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STAFF AUDIT PRACTICE ALERT NO. 15

MATTERS RELATED TO AUDITING REVENUE FROM CONTRACTS WITH CUSTOMERS

October 5, 2017

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Introduction

This practice alert is being issued to discuss certain significant matters relating to the application of Public Company Accounting Oversight Board ("PCAOB") standards relevant to auditing the implementation of the new accounting standard for revenue from contracts with customers. This practice alert is intended to facilitate auditors' consideration of these matters in interim reviews of issuers and year-end audits of issuers and brokers and dealers.

For many companies, revenue is one of the largest accounts in the financial statements and is an important driver of operating results. In audits performed in accordance with PCAOB standards, revenue typically is a significant account, often involving significant risks that warrant special audit consideration.

The Financial Accounting Standards Board ("FASB") has issued a new accounting standard, *Revenue from Contracts with Customers.*[1] The new revenue

[1] *See* FASB Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (May 2014) ("FASB ASU 2014-09"), as codified in FASB Accounting Standards Codification ("ASC") Topic 606, *Revenue from Contracts with Customers*, and additional ASUs that link to the transition guidance in FASB ASC paragraph 606-10-65-1 (the "new revenue standard"). Additionally, the International Accounting Standards Board ("IASB") has issued International Financial Reporting Standard 15, *Revenue from Contracts with Customers*, which is substantially

standard replaces most industry-specific revenue recognition requirements in U.S. GAAP with a new principles-based, five-step revenue recognition model. It also requires new disclosures, such as qualitative and quantitative information about revenue recognized from contracts with customers (including disaggregated revenue, contract balances, and performance obligations) and significant judgments and changes in judgments. The new revenue standard also specifies, among other things, the accounting and disclosure for some costs to obtain or fulfill a contract with a customer.[2]

As companies implement the new revenue standard, they may need to change existing (or develop new) systems, processes, and controls used to gather and archive contract data, make required estimates, and provide required disclosures.[3] Inadequate or ineffective design or implementation of changes to systems, processes, and controls can pose heightened risks of material misstatement, including the risks of material misstatement due to fraud ("fraud risks").

This practice alert highlights certain requirements of PCAOB standards that are relevant to auditors' consideration of companies' implementation of the new revenue standard in upcoming interim reviews and year-end audits.[4] It discusses (a) auditing management's transition disclosures in the notes to the financial statements, (b) auditing transition adjustments, (c) considering internal control over financial reporting, (d) identifying and assessing fraud risks, (e) evaluating whether revenue is recognized in conformity with the applicable financial reporting framework, and (f) evaluating whether the financial statements include the required disclosures regarding revenue.[5]

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converged with U.S. generally accepted accounting principles ("U.S. GAAP"). The references to U.S. GAAP in this practice alert are not intended to identify all relevant ASUs or ASC Topics.

2 *See* FASB ASU 2014-09, Summary.

3 *See, e.g.,* FASB ASU 2014-09, paragraph BC486.

4 The auditing matters discussed in this practice alert are relevant to the auditor's consideration of implementation of the new revenue standard issued by both the FASB and IASB.

5 While this practice alert highlights certain areas, it is not intended to identify all areas that might affect audit risk arising from the implementation of the new revenue standard, nor is it a substitute for the relevant auditing standards. This practice alert does not change auditors' responsibilities; all audits of issuers and brokers and dealers must be conducted in accordance with the standards of the PCAOB. Certain matters included in this practice alert have been the subject of previous inspection findings, as

Auditing Management's Transition Disclosures in the Notes to the Financial Statements

PCAOB standards require auditors to perform procedures to identify and assess the risks of material misstatement of the financial statements, including consideration of the risk of omitted, incomplete, or inaccurate disclosures.[6] Additionally, auditors are required to perform substantive procedures to test the relevant assertions of significant financial statement disclosures.[7] This includes transition disclosures[8] regarding the new revenue standard when presented in the notes to the financial statements (including

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discussed in more detail in *Maintaining and Applying Professional Skepticism in Audits*, Staff Audit Practice Alert No. 10 (Dec. 4, 2012) ("Practice Alert No. 10"); *Considerations For Audits of Internal Control Over Financial Reporting*, Staff Audit Practice Alert No. 11 (Oct. 24, 2013) ("Practice Alert No. 11"); and *Matters Related to Auditing Revenue in an Audit of Financial Statements,* Staff Audit Practice Alert No. 12 (Sept. 9, 2014) ("Practice Alert No. 12").

[6] *See, e.g.,* paragraphs .49, .52, and .67 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[7] *See* paragraph .36 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

[8] *See* Securities and Exchange Commission ("SEC") Staff Accounting Bulletin No. 74 (codified in Topic 11.M), *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (Dec. 30, 1987), which provides the SEC staff's view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those ASUs on the financial statements when adopted. In this practice alert, such disclosures in the notes to the financial statements are referred to as "transition disclosures."

See also FASB ASC Topic 250, *Accounting Changes and Error Corrections,* paragraph 10-S99-6, *SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M)*. This guidance also applies to transition disclosures related to FASB ASU No. 2016-02, *Leases (Topic 842)* (Feb. 2016); and FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (June 2016).

when the transition disclosure asserts that the impact of the standard is not expected to be material to the financial statements).[9]

Auditors are required to evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.[10] This includes evaluating the company's transition disclosures regarding the new revenue standard and, if such disclosures are omitted, incomplete, or inaccurate, evaluating the effect on the financial statements and auditor's report.

Additionally, in an integrated audit, the auditor should test controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of material misstatement to the relevant assertions of significant disclosures, including transition disclosures.[11]

Auditors also have responsibilities under PCAOB standards for performing procedures with respect to transition disclosures presented in interim financial information.[12] The objective of the auditor's review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[13] The auditor's procedures in such a review are generally limited to analytical procedures, inquiries, and other

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[9] The SEC's Chief Accountant has reminded companies that the basis of any statement in disclosures that the impact of the new revenue standard is immaterial should reflect consideration of the anticipated effect of the full scope of the standard, which covers recognition, measurement, presentation, and disclosure for revenue transactions. *See* Wesley R. Bricker, SEC Chief Accountant, *Remarks before the Annual Life Sciences Accounting & Reporting Congress: "Advancing Effective Internal Control and Credible Financial Reporting"* (Mar. 21, 2017).

[10] *See* paragraph .31 of AS 2810, *Evaluating Audit Results*.

[11] *See* paragraph .39 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[12] *See* paragraph .02 of AS 4105, *Reviews of Interim Financial Information,* which defines the term "interim financial information" to mean "financial information or statements covering a period less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end."

[13] *See* AS 4105.07.

procedures that address significant accounting and disclosure matters relating to the interim financial information to be reported.[14] Examples of review procedures directed toward a company's transition disclosures include the following:

- Inquiring about the company's implementation progress and the anticipated effects of the new revenue standard on the company's financial statements. Auditors may find it necessary to make inquiries of company personnel outside of the accounting function to obtain such information.

- Obtaining evidence about whether interim transition disclosures about the new revenue standard agree or reconcile with supporting data in the company's records,[15] such as management's reports to the audit committee about the anticipated effects of the new revenue standard.

Information obtained by the auditor in performing procedures related to a company's transition disclosures may identify a concern regarding management's anticipated application of the new revenue standard. Auditors are reminded of their responsibility to communicate such concerns to the audit committee.[16]

Auditing Transition Adjustments

Obtaining an understanding of a company's selection and application of accounting principles is part of the auditor's procedures to identify and evaluate risks of material misstatement under PCAOB standards.[17] Additionally, the auditor is required to evaluate a change in accounting principle to determine whether the method of accounting for the effect of a change in accounting principle is in conformity with generally accepted accounting principles, and whether the disclosures related to the accounting change are adequate.[18]

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[14] *See* AS 4105.15.

[15] *See* AS 4105.18d.

[16] *See* paragraph .13f of AS 1301, *Communications with Audit Committees*.

[17] *See* AS 2110.12-13.

[18] *See* paragraph .07 of AS 2820, *Evaluating Consistency of Financial Statements*.

The new revenue standard provides two transition options for applying the new standard (full or modified retrospective application).[19] A full retrospective application requires the recasting of prior year financial statements as if the new standard had been applied in those years. In contrast, a modified retrospective application requires disclosure of the effect on each financial statement line item in the period of application, and explanations of significant changes between the reported results under the new standard and those that would have been reported under current accounting principles. Under either option, the company recognizes the cumulative effect of adopting the new standard against opening equity of the earliest period of application.[20]

The new revenue standard also provides optional practical expedients that may be applied during the transition.[21] The standard requires the practical expedients to be consistently applied and disclosed in the financial statements.[22]

It is important for auditors to identify and assess the risks of material misstatement associated with the company's transition adjustments[23] and design and implement audit responses that address those assessed risks. Specific considerations in assessing and responding to the risks of material misstatement of the transition adjustments include, among others, (a) internal control over financial reporting, (b) data that may not have been audited previously, (c) opportunities for committing and concealing fraud, and (d) prior-period misstatements identified in the current period's audit.

Internal controls over the transition adjustments will generally be relevant to the audit, including in selecting controls to test in an audit of financial statements (if the auditor plans to rely on such controls)[24] or an audit of internal control over financial reporting.[25] As described in Practice Alert No. 11, auditors are cautioned that a control

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[19] *See* FASB ASC subparagraph 606-10-65-1(d).

[20] *See* FASB ASC paragraph 606-10-65-1 for transition information and requirements.

[21] *See* FASB ASC subparagraph 606-10-65-1(f).

[22] *See* FASB ASC subparagraph 606-10-65-1(g).

[23] In this practice alert, journal entries or other adjustments recorded by the company to adopt the new revenue standard are referred to as "transition adjustments."

[24] *See* AS 2301.16-.18.

[25] *See* AS 2201.39.

must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.[26] This applies to evaluating evidence about the effectiveness of internal controls over the transition adjustments.

Auditing transition adjustments involves obtaining company-produced information (e.g., standalone selling prices of the distinct goods or services underlying each performance obligation). As is the case generally with company-produced information, the auditor should perform procedures to evaluate whether the information produced by the company is sufficient and appropriate for purposes of the audit.[27]

In situations where management has asserted in the financial statements that the company's transition adjustments are immaterial, it is important for auditors to perform procedures to test the accuracy of management's assertions.[28]

The transition adjustments could pose new or heightened fraud risks. For example, a company could improperly identify performance obligations or improperly allocate transaction prices to performance obligations to defer revenue in order to recognize that revenue in subsequent periods. Auditors should evaluate whether the information gathered in obtaining an understanding of the company's transition adjustments indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.[29]

When auditing the company's transition adjustments, the auditor may identify a misstatement of revenue reported in prior-period financial statements. The auditor should perform procedures described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* to determine whether or not the financial statements and auditor's report should be revised as a consequence of the misstatement.

Considering Internal Control Over Financial Reporting

PCAOB standards require the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential

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[26] *See* AS 2201.B9.

[27] *See* paragraph .10 of AS 1105, *Audit Evidence*.

[28] *See* AS 2301.36 and AS 2810.30-.31.

[29] *See* AS 2110.65.

misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[30] Changes to company processes for the implementation of the new revenue standard can affect one or more components of internal control. For example, the auditor is required to obtain an understanding of the company's control environment, including the policies and actions of management, the board of directors, and the audit committee concerning the company's control environment.[31] Under the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") internal control framework, one principle relating to the control environment is the company's commitment to attract, develop, and retain competent individuals.[32] A point of focus relating to this principle is management evaluating competence across the organization and in outsourced service providers and acting as necessary to address any shortcomings identified.[33]

In addition, new or modified processes and systems to gather contract data, develop new estimates, and support new financial statement disclosures[34] can affect the auditor's risk assessment. Performing walkthroughs can help the auditor understand the flow of transactions, evaluate the design of controls relevant to the audit, and determine whether those controls have been implemented.[35] In an audit of internal control, walkthroughs can also be an effective way to further understand the likely sources of potential misstatements and select controls to test.[36]

The following discussion highlights certain internal control-related considerations that may be relevant to auditing the implementation of the new revenue standard in audits of internal control over financial reporting and audits of financial statements.

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30 *See* AS 2110.18.

31 *See* AS 2110.23.

32 *See* COSO Internal Control – Integrated Framework (2013), Chapter 5, *Control Environment*.

33 *Id.*

34 *See, e.g.,* FASB ASU 2014-09, paragraph BC486.

35 *See, e.g.,* AS 2110.37.

36 *See* AS 2201.37.

Information System and Manual Controls

The auditor should obtain an understanding of the information system relevant to financial reporting, including, among other things, (a) the related business processes; (b) the related accounting records and supporting information used to initiate, authorize, process, and record transactions; and (c) how the information system captures events and conditions, other than transactions, that are significant to the financial statements.[37]

As discussed in Practice Alert No. 11, how a company uses or modifies its information systems (e.g., upon implementation of the new revenue standard) can affect internal controls and, in turn, the auditor's evaluation of those controls. The auditor should obtain an understanding of, among other things:

- The extent of manual controls and automated controls related to revenue used by the company, including the information technology general controls ("ITGCs") that are important to the effective operation of the automated controls;[38] and

- The specific risks to a company's internal control resulting from information technology.[39]

During the transition to the new revenue standard, some companies might utilize spreadsheets and other short-term manual processes until automated processes and controls are implemented.[40] These short-term manual processes may present different or greater risks of material misstatement than automated processes subject to effective ITGCs.

Management Review Controls

Some companies may design and implement management review controls over revenue as part of their implementation of the new revenue standard. When testing

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[37] *See* AS 2110.28 for the auditor's responsibility to obtain an understanding of the information system.

[38] *See* AS 2110.B1.

[39] *See* AS 2110.B4.

[40] *See, e.g.,* discussion of "Report back from breakout sessions: Emerging issues that may affect audits, auditors, or the PCAOB," Standing Advisory Group meeting webcast archive (May 24-25, 2017), available on the Board's website.

management review controls, PCAOB standards require the auditor to perform procedures to obtain evidence about how those controls are designed and operate to prevent or detect misstatements.[41] Practice Alert No. 11 described considerations for evaluating the precision of management review controls and identifies factors, such as the level of aggregation and the criteria for investigation, that can affect the level of precision of an entity-level control.

When selecting and testing management review controls over revenue, it is important for auditors to consider the impact of the new revenue standard on management review controls that rely on expectations based on historical operations or trends. Further, controls over the accuracy and completeness of the information used to perform the management review control can affect the control's operating effectiveness.

Reviews of Interim Financial Information

The auditor's understanding of internal control is also important when performing a review of interim financial information. The auditor should have sufficient knowledge of the company's business and its internal control as they relate to the preparation of both annual and interim financial information to:

- Identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence; and
- Select the inquiries and analytical procedures that will provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[42]

The auditor should perform procedures to update his or her knowledge of the company's business and its internal control during the interim review to (a) aid in the determination of the inquiries to be made and the analytical procedures to be performed and (b) identify particular events, transactions, or assertions to which the inquiries may

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[41] *See generally* AS 2201.42-.45. PCAOB oversight activities have frequently identified deficiencies in auditing internal control related to firms' failures to sufficiently test the design and operating effectiveness of management review controls. *See, e.g.,* PCAOB Staff Inspection Brief, *Preview of Observations from 2015 Inspections of Auditors of Issuers* (Apr. 2016); and *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting,* PCAOB Release No. 2012-006 (Dec. 10, 2012).

[42] *See* AS 4105.10.

be directed or analytical procedures applied. Such procedures should include, among other things, inquiries of management about changes to the company's business activities, and the nature and extent of changes to internal control.[43]

Identifying and Assessing Fraud Risks

The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[44] Auditors should perform substantive procedures, including tests of details that are specifically responsive to the assessed fraud risks.[45] As discussed in Practice Alert No. 12, performing such procedures involves (a) considering the ways management could intentionally misstate revenue and related accounts and how they might conceal such misstatements, and (b) designing audit procedures directed toward detecting intentional misstatements. Identifying specific fraud risks arising from implementation of the new revenue standard involves having a sufficient understanding of the standard as well as the company’s processes, systems, and controls over its implementation of the standard.

Fraud risks may exist at various levels and in different areas of a company. PCAOB standards require auditors to make certain fraud-related inquiries of management, the audit committee (or the equivalent), and others within the company.[46]

Key engagement team members, including the engagement partner, should brainstorm about how and where they believe the company's revenue and related accounts might be susceptible to fraud.[47] They should also discuss how management could perpetrate and conceal fraud, including by omitting or presenting incomplete or inaccurate disclosures.[48]

Brainstorming also includes discussing factors that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for

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[43] *See* AS 4105.11.

[44] *See* AS 2110.68.

[45] *See* AS 2301.13.

[46] *See* AS 2110.56-.57.

[47] *See generally* AS 2110.49-.52 and .68.

[48] *See* AS 2110.52.

management to perpetrate fraud, and (c) indicate a culture or environment that enables management to rationalize committing fraud.[49]

One potential incentive for fraud arises when new accounting requirements affect a company's reported financial performance. When combined with excessive pressure to meet expectations of third parties or targets set by the board of directors or management, this could create the motivation to misstate revenue to achieve these expectations.[50] For example, management could establish incorrect accounting policies and practices that achieve revenue targets when the correct application of the new revenue standard would result in revenue below expectations.

Opportunities for fraud in implementing the new revenue standard may arise in the development of significant new accounting estimates or due to control deficiencies that might result from changes made to systems, processes, and controls to implement the new standard. For example, companies may be required to develop estimates for variable consideration and standalone selling prices, which might involve subjective judgments or uncertainties that are difficult to corroborate.[51]

Certain risk factors may reflect attitudes or rationalizations by board members, management, or employees that lead them to engage in or justify fraudulent financial reporting, and may not be susceptible to observation by the auditor. Nevertheless, an auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. Examples of risk factors that might arise in connection with implementation of the new revenue standard are (a) non-financial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates, and (b) attempts by management to justify marginal or inappropriate accounting on the basis of materiality.[52]

The auditor's identification of fraud risks should also include the risk of management override of controls.[53] Controls over management override are important

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49 *Id.*

50 *See* paragraph .85A.2 of AS 2401, *Consideration of Fraud in a Financial Statement Audit.*

51 *Id.*

52 *Id.*

53 *See* AS 2110.69.

to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process.[54]

Furthermore, the auditor should emphasize to all engagement team members the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence.[55] Practice Alert No. 10 identifies a number of threats to professional skepticism inherent in the audit environment. Auditors should be mindful that circumstances related to the implementation of the new revenue standard may increase such threats in some audits.

Circumstances where a company is late in implementing the new revenue standard might create incentives and pressures on the auditor that could inhibit the exercise of professional skepticism and allow unconscious bias to prevail. Incentives and pressures may arise, for example, to avoid significant conflicts with management or provide an unqualified audit opinion prior to obtaining sufficient appropriate audit evidence. In addition, the implementation of the new revenue standard could heighten scheduling and workload demands, putting pressure on partners and other engagement team members to complete their assignments too quickly. This might lead auditors to seek audit evidence that is easy to obtain but may not be sufficient and appropriate, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence.[56]

As discussed in Practice Alert No. 12, 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.

Evaluating Whether Revenue Is Recognized in Conformity with the Applicable Financial Reporting Framework

Practice Alert No. 12 described PCAOB Inspections staff's observations of frequent significant audit deficiencies in testing the recognition of revenue. Among these were deficiencies in understanding contractual arrangements, auditing estimates, and performing substantive analytical procedures. The following are reminders of how a

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[54] *Id.*

[55] *See* AS 2110.53.

[56] *See* Practice Alert No. 10.

company's implementation of the new revenue standard might affect the application of relevant PCAOB standards in these areas.

Understanding Contractual Arrangements

The auditor's understanding of the company, its environment, and its internal control over financial reporting necessarily includes knowledge of the company's key products and services, key provisions of contractual arrangements, and the extent to which contractual terms are standardized across the company.[57] In obtaining that understanding, the auditor should be alert that, under the new revenue standard, contracts can be written, oral, or implied by an entity's customary business practices.[58]

This understanding helps the auditor identify matters important to determining whether revenue and the related costs to obtain or fulfill a contract are recognized in conformity with the new revenue standard, such as:

- How performance obligations are identified, including whether the company is acting as a principal or an agent;
- How the transaction price is determined, including estimation of variable consideration;
- How the transaction price is allocated, including determination of standalone selling price;
- When a performance obligation is satisfied and, thus, the period in which revenue should be recognized; and
- What assets should be recognized from the costs to obtain or fulfill a contract with a customer.[59]

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[57] *See* Practice Alert No. 12.

[58] *See* FASB ASC paragraph 606-10-25-2.

[59] *See* FASB ASC Topic 606 and Topic 340, *Other Assets and Deferred Costs*, for specific provisions of accounting for revenue and the related costs from contracts with customers.

Auditing Accounting Estimates Related to Revenue

Auditors are reminded of their responsibility, when auditing accounting estimates used to record revenue, to evaluate the appropriateness of the company's methods, the completeness and accuracy of company data, and the reasonableness of assumptions used in developing the estimates.[60] The auditor is also required to evaluate accounting estimates for possible bias.[61]

For many companies, the application of the new revenue standard will involve new areas of management judgment and new estimates of revenue-related amounts. Examples of such judgments and estimates include:

- Variable consideration using either the expected value method or the most likely amount method, including the constraint on recognition of variable consideration;[62]
- Fair value of noncash consideration;[63]
- Standalone selling price that is not directly observable;[64] and
- Selecting an appropriate method for measuring progress toward complete satisfaction of a performance obligation.[65]

The auditor should obtain an understanding of how management develops revenue-related estimates and use that understanding to inform the auditor's approach to testing those estimates (i.e., testing the process used by management, developing an

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[60] If the accounting estimate is a fair value measurement, the auditor should apply the requirements of AS 2502, *Auditing Fair Value Measurements and Disclosures*. For other estimates, the auditor should apply the requirements of AS 2501, *Auditing Accounting Estimates*.

[61] *See* AS 2810.27.

[62] *See* FASB ASC paragraphs 606-10-32-8 and 11.

[63] *See* FASB ASC paragraph 606-10-32-21.

[64] *See* FASB ASC paragraph 606-10-32-33.

[65] *See* FASB ASC paragraphs 606-10-55-17 to 21.

independent expectation of the estimate, or reviewing subsequent events or transactions occurring prior to the date of the auditor's report).[66]

Performing Substantive Analytical Procedures to Test Revenue

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. Such expectations are developed by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the company and the industry in which it operates.[67]

The decision about whether to use substantive analytical procedures to test revenue is based on the expected effectiveness and efficiency of those procedures.[68] Changes in accounting brought about by implementation of the new revenue standard could affect the following matters, among others, that are relevant to the auditor's determination of the expected effectiveness and efficiency of analytical procedures:

- The plausibility and predictability of relationships;
- The availability and reliability of the data used to develop expectations; and
- The precision of expectations.[69]

Auditors are also reminded that for significant risks, including fraud risks, they are required to perform tests of details that are specifically responsive to the assessed risks.[70]

Evaluating Whether the Financial Statements Include the Required Disclosures Regarding Revenue

PCAOB standards require auditors to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures. The auditor

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[66] *See generally* AS 2501.10.

[67] *See* paragraph .05 of AS 2305, *Substantive Analytical Procedures*.

[68] *See* AS 2305.09.

[69] *See* AS 2305.11.

[70] *See* AS 2301.11.

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.[71] Auditors also are required to perform procedures to address the risks of material misstatement regarding significant financial statement disclosures.[72]

Practice Alert No. 12 described significant audit deficiencies involving the failure to evaluate sufficiently whether revenue was appropriately disclosed in the financial statements. Changes in disclosure requirements under the new revenue standard could introduce new risks for auditors.

Historically, other than in accounting policies disclosures and segment reporting, most companies have provided limited information about revenue contracts.[73] Under the new revenue standard, however, a company is required to provide information about, among other things:

- Revenue recognized from contracts with customers, including a disaggregation of revenue into appropriate categories;
- Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities;
- Performance obligations, including when the company typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract;
- Significant judgments, and changes in judgments, made in applying the requirements to those contracts; and
- Quantitative and/or qualitative information about assets recognized from the costs to obtain or fulfill a contract with a customer.[74]

PCAOB standards require the auditor to obtain an understanding of the information system, including the period-end financial reporting process.[75] The new

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[71] *See* AS 2110.12.

[72] *See, e.g.,* AS 2301.08-.09 and AS 2110.59.

[73] *See* FASB In Focus, Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (*Topic 606*) (May 28, 2014) (revised Jan. 2016).

[74] *Id.*

disclosure requirements may involve updates to data, systems, processes, and controls used to develop the disclosures, and coordination with company personnel outside of the accounting function. Thus, understanding these matters will be important to the auditor's risk assessment and design of audit procedures.

A review of interim financial information generally includes procedures that address significant disclosure matters relating to the interim financial information. These procedures form part of the basis for communicating whether the auditor is aware of any material modifications that should be made to the interim financial information to conform with generally accepted accounting principles.[76] In reviewing a company's disclosures about revenue in each quarterly report in the year of adoption of the new revenue standard, it is important for the auditor to consider whether the company complied with SEC requirements to provide both the annual and the interim period financial statement disclosures prescribed by a new accounting standard.[77]

Conclusion

Because of the nature and importance of the matters covered in this practice alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when conducting their engagement quality reviews. Auditing firms may find this practice alert helpful in determining whether additional training of their personnel, revisions to their methodologies or implementation thereof, or other steps are needed to assure that PCAOB standards are followed.

Auditors and auditing firms might also find certain matters discussed in this practice alert to be relevant to their preparations for auditing the application of new accounting standards on leases and credit losses.[78]

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[75] *See* AS 2110.28. *See also* AS 2110.32, which states that a company's period-end financial reporting process includes the procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

[76] *See* AS 4105.15.

[77] *See* Article 10 of Regulation S-X, which requires disclosures about material matters that were not disclosed in the most recent annual financial statement. *See also* SEC Division of Corporation Finance Financial Reporting Manual, Section 1500 ("Interim Period Reporting Considerations (All Filings)") for further guidance regarding this requirement.

[78] *See* FASB ASU 2016-02 and FASB ASU 2016-13.

The PCAOB will continue to monitor auditing of revenue as part of its ongoing oversight activities.

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Contact Information

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Related PCAOB Resources

In compiling this practice alert the Office of the Chief Auditor considered relevant PCAOB standards and guidance, PCAOB reports and other PCAOB documents, including:

- Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* (September 9, 2014);
- Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (October 24, 2013);
- Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (December 4, 2012);
- PCAOB Release No. 2015-007, *Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No.15)* (October 15, 2015);
- PCAOB Release No. 2012-006, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (December 10, 2012); and
- Standing Advisory Group. Emerging issues that may affect audits, auditors, or the PCAOB (discussed May 24-25, 2017).