CPAB CASE STUDY 1 - Auditing revenue recognition – fraud risk identification and assessment

Source: "Fraud thematic review", cpab exchange, May 2022, p. 11, see ww.cpab-ccrc.ca
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Overview – *This case illustrates how an assurance engagement team presumed controls to be adequate without being sufficiently skeptical to actually test if controls were being overridden by senior management or financial matters were too complex to be assessed correctly by non-senior management.*

1. Case facts

- The entity supplies vehicle parts to automobile manufacturers.
- The entity had been growing rapidly and that attracted more coverage of its stock by equity analysts.

2**. Engagement team's conclusions**

Fraud risk factors identified

The engagement team identified that equity analysts were valuing the entity's stock based on aggressive year-over-year revenue growth targets and that a significant proportion of management's remuneration was contingent on the stock's performance.

Identified and assessed fraud risks

The engagement team determined that although there were pressures on management to meet analysts' expectations, management did not have the opportunity to inflate revenues recognized. The entity recognizes revenue when parts are delivered to customers (i.e., product deliveries satisfy the entity's performance obligations). However, <u>because the engagement team assumed that tampering of delivery dates would be readily detected by the entity's control activities, they concluded that revenue recognition for the entity was not susceptible to fraud risks</u>.

Procedures performed to respond to assessed risks

The engagement team adopted a substantive approach (i.e., did not rely on internal controls) to respond to assertion-level risks arising from possible errors in revenue recognized during the period.

For a sample of sales transactions, the engagement team reviewed sales agreements to identify unusual terms. They also matched details in that sample of sales transactions to shipping documents, billing invoices and customer payments to identify exceptions that could be indicative of errors in revenue recognition.

3. Analysis

Risk identification and assessment

The engagement team did not have a persuasive argument to support their rebuttal of the presumption that there are fraud risks associated with revenue recognized by the entity during the reporting period[18].

Generally, a rebuttal of the fraud risk presumption in revenue recognition is reasonable when an entity has relatively simple revenue streams and no related assertion-level fraud risks, before considering the entity's controls. However, the engagement team assumed (i.e., without any testing) that controls at the entity would detect fraudulent financial reporting schemes to inflate revenues. Controls are not considered when rebutting the fraud risk presumption in revenue recognition because controls are susceptible to being overridden by management.

Finally, the engagement team failed to revisit[19] their fraud risk assessment when they identified unusual and complex bill-and-hold arrangements while performing their substantive tests.

Responses to assessed risks

The engagement team's failure to appropriately identify and assess fraud risks also meant that the substantive evidence obtained was not sufficient or appropriate.

Although the engagement team identified that the entity had entered into bill-and-hold transactions with several customers in the last quarter of the reporting period, the evidence obtained was not sufficient to support the engagement team's conclusions that revenue had been appropriately recognized during the reporting period.

Bill-and-hold transactions are very complex, as are the related accounting requirements. The engagement team did not consult with the firm's technical accounting leaders for help in determining whether the transactions had commercial substance or, alternatively, whether they were entered into to fraudulently shift revenues to the reporting period.

4. Lessons learned

Identified fraud risk factors need to be carefully evaluated by more senior members of the engagement team because they could be indicative of the existence of fraud.

Controls should not be considered when determining whether to rebut the fraud risk resumption in revenue recognition.

Fraud risk identification and assessment is an iterative and dynamic process that happens throughout the audit. Upon identifying the bill-and-hold transactions, the auditors should have identified and assessed fraud risks associated with the occurrence of revenue.

The engagement team should have consulted with the firm’s technical accounting leaders for help in determining whether the bill-and-hold transactions had commercial substance.

18. 9ISA 315 (Revised), paragraph 7.

19. 8ISA 240 requires auditors to presume that there are risks of fraud in revenue recognition, and to evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Auditors can, however, rebut that presumption for simple revenue streams (ISA 240, paragraph A31).

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.