No. 2017-34
10 October 2017

To the Point

PCAOB – staff alert

How companies should prepare for the audit of the new revenue standard

The PCAOB staff highlighted the importance of a company having controls over the processes it uses to implement the new revenue standard.

What you need to know

- The PCAOB staff issued a practice alert discussing what auditors need to do to audit a company's implementation of the new revenue recognition standard.
- While the alert is aimed at auditors, it provides a roadmap for management about how to prepare for the audit of the company's implementation of the new standard.
- Companies need to be prepared to support their transition disclosures and adjustments and need to have controls in place over their processes during implementation and after adoption.

Overview

The staff of the Public Company Accounting Oversight Board (PCAOB) issued a practice alert that provides a roadmap for management about how to prepare for the audit of a company's implementation of the new revenue recognition standard.

In the alert, the PCAOB staff discusses what auditors need to do to audit a company's transition disclosures and transition adjustments, identify and assess fraud risks, and evaluate whether revenue is recognized appropriately and whether the financial statements include appropriate disclosures. The alert also addresses internal control over financial reporting and highlights the importance of a company having effective controls over the processes it uses to implement the standard and to apply it after adoption. This publication is intended to help management understand the testing and documentation that is required in an interim review and an audit.

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Key considerations

The PCAOB staff noted that, for many companies, revenue is one of the largest accounts in the financial statements and is an important driver of operating results.

Transition disclosures

The PCAOB staff noted that PCAOB standards require auditors to perform procedures to identify and assess the risks of material misstatement of the financial statements, including the risk of omitted, incomplete or inaccurate disclosures. These include substantive procedures to test the relevant assertions of significant financial statement disclosures.

The PCAOB staff said in the alert that this requirement applies to disclosures companies make about the new revenue standard in the notes to the financial statements, including a disclosure asserting that the impact of the standard is not expected to be material to the financial statements.

In an integrated audit, the auditor also tests 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 about the new revenue standard. The PCAOB staff noted that auditors also have a responsibility to review the disclosures companies make about the new revenue standard as part of a review of interim financial information in the periods leading up to adoption. The objective of those reviews is to provide auditors with a basis for communicating whether they are aware of any material modifications that should be made to the interim financial information for it to conform with US GAAP. The PCAOB staff also provided examples of review procedures directed at transition disclosures, which included inquiring about the company's implementation progress and the anticipated effects of the new revenue standard, and obtaining evidence about whether interim transition disclosures agree or reconcile with supporting data in the company's records.

Auditors who identify a concern regarding management's anticipated application of the new revenue standard have a responsibility to communicate their concerns to the audit committee, the PCAOB staff said.

How we see it

Companies may need a suite of controls to address the risks associated with the transition disclosures and the finalization of the transition adjustments in the year of adoption. For example, a company may need controls over its process of grouping contracts for analysis, its reviews of those contracts and its development of new policies to address the risk that terms that have an accounting effect are not identified.

Risk assessment

Companies may need to change existing systems, processes and controls or develop new ones to gather information in order to make estimates required by the new standard and provide the required disclosures.

The PCAOB staff said auditors need to consider in their risk assessment whether any changes the company made to its systems, processes and controls increase the risk of material misstatement. The staff noted that making these changes can heighten the risk of material misstatement, including fraud risks, if the changes are designed or implemented inadequately or ineffectively. Auditors also need to address the risks of material misstatement associated with the company's transition adjustments and design and implement audit responses that address those risks, the PCAOB staff said. To audit these adjustments, auditors will have to perform procedures to determine whether information produced by the company about items, such as the standalone selling price of a good or service, is sufficient and appropriate for use in the audit, the staff said. The PCAOB staff also said that if management has asserted in the financial statements that the company's transition adjustments are immaterial, the auditor will need to perform procedures to test the accuracy of that assertion.

How we see it

Companies that are behind schedule on implementation face a higher risk of deficiencies in controls over both implementation and reporting after adoption due to the abbreviated time period to design and implement them. It is critical that these companies accelerate their progress on implementation and make sure they have controls in place to address the new risks.

Changes a company makes to its systems, processes and controls may increase the risk of material misstatement.

Fraud risks

Implementing the standard may create new fraud risks, including new incentives or pressures for management to commit fraud, provide an opportunity for management to perpetrate fraud or facilitate a culture or environment that enables management to rationalize committing fraud. For example, due to incentives or pressures for a company to achieve a certain level of financial performance, a company could improperly identify performance obligations or improperly allocate transaction prices to performance obligations in an effort to defer revenue recognition into subsequent periods. The PCAOB staff said auditors will need to evaluate whether the information they gather to obtain an understanding of the company's transition adjustments indicates that one or more fraud risk factors are present and need to be considered as part of the assessment of fraud risks.

The PCAOB staff reminded auditors that they need to plan and perform audit procedures to address risks related to any new opportunities for fraud. These opportunities may arise due to the increase in accounting estimates companies will make under the standard. For example, companies that are required to develop estimates for variable consideration and standalone selling prices might make subjective judgments that are difficult to corroborate. A control deficiency that might result from changes a company makes to its systems and processes could also be exploited.

Internal control considerations

The PCAOB staff noted that changes a company makes to its processes when it implements the new revenue standard can affect one or more components of internal control over financial reporting. Auditors will need to consider these changes when they 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.

Auditors need to evaluate the design and test the operating effectiveness of controls. Entities need to perform a risk assessment and identify controls over both the implementation process and their ongoing accounting. Public companies that use the 2013 Committee of Sponsoring Organizations of the Treadway Commission Internal Control — Integrated Framework need to consider all five components of that framework.

Some companies may design and implement management review controls over revenue as part of their implementation of the new standard. When testing management review controls, auditors are required by PCAOB standards to perform procedures to obtain evidence about how those controls are designed and operate to prevent or detect misstatements.

When testing management review controls over revenue, auditors need to consider the effect of the new revenue standard on management review controls that rely on expectations based on historical operations or trends. The PCAOB staff reminded auditors that controls over the accuracy and completeness of the information used to perform the management review control can affect whether it operates effectively.

How we see it

Management needs to make sure everyone in the organization understands the importance of appropriately implementing the standard, including the importance of controls and the emphasis placed on them in determining the company's policies and processes. The company's controls over implementation should provide sufficient evidence that the complete population of contractual terms that are relevant to the development of new accounting policies have been identified, especially if the entity has a lot of nonstandard contracts.

Information technology considerations

During the transition, companies may use spreadsheets and other manual processes to track information while automated processes and controls are being implemented. The PCAOB staff noted that these manual processes may present different or greater risks of material misstatement than automated processes that are subject to effective information technology general controls. The PCAOB staff said the auditor needs to plan and perform procedures to address both the manual and automated controls a company uses.

Estimates

The new revenue standard requires entities to make more estimates and use more judgment than legacy guidance. Key judgments and estimates include identifying contracts and performance obligations in contracts, estimating the amount of variable consideration to include in the transaction price (including application of the constraint) and allocating the transaction price to each performance obligation based on its standalone selling price.

The PCAOB staff said auditors need to obtain an understanding of how management develops revenue-related estimates and use that understanding to inform their approach to testing the estimates (e.g., testing the process used by management, developing an independent expectation of the estimate or reviewing subsequent events or transactions that occur after the balance sheet date but before the auditor's report is issued).

Disclosures

The new revenue standard requires significant new disclosures that could introduce new risks for auditors. To comply with the new disclosure requirements, a company may need to update its data, systems, processes and controls used to develop the disclosures and increase coordination between company personnel inside and outside of the accounting department. The PCAOB staff said the auditor needs to understand the new processes, including information systems, and perform audit procedures.