CPAB CASE STUDY 2 Auditing revenue recognition – response to assessed fraud risk

Source: "Fraud thematic review", cpab exchange, May 2022, p. 12, see ww.cpab-ccrc.ca

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Overview – *This case illustrates how an assurance engagement team did not demonstrate sufficient professional skepticism when evaluating assessed fraud risk.*

1. Case facts

- The entity is engaged in fixed-price construction projects for its customers which take years to complete.
- The entity transfers control of each asset under construction over time and recognizes revenue for each project at the financial reporting date based on an estimate of each project's stage of completion (i.e., percentage-of-completion method) determined on the basis of costs incurred as follows:

$$\text{Revenue recognized} = \frac{\text{Cost incurred to date}}{\text{Estimated total cost}} \times \text{Contract price} - \text{Revenue previously recognized}$$

2. Engagement team's conclusions

Fraud risk factors identified

- The engagement team identified that the entity had experienced declining margins on its construction projects and severe staffing shortages as a result of the pandemic. The engagement team determined that management was under significant pressure to show an improvement in the entity's operating results.

Identified and assessed fraud risks

- Based on their evaluation of fraud risk factors and the elevated measurement uncertainty associated with estimating remaining costs-to-complete on uncompleted projects (i.e., open projects), the engagement team assessed a fraud risk associated with the costs-to-complete estimate. Specifically, understating costs-to-complete would allow management to overstate revenue recognized during the year for open projects.

Procedures performed to respond to the assessed fraud risk

- Adopted a combined audit approach (i.e., relied on internal controls) to respond to the assessed fraud risk.
- <u>No retrospective review was performed</u> to determine how accurate management had been in the past in forecasting/approving the costs-to-complete estimates.

- Relied on one key control, a monthly contract review meeting attended by senior management, designed to review: the status of the entity's open projects, risks to complete open projects and estimates of remaining costs-to-complete open projects.
- Performed substantive procedures that focused on corroborating costs included in forecasts of costs-to-complete estimates but not on identifying costs that had been inappropriately excluded from costs-to-complete estimates.

3. Analysis

Risk identification and assessment

- The engagement team's evaluation of fraud risk factors and their assessed fraud risk was reasonable. However, the engagement team did not exercise an appropriate level of professional skepticism when designing further audit procedures (e.g., tests of controls and substantive tests) to respond to the assessed fraud risk.
- A retrospective review was not performed to determine how accurate management had been historically at forecasting remaining costs-to-complete on open projects. A retrospective review might have revealed that management understated these estimates in the past and provided insight about how the understatement was carried out (e.g., directives by management to project leaders to record adjusting entries to project sub-ledgers). If applicable, that understanding would have helped the engagement team design a more targeted audit approach to address the assessed fraud risk.

Responses to assessed risks

- Tests of operating effectiveness of the contract review meeting control involved inspecting meeting minutes. However, the minutes only described action items discussed at the meetings (e.g., decrease remaining costs-to-complete for project ABC by 10 per cent) and not the detailed considerations that led to the proposed actions. Furthermore, the engagement team did not consider whether the control was sufficiently responsive to the assessed fraud risk given that the contract review meeting is attended by management with the authority to propose fraudulent adjustments to costs-to-complete estimates.
- Finally, the substantive procedures did not address the fraud risk because they were not designed to identify costs that should have been included in costs-to-complete estimates but inappropriately excluded by management (and the project leaders).

4. Lessons learned

- A stand-back evaluation, after all the evidence was accumulated, could have alerted the engagement team that the fraud risk had not been appropriately addressed by the procedures performed.

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.