

STAFF AUDIT PRACTICE ALERT NO. 12

**MATTERS RELATED TO AUDITING REVENUE
IN AN AUDIT OF FINANCIAL STATEMENTS**

September 9, 2014

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.

Summary

For many companies, revenue is one of the largest accounts in the financial statements and is an important driver of a company's operating results. In audits under Public Company Accounting Oversight Board ("PCAOB" or "Board") standards, revenue typically is a significant account, often involving significant risks that warrant special audit consideration.

Because of the importance of auditing revenue, it often is a significant focus area in PCAOB inspections of registered firms. PCAOB Inspections staff continue to observe frequently significant audit deficiencies in which auditors did not perform sufficient auditing procedures with respect to revenue.

In light of these significant auditing practice issues observed by Inspections staff, the Office of the Chief Auditor is issuing this practice alert. This practice alert highlights certain requirements of PCAOB standards relating to aspects of auditing revenue in which significant auditing deficiencies have been frequently observed by Inspections staff.

Accordingly, this practice alert discusses the following topics, and related significant deficiencies, regarding auditing revenue:

Testing Revenue Recognition, Presentation, and Disclosure

- Testing the recognition of revenue from contractual arrangements

- Evaluating the presentation of revenue—gross versus net revenue
- Testing whether revenue was recognized in the correct period
- Evaluating whether the financial statements include the required disclosures regarding revenue

Other Aspects of Testing Revenue

- Responding to risks of material misstatement due to fraud ("fraud risks") associated with revenue
- Testing and evaluating controls over revenue
- Applying audit sampling procedures to test revenue
- Performing substantive analytical procedures to test revenue
- Testing revenue in companies with multiple locations

Auditors should take note of the matters discussed in this practice alert in planning and performing audit procedures over revenue. Audit firms should also revisit their audit methodologies, and their implementation of those methodologies, to assure that PCAOB auditing standards are followed in the area of auditing revenue. In addition, audit firms should consider whether additional training of their auditing personnel or other steps are needed to assure that PCAOB standards are followed. 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 take action to ensure that engagement teams appropriately implement the auditing standards in these areas throughout the audit and for engagement quality reviewers to focus on these matters when conducting their engagement quality reviews.

Due to the significance of revenue to many companies' financial and operating results, auditing revenue also raises matters of potential interest to audit committees. Audit committees might wish to discuss with their auditors their approach to auditing revenue, including the matters addressed in this alert.

On May 28, 2014, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board jointly adopted a converged accounting standard on revenue recognition. The new accounting standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless the contracts are within the scope of other standards (for example, insurance contracts or lease contracts are within the scope of other standards). The effective date of the new accounting

standard for public companies reporting under U.S. generally accepted accounting principles ("U.S. GAAP") is annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The effective date of the new accounting standard for companies reporting under International Financial Reporting Standards ("IFRS") is on or after January 1, 2017. Early adoption is permitted for companies that report under IFRS but not for public companies that report under U.S. GAAP. The Board's staff believes that the auditing matters discussed in this practice alert are likely to continue to have relevance to auditing revenue under the new accounting standard.

Introduction

For many companies, revenue is one of the largest accounts in the financial statements and is an important driver of a company's 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.¹ For example, PCAOB standards require auditors to presume that improper revenue recognition is a fraud risk, a type of significant risk.²

Historically, many fraudulent financial reporting cases have involved intentional misstatement of revenue. For example, according to a study published by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO Study"),³ which is based upon information disclosed by the U.S. Securities and Exchange Commission in accounting and auditing enforcement releases over a ten-year period, 61 percent of the 347 companies cited in such releases recorded revenue inappropriately, primarily by creating fictitious revenue transactions or by recording revenue prematurely.⁴ The study identified improper revenue recognition as the most common method used to report fraudulent financial statement information.⁵ Similarly, the PCAOB has settled disciplinary orders against auditors for violating PCAOB rules and standards in an audit, including violations involving failing to: (1) adequately address signs of improperly recognized revenue in significant unusual transactions; (2) sufficiently audit estimates regarding revenue, including sales returns; (3) adequately address contradictory evidence when auditing revenue; and (4) evaluate or sufficiently evaluate whether revenue was properly disclosed in the financial statements.⁶

¹ See paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

² See *id.*

³ See Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, *Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies*, COSO (May 2010), available at http://www.coso.org/documents/COSO_FRAUDSTUDY2010_001.pdf.

⁴ *Id.* at 17.

⁵ *Id.*

⁶ See *Order Making Findings and Imposing Sanctions In the Matter of Randall A. Stone, CPA, Respondent*, PCAOB Release No. 105-2014-007 (July 7, 2014); *Order Making Findings and Imposing Sanctions In the Matter of Ernst & Young*,

It is important that auditors appropriately apply professional skepticism, including when auditing revenue.⁷ Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.⁸ Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.⁹ Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks involved in auditing revenue. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.¹⁰

Because of the importance of revenue, it often is a significant focus area in PCAOB inspections of firms. Inspections staff continue to observe frequently significant

LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, Respondents, PCAOB Release No. 105-2012-001 (February 8, 2012); Order Making Findings and Imposing Sanctions In the Matter of Ray O Westergard, CPA, Respondent, PCAOB Release No. 105-2010-003 (February 17, 2010); and Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions In the Matter of James L. Fazio, CPA, Respondent, PCAOB Release No. 105-2007-006 (December 10, 2007).

⁷ See paragraph 13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

⁸ See paragraph .07 of AU sec. 230, *Due Professional Care in the Performance of Work*. See also, *Maintaining and Applying Professional Skepticism in Audits*, PCAOB Staff Audit Practice Alert No. 10 (December 4, 2012), which reminds auditors of the requirement to exercise professional skepticism throughout their audits and discusses factors that impair an auditor's skepticism and discusses steps that auditors can take to enhance their application of professional skepticism. With respect to revenue, the practice alert cites examples in which auditors failed to appropriately consider contradictory evidence when auditing revenue.

⁹ See AU sec. 316.08.

¹⁰ See AU sec. 316.13.

audit deficiencies in which auditors did not perform sufficient auditing procedures with respect to revenue, including:¹¹

- The failure to perform sufficient procedures to test whether revenue was recognized in conformity with the applicable financial reporting framework, including whether revenue was recognized in the correct period;
- The failure to evaluate, or evaluate sufficiently, whether revenue was appropriately disclosed in the financial statements;
- The failure to address fraud risks regarding revenue;
- Unsupported reliance on controls over revenue because either controls were not tested sufficiently or identified control deficiencies were not evaluated sufficiently;
- Unsupported reliance on company-generated data and reports used to audit revenue because the data and reports were not tested or not tested sufficiently;
- Insufficient testing of revenue transactions, including failure to appropriately apply audit sampling;
- The failure to perform sufficient substantive analytical procedures; and
- The failure to sufficiently test revenue in companies with multiple locations or business units.

Testing Revenue Recognition, Presentation, and Disclosure

The auditor has a responsibility to evaluate whether the company's financial statements are presented fairly, in all material respects, in conformity with the applicable

¹¹ The specific auditing deficiencies discussed in this practice alert were drawn from inspections that occurred during 2010–2012, and the nature and frequency of auditing deficiencies may vary across large and small firms—including domestic firms and international firms—and the issuers' industries. Inspections staff continue to observe similar auditing deficiencies in subsequent years' inspections across industries and firm sizes. Although this practice alert discusses topics related to frequently cited inspection observations, for a given audit, other matters also might be significant to auditing revenue, such as sales returns, rebates, allowances, credits, and collectability.

financial reporting framework.¹² This includes evaluating whether revenue was recognized in conformity with the requirements of the applicable financial reporting framework. The way in which revenue should be recognized can vary depending on, for example, the type of revenue and terms of the contractual arrangement. To audit revenue effectively, auditors should understand, among other things, the company's key products and services, and business processes that affect revenue.¹³ The auditor also is required to evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the company's relevant industry.¹⁴ For example, if a company's accounting principles for revenue recognition are more aggressive than those of its industry peers, that may indicate a risk of material misstatement.

Testing the Recognition of Revenue from Contractual Arrangements

Inspections staff observed instances—for example, with respect to construction-type or production-type contracts¹⁵ and multiple-element arrangements—in which auditors failed to perform sufficient procedures to evaluate whether a company's recognition of revenue was in conformity with the applicable financial reporting framework. In other instances, auditors failed to perform sufficient procedures to evaluate whether the revenue under a company's contractual arrangements was recognized appropriately. For example, it appeared to Inspections staff that the auditors did not perform sufficient procedures to review the company's contracts and as a result did not sufficiently understand the contractual terms and conditions, such as transfer of title, risk of loss, and delivery and acceptance. Also, in some instances, auditors identified sales contracts whose terms or conditions varied from the company's standard contract language, yet the auditors failed to evaluate the effect of such nonstandard contractual terms on the recognition of revenue.

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

¹² See paragraph 30 of Auditing Standard No. 14, *Evaluating Audit Results*.

¹³ See paragraphs 10 and 28 through 32, respectively, of Auditing Standard No. 12, which set forth the requirements for performing risk assessment procedures in these areas.

¹⁴ See paragraphs 12 and 13 of Auditing Standard No. 12.

¹⁵ In these situations, contractual arrangements might be oral or written.

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 observed instances in which auditors failed to perform procedures to evaluate the company's recognition of revenue derived from transactions involving the delivery of multiple elements in accordance with the applicable financial reporting framework. Examples of deficiencies observed by Inspections staff included the auditors' failures to:

- Evaluate each of the deliverables to determine whether they represented separate units of accounting; and
- Test the value assigned to the undelivered elements (for example, allocation of relative selling price based on vendor-specific objective evidence, third party evidence or best estimate of selling price).

Gaining an understanding of the company, its environment, and its internal control over financial reporting includes gaining an understanding of the business, the different types of sales contracts, and the controls over revenue, including the company's development of accounting estimates for revenue. Such an understanding necessarily includes knowledge of the company's key products and services and the contractual terms by which sales are made, such as the key provisions of contractual arrangements and the extent to which contractual terms are standardized across the company.¹⁶ This understanding can assist the auditor in identifying the contractual terms for standardized contracts relevant to recognizing revenue as well as to identify and evaluate the effects of nonstandard contractual terms. Further, this understanding will assist the auditor in determining the audit procedures necessary to test whether revenue was properly reported in the financial statements in conformity with the applicable financial reporting framework.

Revenue recognition often involves accounting estimates, such as estimates of future obligations under the terms of sale in the contract. If the accounting estimate is a fair value measurement, the auditor should apply the requirements of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*. For other estimates, the auditor should apply the requirements of AU sec. 342, *Auditing Accounting Estimates*, for example, when auditing accounting estimates used to record revenue in transactions involving seller performance obligations. Those standards address, among other things,

¹⁶ Understanding such contracts also involves understanding sales to related parties or significant, unusual sales transactions, which warrant additional audit attention. See, e.g., AU sec. 334, *Related Parties*, and paragraphs .66 and .67 of AU sec. 316.

the auditor's responsibilities with respect to evaluating the appropriateness of the company's methods and the reasonableness of management's assumptions used in the estimates and related disclosures, as well as the completeness and accuracy of company data used in the estimates. For example, in evaluating the reasonableness of an estimate, the auditor is required to obtain an understanding of how management developed the estimate.¹⁷ Based on that understanding, the auditor should use one or a combination of the following approaches:

1. Review and test the process used by management to develop the estimate;
2. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate; or
3. Review subsequent events or transactions occurring prior to the date of the auditor's report.¹⁸

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 (as a principal) versus a net basis (as an agent) was in conformity with the applicable financial reporting framework.¹⁹ More specifically, Inspections staff observed deficiencies in which auditors failed to evaluate whether the company is a seller that has the primary obligation to the customer or the company is a seller that is acting in the capacity of an agent, and to evaluate the effect that determination would have on presentation of revenue.

¹⁷ AU sec. 342.10.

¹⁸ AU sec. 342.10. See also AU sec. 328.23.

¹⁹ For example, under U.S. GAAP, a company would present revenue at a gross amount as the amount billed to a customer if it has earned revenue (as a principal) from the sale of the goods or service. Or the company would present revenue at the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) if it has earned a commission or fee as an agent. See FASB Accounting Standards Codification Subtopic 605-45, *Revenue Recognition—Principal Agent Considerations*.

The auditor's evaluation of audit results is required to include an evaluation of, among other things, the presentation of the financial statements.²⁰ This includes the auditor's evaluation of whether revenue is presented in conformity with the applicable financial reporting framework.

When understanding the contractual terms of sales, as discussed in "Testing the Recognition of Revenue from Contractual Arrangements," it is important for the auditor to evaluate whether the company is the principal or the agent in the transaction in order to evaluate the presentation of revenue relative to whether gross revenue or net revenue is appropriate.

Testing Whether Revenue Was Recognized in the Correct Period

Inspections staff observed instances in which auditors failed to perform, or sufficiently perform, procedures to test whether revenue was recognized in the correct period ("cutoff procedures"). Examples of such instances included:

- The failure to perform cutoff procedures to address the risk of material misstatement;
- The failure to obtain evidence about whether the necessary delivery of goods had occurred or service had been rendered to enable the company to appropriately record revenue; and
- Inappropriate reliance on untested company-generated information, such as sales invoices or inventory records, to determine whether revenue was recorded in the appropriate period.

The risk of material misstatement involving the recognition of revenue in the incorrect period might be a risk of error (for example, as a result of problems with related company systems or controls) or a risk of fraud (for example, intentionally recognizing revenue prematurely), both resulting in improper revenue recognition.

When designing and performing cutoff procedures, the auditor should plan and perform audit procedures that address the risk of material misstatement. This includes determining that the procedures are designed to detect the types of potential misstatements related to the risk and obtaining sufficient relevant and reliable (that is, appropriate) evidence regarding whether revenue transactions are recorded in the appropriate period.²¹ Further, if the risk of improper cutoff²² is related to overstatement

²⁰ Paragraph 4 of Auditing Standard No. 14.

²¹ See paragraphs 4 through 9 of Auditing Standard No. 15, *Audit Evidence*.

or understatement of revenue, it is important for the cutoff procedures to encompass testing of revenue recorded in the period covered by the financial statements and revenue recorded in the subsequent period. 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.²³

Evaluating Whether the Financial Statements Include the Required Disclosures Regarding Revenue

Inspections staff observed instances in which auditors did not evaluate whether the disclosures of revenue in the financial statements were in conformity with the applicable financial reporting framework. For example, Inspections staff observed instances in which firms did not evaluate whether the company's disclosures regarding its revenue recognition policy regarding multiple-element arrangements and warranty policies were in conformity with U.S. GAAP. In another instance, a firm failed to identify the company's omitted disclosures regarding the revenue recognition policies for the company's new line of business.

As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, PCAOB standards require the auditor to evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, 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.²⁴

PCAOB standards require auditors to perform procedures to identify and assess the risks of material misstatement of the financial statements, including consideration of

²² The risk of material misstatement due to recording revenue in the wrong period may be referred to as "the risk of improper cutoff."

²³ This example assumes that the auditor tested the accuracy and completeness or tested the controls over accuracy and completeness of company-generated information used to perform the cutoff procedures as required by PCAOB standards. See paragraph 10 of Auditing Standard No. 15.

²⁴ Paragraph 12 of Auditing Standard No. 12.

the risk of omitted, incomplete, or inaccurate disclosures.²⁵ Auditors also are required to perform procedures to address the risks of material misstatement regarding significant financial statement disclosures.²⁶ When evaluating the financial statements, auditors are required to evaluate whether the financial statements contain the information essential for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.²⁷ More specifically, the auditor is required to evaluate the disclosures, which includes, among other things:

- Evaluating whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;²⁸ and
- Considering the form, arrangement, and content of the financial statements (including the 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.²⁹

Evaluation of disclosures also involves evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures. Although evaluation of uncorrected misstatements requires consideration of relevant qualitative and quantitative factors,³⁰ qualitative considerations are especially important to the evaluation of misstatements in disclosures that are more narrative in nature. PCAOB standards describe the auditor's

²⁵ See, e.g., paragraphs 49, 52, and 67 of Auditing Standard No. 12.

²⁶ See, e.g., paragraphs 8 and 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. See also paragraph 59 and footnote 33 of Auditing Standard No. 12. A disclosure is a significant disclosure if there is a reasonable possibility that it could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

²⁷ See paragraph 31 of Auditing Standard No. 14.

²⁸ See Paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

²⁹ See Paragraph 31 of Auditing Standard No. 14.

³⁰ See Paragraph 17 of Auditing Standard No. 14.

responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.³¹

Other Aspects of Testing Revenue

PCAOB standards require the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure, which typically includes revenue.³² In designing the audit procedures to be performed, the auditor is required to: (1) obtain more persuasive audit evidence the higher the auditor's assessment of risk; (2) take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement; and (3) in a financial statement audit, design the tests of controls over revenue to obtain sufficient evidence to support the auditor's control risk assessments when the auditor relies on controls.³³

As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain to test revenue also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate audit evidence to respond to the assessed risk of material misstatement.³⁴ For example, substantive procedures for testing revenue typically involve a combination of tests of revenue transactions and substantive analytical procedures.

The following topics relate to areas where Inspections staff frequently observed significant deficiencies in the auditing procedures applied to revenue.

³¹ See, e.g., paragraph 24 and Appendix B of Auditing Standard No. 14.

³² Paragraph 8 of Auditing Standard No. 13.

³³ Paragraph 9 of Auditing Standard No. 13. Also, in an integrated audit, the auditor is required to design the tests of controls to accomplish the objectives of both audits—the audit of financial statements and the audit of internal control over financial reporting—simultaneously. See paragraph 7 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

³⁴ Paragraph 37 of Auditing Standard No. 13.

Responding to Fraud Risks Associated with Revenue

As mentioned previously, the most common fraud technique highlighted in the COSO Study involved improper revenue recognition. This underscores the importance of devoting proper audit attention to assessing and responding to fraud risks associated with revenue.

Inspections staff observed instances in which auditors failed to sufficiently respond to fraud risks associated with revenue, including the risk of improper revenue recognition. Examples of such deficiencies included the auditors' failures to:

- Identify and respond to the presumed fraud risk related to improper revenue recognition or to demonstrate how the presumption was overcome under the existing circumstances;
- Perform procedures to address an identified fraud risk related to revenue; and
- Sufficiently address an identified fraud risk related to side agreements³⁵ because the firm's planned response—confirmation procedures—resulted in a high percentage of nonresponses, for which the auditor's procedures were limited to management inquiries.

To effectively address fraud risks, it is important for auditors to devote attention to identifying and assessing fraud risks. With regard to auditing revenue, 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.³⁶

Published studies have identified a number of different fraud schemes involving material misstatement of revenue, including schemes involving fictitious revenue transactions or recording revenue prematurely.³⁷ Specific examples of techniques involving improper revenue recognition described in the COSO Study include: (1) sham

³⁵ Side agreements are agreements with customers that modify the terms and conditions of the company's standard sales contracts. Undisclosed side agreements can be used to inappropriately manipulate the recognition of revenue.

³⁶ See paragraph 68 of Auditing Standard No. 12.

³⁷ See, e.g., the COSO Study at 18.

sales;³⁸ (2) recording transactions even though the sales involved unresolved contingencies; (3) round-tripping³⁹ or recording loans as sales; (4) improper recording of sales from bill and hold transactions that did not meet the criteria for revenue recognition; (5) recording revenues before all the terms of the sales were completed; (6) improper cutoff of sales; (7) improperly accelerating the estimated percentage of completion method for projects in process; (8) shipping goods never ordered by the customer or shipping defective products and recording revenues at full, rather than discounted, prices; and (9) recording revenue for consignment shipments or shipments of goods for customers to consider on a trial basis.⁴⁰

When addressing fraud risks in the audit of the financial statements, PCAOB standards require auditors to perform substantive procedures, including tests of details, that are *specifically responsive* to the assessed fraud risks.⁴¹ Performing procedures that are specifically responsive involves considering the ways that revenue could be intentionally misstated and how the fraud might be concealed⁴² and designing audit procedures directed toward detecting intentional misstatements. 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 design and perform procedures that seek reliable evidence that would be difficult for potential perpetrators to manipulate, such as evidence obtained directly from independent and knowledgeable

³⁸ The COSO Study describes sham sales by noting situations in which "company representatives often falsified inventory records, shipping records, and invoices [to conceal the fraud]. In some cases, the company recorded sales for goods merely shipped to another company location. In other cases, the company pretended to ship goods to appear as if a sale occurred and then hid the related inventory, which was never shipped to customers, from company auditors." Id. at 18.

³⁹ The COSO Study describes round-tripping by noting that "[s]ome companies recorded sales by shipping goods to alleged customers and then providing funds to the customers to pay back to the company." Id. at 18.

⁴⁰ Id. at 18.

⁴¹ Paragraph 13 of Auditing Standard No. 13.

⁴² See, e.g., paragraph 52 of Auditing Standard No. 12, regarding "brainstorming" among engagement team members about how fraud could be perpetrated and concealed.

sources outside the company. Merely increasing the extent of testing (for example, using larger sample sizes) without designing procedures to obtain more reliable evidence is unlikely to adequately respond to a fraud risk of material misstatement in the financial statements.

Incorporating an element of unpredictability in audit procedures⁴³ also is important in responding to fraud risks. Unpredictable audit procedures are more difficult for individuals looking to perpetrate a fraud to anticipate, which can make an intentional misstatement more difficult to conceal. Examples of ways to incorporate an element of unpredictability when testing revenue include:

- Performing audit procedures related to components of revenue or assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk;
- Varying the timing of the audit procedures;
- Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;
- Performing audit procedures on an unannounced basis; and
- In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.⁴⁴

As noted previously, the application of professional skepticism is important in assessing and responding to fraud risks. This includes, among other things, performing procedures to obtain evidence regarding management's representations, being alert for contrary evidence, and critically evaluating the audit evidence obtained.

Testing and Evaluating Controls over Revenue

In many audits, auditors rely on controls to reduce their substantive testing of revenue, for example, reducing the extent of their testing through smaller sample sizes. Auditors typically use this approach in integrated audits of financial statements and internal control over financial reporting and may use this approach in audits of financial statements only.

⁴³ Paragraph 5(c) of Auditing Standard No. 13.

⁴⁴ Id.

Inspections staff observed instances in which auditors relied on controls over revenue to reduce their substantive testing, but their reliance was unsupported because:

- The testing of controls was insufficient (for instance, auditors failed to test controls over the entire period for which the firm relied on controls or failed to perform sufficient procedures to test controls over significant categories of revenue);⁴⁵
- The results of the testing identified control deficiencies indicating that the controls were ineffective; or
- The auditor failed to perform sufficient procedures to test the design and operating effectiveness of the company's controls over a significant category of revenue because it failed to evaluate whether the control addressed the relevant assertions for revenue.

Unsupported reliance on internal control can lead to inadequate substantive testing of revenue.

PCAOB standards provide that, if 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 controls⁴⁶ and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing, and being relied upon, are designed effectively and operated effectively during the entire period of reliance.⁴⁷ Not having evidence to

⁴⁵ For other examples of insufficient testing of controls, see *Considerations for Audits of Internal Control Over Financial Reporting*, PCAOB Staff Audit Practice Alert No. 11 (October 24, 2013).

⁴⁶ Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures. See footnote 12 of Auditing Standard No. 13.

⁴⁷ Paragraph 16 of Auditing Standard No. 13. See also Appendix A of Auditing Standard No. 13, which defines "period of reliance" as the period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

support the auditor's reliance on controls for the entire period of reliance results in insufficient audit work. Also, it is important for the auditor to select for testing controls that address the risks of material misstatement for the categories of revenue for which the auditor intends to rely on controls.

PCAOB standards require the auditor to test the design and operating effectiveness of the controls selected for testing by determining whether the controls are (1) operating as designed by persons possessing the necessary authority and competence to perform the control effectively, and (2) satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.⁴⁸

When the auditor detects deficiencies in controls over revenue on which the auditor plans to rely, PCAOB standards require the auditor to evaluate the severity of the control deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion but the controls that the auditor tests are ineffective because of control deficiencies, the auditor is required to:

1. Perform tests of other controls related to the same assertion as the ineffective controls; or
2. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.⁴⁹

Applying Audit Sampling Procedures to Test Revenue

Designing substantive tests of details includes determining the means of selecting items for testing from among the items included in an account. The auditor is required to determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure.⁵⁰ The alternative means of selecting items for testing are:

- Applying audit sampling;
- Selecting specific items; and

⁴⁸ Paragraphs 19 and 21 of Auditing Standard No. 13.

⁴⁹ Paragraph 34 of Auditing Standard No. 13.

⁵⁰ Paragraph 22 of Auditing Standard No. 15.

- Selecting all items.⁵¹

Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.⁵² AU sec. 350 establishes requirements for planning and performing audit sampling procedures, and evaluating the results of such procedures.

Inspections staff observed instances in which auditors did not appropriately design and perform sampling procedures to test revenue transactions. Instances of such deficiencies included:

- Using samples that were too small to provide sufficient audit evidence;
- Failing to select a representative sample of items for testing, which is necessary to be able to extend the auditor's conclusions to the entire population (for example, limiting the sample selection to certain types of revenue transactions or contracts within the population); and
- Failing to apply audit procedures to all of the sample items selected and inappropriately evaluating the sample results as if the untested sample items were tested without exception.

Determining Sample Sizes

Under PCAOB standards, to determine the number of items to be selected in a sample for a particular substantive test of details, such as when testing revenue, the auditor should take into account the following factors:

- Tolerable misstatement for the population;
- The allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and

⁵¹ Id.

⁵² Paragraph .01 of AU sec. 350, *Audit Sampling*.

- The characteristics of the population, including the expected size and frequency of misstatements.⁵³

Although auditors may use statistical or nonstatistical sampling methods, PCAOB standards provide that when circumstances are similar, the effect on sample size of the factors discussed in the previous paragraph should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.⁵⁴

Choosing a Representative Sample

Auditors typically use sampling methods to be able to test a portion of a population and extend the conclusions about the sample to the entire population. To do that, the sample of items selected for testing must be representative of the entire population. Otherwise, the auditor's conclusion applies only to the items tested rather than the entire population.

Under PCAOB standards, a sample is representative if all of the items in the population have an opportunity to be selected.⁵⁵ Items may be selected randomly, systematically, or haphazardly.⁵⁶ The following are examples of selection methods for testing revenue transactions that are not representative of the entire population of revenue:

- Testing all revenue transactions over a specified amount or with specified characteristics;

⁵³ AU sec. 350.23.

⁵⁴ AU sec. 350.23A., which became effective for audits of fiscal years beginning on or after December 15, 2010.

⁵⁵ AU sec. 350.39.

⁵⁶ AU sec. 350.24. Haphazard selection refers to selection without conscious bias.

- Testing only the unpaid revenue transactions that compose accounts receivable;⁵⁷ and
- Limiting the sample selection to certain days, weeks, or months during the year rather than selecting from the entire population.

Testing Sample Items

The auditor should apply the planned audit procedures to each sample item selected.⁵⁸ In some circumstances, the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, 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.⁵⁹ Instead, the untested item should be treated as a misstatement and projected to the population along with other misstatements.

However, if considering those unexamined items to be misstated would lead to a conclusion that revenue contains material misstatement, the auditor should consider alternative procedures that would provide him or her with sufficient evidence to form a conclusion. The auditor also should evaluate whether the reasons for his or her inability to examine the items have: (1) implications in relation to his or her risk assessments, including the assessment of fraud risk; (2) implications regarding the integrity of management or employees; and (3) possible effects on other aspects of the audit.⁶⁰

Selecting Specific Items Not Involving Sampling

Selecting specific items refers to testing all items in a population that have a specific characteristic.⁶¹ For example, the auditor may decide to select for testing all of

⁵⁷ In this example, the auditor might use sampling and extend his or her conclusions to the population of accounts receivable but could not apply those conclusions to all revenue transactions for the year (except for rare instances in which the accounts receivable and revenue populations are identical).

⁵⁸ AU sec. 350.25.

⁵⁹ Id.

⁶⁰ Id.

⁶¹ Paragraph 25 of Auditing Standard No. 15.

the revenue transactions that have certain size, risk, or other characteristics ("key item testing"). In those cases, the auditor should remove those selected items from the population and apply audit sampling or other substantive procedures to the remaining transactions.⁶² This type of approach can be particularly effective when the revenue account consists of: (1) relatively few transactions that have large amounts or a higher risk of material misstatement, and (2) a great volume of transactions with lower amounts and lower risks of material misstatement.

As indicated above, the application of audit procedures to selected specific items does not constitute audit sampling, so the results of those audit procedures cannot be projected to the entire population.⁶³ Separately testing the largest revenue transactions can lower the size of the sample population and the necessary sample size. Separately testing the higher-risk transactions—and applying audit sampling to the low-risk transactions—can reduce the assurance needed from the sampling procedure and the necessary sample size.⁶⁴ However, auditors cannot limit their substantive procedures solely to key item testing if the remaining portion of the account has a risk of material misstatement, that is, if there is a reasonable possibility that the remaining portion could have a misstatement that, individually or in combination, would result in material misstatement of the financial statements.⁶⁵ In those situations, the auditor should design and perform audit procedures to address the assessed risks of material misstatement in that remaining untested portion of the account.⁶⁶ Furthermore, the auditor cannot obtain sufficient appropriate audit evidence about one group of items in a population by examining dissimilar items in the population.⁶⁷

⁶² See paragraphs 25 and 27 of Auditing Standard No. 15 and paragraph 21 of AU sec. 350.

⁶³ Paragraph 27 of Auditing Standard No. 15.

⁶⁴ Paragraph 22 of AU sec. 350 also provides that the auditor may be able to reduce the required sample size for a particular test by separating the sample population into relatively homogenous groups based on some characteristic related to the test objective.

⁶⁵ For example, a risk of material misstatement typically exists when the remaining portion of revenue is material.

⁶⁶ See paragraphs 8 and 9 of Auditing Standard No. 13.

⁶⁷ See *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release 2009-007 (December 17, 2009), at A9-64.

Performing Substantive Analytical Procedures to Test Revenue

Analytical procedures are an important part of the audit process when they are properly designed and performed.⁶⁸ Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.⁶⁹ Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.⁷⁰

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.⁷¹ Depending on the level of assurance the auditor desires from substantive testing for a particular audit objective, the auditor decides, among other things, which procedure or combination of procedures can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance.⁷²

Analytical procedures performed as substantive procedures involve, among other things, investigation of significant differences from expected amounts and obtaining evidence regarding management's explanations of significant unexpected differences. When properly applied under appropriate conditions,⁷³ substantive analytical procedures can identify potential material misstatement in an account, such as revenue.

⁶⁸ See Paragraphs .02 and .10 of AU sec. 329, *Substantive Analytical Procedures*.

⁶⁹ AU sec. 329.02.

⁷⁰ Id.

⁷¹ AU sec. 329.04.

⁷² AU sec. 329.10.

⁷³ Such conditions include having: (1) a plausible and predictable relationship between the account and the information to which it is compared and (2)

Inspections staff observed instances in which firms' performance of substantive analytical procedures for testing revenue were insufficient. For example, Inspections staff observed instances in which auditors, when using substantive analytical procedures that were intended to achieve a high level of assurance:

- Failed to develop expectations that were sufficiently precise, for example, because the expectations did not appropriately disaggregate data to identify potential material misstatements;
- Did not determine that there was a plausible and predictable relationship among the data used in the substantive analytical procedure, which is necessary to develop suitable expectations of the recorded amount of revenue;
- Did not establish an amount of difference from the expectation that could be accepted without further investigation;
- Did not investigate significant differences from expectations;
- Failed to perform procedures to obtain evidence to corroborate management's responses regarding significant unexpected differences with other evidential matter; and
- Failed to test the completeness and accuracy of the information obtained from the company that was used in performing analytical procedures.

Designing Substantive Analytical Procedures

It is important for auditors to design their substantive analytical procedures to provide the necessary level of assurance regarding the assertion being tested. The level of assurance that is needed from a substantive analytical procedure depends on:

1. The risk of material misstatement, considering reliance on controls when appropriate, for the relevant assertion being tested; and

reliable data available. See paragraphs .13 through .16 in AU sec. 329. Substantive analytical procedures alone are not sufficient to respond to significant risks, including fraud risks. Under PCAOB standards, the audit procedures to respond to significant risks should include substantive tests of details. See paragraphs 11 and 13 of Auditing Standard No. 13.

2. The assurance provided by other substantive procedures directed to the same assertion as the analytical procedure.⁷⁴

As the assessed risk of material misstatement increases, the level of assurance needed from substantive procedures also increases.⁷⁵ That assurance might be provided through a combination of substantive analytical procedures and substantive tests of details. The lower the level of assurance provided by tests of details, the greater the assurance needed from substantive analytical procedures. For example, if the risk of material misstatement is high and no other substantive procedures are performed, a high level of assurance would be needed from the substantive analytical procedures. However, under PCAOB standards, substantive analytical procedures alone are not sufficient to respond to fraud risks or other significant risks; therefore, tests of details also are needed in those situations.⁷⁶

To achieve the necessary level of assurance from a substantive analytical procedure, the auditor should design and perform analytical procedures that appropriately take into account, among other things, the following:

1. The nature of the assertion;
2. The plausibility and predictability of the relationship;
3. The availability and reliability of the data used to develop the expectation;
4. The precision of the expectation;⁷⁷ and
5. The threshold for investigation of differences.⁷⁸

Plausibility and predictability of relationships. Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by

⁷⁴ See generally Auditing Standard No. 8, *Audit Risk*, and Auditing Standard No. 13. See also AU sec. 350.48, which discusses the relationship among the components of audit risk in an audit of financial statements.

⁷⁵ Paragraph 37 of Auditing Standard No. 13.

⁷⁶ See paragraphs 11 and 13 of Auditing Standard No. 13.

⁷⁷ AU sec. 329.11.

⁷⁸ AU secs. 329.20–.21.

identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the company and its environment. Following are examples of sources of information for developing expectations:

1. Financial information for comparable prior period(s) giving consideration to known changes;
2. Anticipated results, for example, budgets, or forecasts including extrapolations from interim or annual data;
3. Relationships among elements of financial information within the period;
4. Information regarding the industry in which the company operates—for example, gross margin information; and
5. Relationships of financial information with relevant nonfinancial information.⁷⁹

An understanding of the reasons that make relationships plausible is important for the auditor to understand since data sometimes might appear to be related when they are not, which could lead the auditor to erroneous conclusions.⁸⁰ Such an understanding generally requires knowledge of the company and its industry.⁸¹

As higher levels of assurance are needed from analytical procedures, more predictable relationships are required to develop the expectation.⁸² Relationships typically are less predictable when there are less stable environments or when amounts are determined from complex processes, subjective judgments, or transactions subject to management discretion.⁸³ On the other hand, relationships might be more predictable if they are based on established relationships, such as, cash flows based on contract terms (when nonpayment risk is low) and verifiable rate-volume determinations.

⁷⁹ AU sec. 329.05.

⁸⁰ AU sec. 329.13.

⁸¹ See AU 329.03. See also Auditing Standard No. 12, which establishes requirements for understanding the company and its environment, including its industry.

⁸² AU sec. 329.14.

⁸³ Id.

Inspections staff observed instances in which auditors did not take into account the plausibility and predictability of relationships when performing substantive analytical procedures to audit revenue. For example:

- The auditor failed to establish the plausibility and predictability of relationships that would support the expectations by not considering any known changes in revenue, including unusual transactions in the prior period and planned growth; and
- The auditor established its expectation for revenue based on a historical average of peer companies, without determining that such an average was predictive of the company's current year revenue.

Availability and reliability of data. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.⁸⁴

The auditor also should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:

- Whether the data was obtained from independent sources outside the entity or from sources within the entity;
- Whether sources within the entity were independent of those who are responsible for the amount being audited;
- Whether the data was developed under a reliable system with adequate controls;
- Whether the data was subjected to audit testing in the current or prior year; and

⁸⁴

AU sec. 329.16.

- Whether the expectations were developed using data from a variety of sources.⁸⁵

Furthermore, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.⁸⁶

Inspections staff observed instances in which auditors did not test the completeness and accuracy of internal data used in applying substantive analytical procedures to test revenue. For example, in one instance, the auditor did not test the completeness and accuracy of company-generated data used in a substantive analytical procedure for revenue. In another instance, the auditor tested certain information technology general controls for a system that processed revenue transactions. But the auditor did not test controls over the system queries used to obtain the data from the system that processed the revenue for purposes of performing substantive analytical procedures nor perform other procedures to test the completeness and accuracy of the data applied in the substantive analytical procedures.

Precision of the expectation. The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements—individually or when aggregated with other misstatements—would be identified for the auditor to investigate.⁸⁷

The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation. For example, revenue may be affected by prices, volume, and product mix. Each of these, in turn, may be affected by a number of factors, and offsetting factors can obscure misstatements. More effective identification of factors that significantly affect the

⁸⁵ Id.

⁸⁶ AU sec. 329.10.

⁸⁷ AU sec. 329.17.

relationship is generally needed as the desired level of assurance from analytical procedures increases.⁸⁸

Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the company, its size, and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.⁸⁹

Inspections staff observed instances in which auditors did not develop expectations, or the auditors' expectations were not sufficiently precise. In some of those instances, the substantive analytical procedures consisted only of comparing the company's total annual revenue to the prior year.

Threshold for investigation. In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.⁹⁰

Inspections staff observed instances in which substantive analytical procedures were aimed at achieving a high level of assurance regarding revenue, but the auditor's threshold for evaluating differences was too high; in some cases, at levels that significantly exceeded the auditor's established level of materiality for the financial statements.

Performing the Planned Substantive Analytical Procedures

Performance of substantive analytical procedures involves making the comparisons of relationships as designed, including evaluating significant unexpected

⁸⁸ AU sec. 329.18.

⁸⁹ AU sec. 329.19.

⁹⁰ AU sec. 329.20.

differences.⁹¹ Although evaluating significant unexpected differences might begin with inquiry of management, management's responses should ordinarily be corroborated with other evidential matter. When an auditor cannot obtain an explanation for the difference, the auditor is required to perform other audit procedures about the assertion to determine whether the difference represents a misstatement in the financial statements.⁹²

Inspections staff observed instances in which auditors failed to perform procedures to corroborate management's explanations for significant unexpected differences or alternatively to perform additional substantive audit procedures in response to significant unexpected differences.

Testing Revenue in Companies with Multiple Locations

Inspections staff 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 material misstatement of the financial statements. For example:

- The auditor relied on entity-level controls to reduce the substantive testing of revenue at certain locations but failed to evaluate the effects of identified deficiencies in those controls; and
- The auditor planned to use the work of internal auditors with respect to certain locations, but the auditor failed to evaluate whether the work of 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. This includes determining locations and business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units.⁹³

⁹¹ AU sec. 329.21.

⁹² See paragraphs 8 and 35 of Auditing Standard No. 14. See also AU sec. 329.21.

⁹³ Paragraph 11 of Auditing Standard No. 9, *Audit Planning*.

The auditor is required to assess the risk of material misstatement to the consolidated financial statements that is associated with the locations or business units. In determining the amount of audit attention the auditor should devote to the location or business unit, the auditor is required to correlate such audit attention with the degree of risk of material misstatement associated with that location or business unit.⁹⁴

Auditing Standard No. 9 lists the following factors that are relevant to the assessment of the risk of material misstatement associated with a location or business unit and the determination of the necessary audit procedures:

1. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, for example, significant transactions executed at the location or business unit that are outside the normal course of business for the company or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;⁹⁵
2. The materiality of the location or business unit;⁹⁶
3. The specific risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements;
4. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;
5. The degree of centralization of records or information processing;
6. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others

⁹⁴ Id.

⁹⁵ AU sec. 316.66 discusses the auditor's requirements for evaluating the company's business rationale for significant unusual transactions.

⁹⁶ Paragraph 10 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

and its ability to effectively supervise activities at the location or business unit; and

7. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.⁹⁷

Sometimes, the auditor might rely on controls at one or more selected locations. These controls might be entity-level controls to address the risk of material misstatement of revenue at certain locations. In those cases, the auditor should determine whether the selected control is designed and operates at a level of precision that would prevent or detect misstatements that, individually or in combination, would result in a material misstatement of the company's financial statements.⁹⁸

In some situations, auditors might use the work of internal auditors to obtain evidence regarding revenue at selected locations. In those situations, the auditor should look to the requirements of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which describes the extent to which the auditor can use the work of internal auditors and establishes requirements for testing that work. Pursuant to AU sec. 322, the extent to which the auditor can use the work of internal auditors depends on, among other things, the competence and objectivity of the internal auditor and the risk associated with the location at which the work is performed.⁹⁹

Conclusion

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

Auditors should take note of the matters discussed in this practice alert in planning and performing audit procedures over revenue. Audit firms should also revisit

⁹⁷ See paragraph 12 of Auditing Standard No. 9. Also, when performing an audit of internal control over financial reporting, refer to Appendix B, "Special Topics," of Auditing Standard No. 5 for considerations when a company has multiple locations or business units.

⁹⁸ See paragraphs 19 and 21 of Auditing Standard No. 13 and paragraph 23 of Auditing Standard No. 5.

⁹⁹ See AU secs. 322.09–.11 and .18–.22.

their audit methodologies, and their implementation of those methodologies, to assure that PCAOB auditing standards are followed in the area of auditing revenue. In addition, audit firms should consider whether additional training of their auditing personnel or other steps are needed to assure that PCAOB standards are followed. 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 take actions to ensure that engagement teams appropriately implement the auditing standards in these areas throughout the audit and for engagement quality reviewers to focus on these matters when conducting their engagement quality reviews.

Due to the significance of revenues to many companies' financial and operating results, auditing revenue also raises matters of potential interest to audit committees. Audit committees might wish to discuss with their auditors their approach to auditing revenue, including the matters addressed in this alert.

The PCAOB will continue to monitor developments in this area. The Board, or its staff, will determine whether additional steps regarding development of a potentially new standard-setting project or other guidance for auditors to enhance audit quality with the goal of protecting investors should be taken.

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Other Related PCAOB Resources

Considerations for Audits of Internal Control Over Financial Reporting, PCAOB Staff Audit Practice Alert No. 11 (October 24, 2013), available at http://pcaobus.org/Standards/QandA/10-24-2013_SAPA_11.pdf.

Maintaining and Applying Professional Skepticism in Audits, PCAOB Staff Audit Practice Alert No. 10 (December 4, 2012), available at http://pcaobus.org/Standards/QandA/12-04-2012_SAPA_10.pdf.