  − Conclusion on the operating effectiveness of the control
  − Resolution of any disconfirming evidence
    • We identify something during reperformance
    • Errors in tests of details
PERFORMING TESTS OF DETAILS

Applying Tests of Controls and Substantive Procedures
Tests of details

• Cover the relevant assertions, such as:
  – Existence/occurrence
  – Valuation/accuracy

• Address revenue recognition criteria:
  – Persuasive evidence of arrangement exists
  – Earnings process is complete
  – Sales price is fixed or determinable
  – Collectability is reasonable assured

• Attribute testing
PERFORMING ANALYTICAL PROCEDURES
Applying Substantive Procedures and Tests of Controls
Four steps in performing analytical procedures

1. Establish expectations
2. Establish threshold for investigation
3. Compare expectation to recorded amount
4. Investigate differences and corroborate explanations
### Required precision for analytical procedures

<table>
<thead>
<tr>
<th>Levels of Assurance</th>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The <strong>lessor</strong> of 45% PM or 5% of the disaggregated account balance</td>
<td>The <strong>lessor</strong> of 90% PM or 10% of the disaggregated account balance</td>
<td>Auditor Judgment. A threshold is required but may be an amount, ratio, trend or percentage.</td>
</tr>
</tbody>
</table>

- The thresholds are ceilings
- This means that a difference in excess of the threshold must be investigated and the explanation for variance should be corroborated.
Requirements for high or moderate level of assurance

- Nature of analytical procedure should be appropriate for account/assertion tested
- Expectation should be based on a large volume of transactions in a stable environment with predictable relationships
- Expectation should be in the form of an expected account balance
- Expectation should be sufficiently precise
- Should be appropriately disaggregated
- Underlying data should be reliable
- Investigate any variance exceeding threshold, identify the underlying cause, and obtain evidence to determine plausibility of explanation
Establishing expectations

• Knowledge of:
  – GAAP
  – Relationships between accounts
  – Client’s business and industry

• Number of potential causes of deviations from expectations

• Reliability of data
Investigating differences

Why not just ask management?

- Management has incentive to provide non-misstatement explanations
- Auditor may fail to consider alternative explanations
- Auditor may “get framed” (i.e. fail to consider explanations of the correct nature)
- Auditor may over-estimate the likelihood of management’s explanation being correct
- Auditor may fall prey to the confirmation bias
Application of the Professional Judgment Framework

1. define and frame the issue
2. determine objectives and identify alternatives
3. collect and analyze information
4. reach a conclusion

Potential Frames:
- Regulator / Auditor
- Management / User
- Error / Fraud

Apply relevant knowledge and learn from experience
QUESTIONS?