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B/D Alert #2: Revenue Recognition

This alert is intended to provide certain auditing considerations that may be relevant for audit and attestation engagements for brokers and dealers registered with the US Securities and Exchange Commission (SEC). The alert discusses some of the more judgmental or complex areas of the audit and attestation engagements, including some of those identified by the Public Company Accounting Oversight Board (PCAOB).[1]

While the alert highlights certain areas and questions for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with applicable rules, standards, and guidance in their entirety. The questions posed in this alert are a mixture of (1) questions applicable to all audits of brokers and dealers and (2) questions that may require further action if certain circumstances are present at the broker or dealer.

Please see previously issued CAQ Alert #2017-05, *Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers* where additional areas of the audit and attestation engagements are highlighted for consideration.[2]

Developing and Performing Auditing Procedures

Brokers and dealers may generate revenue from a variety of the services they perform in the securities industry. Brokers facilitate the purchase and sale of securities for their clients and typically will earn a commission, or mark-up, on the transactions. Dealers or traders will buy and sell for their own accounts, generating a profit or loss based on their trading activity. Some companies act in both capacities.

Brokers and dealers are of various sizes and business models and may generate revenues beyond those previously described. Auditors need to gain an understanding of how brokers and dealers generate and record revenue throughout the transaction lifecycle.

[1] See PCAOB Staff Inspection Brief: *Information about 2017 Inspection of Auditors of Brokers and Dealers* and PCAOB Staff Inspection Brief: *Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers*.
[2] CAQ Alert #2017-05 is available at http://www.thecaq.org/caq-alert-2017-05-select-auditing-considerations-2017-audit-cycle-brokers-and-dealers.

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Questions to Consider

Consider the following questions when developing and performing procedures to test revenue:

- Has the auditor identified and obtained a sufficient understanding of the sources of the broker's or dealer's revenues? Has the auditor identified homogeneous and nonhomogeneous revenue transactions? As part of this process, has the auditor considered:
    - How are revenue transactions initiated, authorized, processed, recorded, and reported?
    - Have parties involved in the revenue transaction process been identified (e.g., related parties, customers, brokers and dealers, registered clearing agencies, and transfer agents)? Have their roles and data been provided to and from each party involved in the transaction process?
    - What systems and reports are utilized in initiating, calculating, and recording revenue?
    - Are service organizations utilized in the revenue recognition process, and if so has a sufficient understanding of what the service organization does and the controls at that service organization been obtained?
    - Are there revenue calculations? Who performs the calculations? Are there contractual agreements to review and evaluate (e.g., accuracy of commission rates)?
    - Are reconciliations performed to ensure completeness of transactions?
    - How are fair value measurements determined? How are the completeness of the assets and/or cutoff of the assets requiring fair value treatment considered?
- Do the auditor's procedures planned or performed align with the auditor's understanding of internal control and risk assessment?
- Does the audit response contemplate a reliance on internal controls? If so, have those controls been tested? Are the results of the control testing sufficient to support the planned reliance on internal controls?
- Are any of the controls tested considered management review controls? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered in this context?
- What reports were used in the revenue cycle audit procedures? How were those reports generated?
- How have the completeness and accuracy of the information in those reports been considered? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered in this context?

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Audit Deficiencies

The following are examples of audit deficiencies that have been identified in PCAOB inspections related to auditing revenue:[3]

- Auditors did not perform, or sufficiently perform, risk assessment procedures for revenue, including obtaining a sufficient understanding of the aspects of internal control over financial reporting relevant to revenue and evaluating the design of the controls intended to address fraud risks, which contributed to deficiencies in testing revenue.[4]

- The auditor incorrectly assumed that a population of revenue transactions is homogeneous. Thus, the samples tested were not representative of all the significant revenue types.[5]

- Auditors did not perform sufficient procedures for material classes of revenue transactions, including instances in which auditors did not design and perform sufficient sampling procedures.[6]

- The auditor reduces the extent of substantive testing based upon reliance on controls without sufficiently testing the design and operating effectiveness of controls to support the planned controls reliance strategy.

- Substantive analytical procedures performed by auditors did not provide the necessary level of assurance.[7]

- Auditors did not perform procedures to obtain sufficient appropriate evidence about the accuracy and completeness of information produced by the broker or dealer or a service organization that the auditor used in its auditing procedures.[8]

- The auditor uses reports (trade blotters, account statements, or reports from clearing brokers) or information (schedules or spread sheets) from the client, including service organizations without obtaining sufficient and appropriate evidence about the accuracy and completeness of that report or information.[9]

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[3] As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.
[4] See AS 2110.
[5] See AS 2315, *Audit Sampling* (AS 2315).
[6] Ibid.
[7] See AS 2305, *Substantive Analytical Procedures* (AS 2305).
[8] See AS 2601, *Consideration of an Entity's Use of a Service Organization* (AS 2601), and AS 1105, *Audit Evidence* (AS 1105).
[9] Ibid.

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- The auditor did not adequately test the relevant assertions for revenue as a result of not doing all or some of the following:
    - Evaluating whether the terms of underlying contractual arrangements were appropriately considered in recognizing revenue
    - Testing whether the values used for assets under management to calculate fees were accurate and complete
    - Determining whether the commission rates used to calculate commission revenue were consistent with the underlying agreements
    - Evaluating the effect on the financial statements of recognizing commission revenue on trade date rather than on a settlement date basis[10]
    - Evaluating whether revenue recognition policies were in accordance with US Generally Accepted Accounting Principles (GAAP)

Accounting Standards Codification 606

As a reminder, Accounting Standards Codification 606, *Revenue from Contract with Customers* (the new revenue recognition standard) will be effective for calendar year end public companies on January 1, 2018. Brokers or dealers that are registered with the SEC meet the Financial Accounting Standards Board (FASB) Master Glossary definition of public business entities, and therefore the effective date for the new revenue recognition standard will be the same as public companies.[11] In October 2017, the PCAOB published Staff Audit Practice Alert No. 15, *Matters Related to Auditing Revenue from Contracts with Customers* (Practice Alert No. 15), which highlights PCAOB requirements and other considerations for audits of a company's implementation of the new revenue accounting standard. Practice Alert No. 15 discusses (a) auditing management's transition disclosures in the notes to the financial statements, (b) auditing transition adjustments, (c) considering internal control over financial reporting, (d) identifying and assessing fraud risks, (e) evaluating whether revenue is recognized in conformity with the applicable financial reporting framework, and (f) evaluating whether the financial statements include the required disclosures regarding revenue.[12]

[10] See FASB Accounting Standards Codification (ASC) Topic 940, *Financial Services – Broker Dealers.*
[11] See FASB ASU *No. 2013-12, Definition of a Public Business Entity*.
[12] Practice Alert No. 15, page 2.

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