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FRAUD RISK AND REVENUE RECOGNITION:

AN ANALYSIS OF AU-C 240 AND ASC 606

Part 1: Overview of AU-C 240 — Consideration of Fraud in a Financial Statement Audit

Auditing Standard AU-C 240, an American Institute of Certified Public Accountants (AICPA) standard, regulates independent auditor responses to the risk of material misstatement through fraud in a financial statement audit setting. The standard provides that auditors have a professional duty to design and conduct the audit with the attitude of professional skepticism in that fraud can manifest itself even in situations where previous audits have indicated no anomaly. Under the Journal of Accountancy, the Auditing Unit, C 240, mandates the audit teams to conduct regular brainstorming at the beginning of every engagement related to how and where fraud can be perpetrated in the financial statements, specifically on schemes involving revenues and how the management can override internal controls (Jenkins).

The standard has two main categories of fraud risk, which it is structured around: fraudulent financial reporting and misappropriation of assets. AU-C 240 paragraphs .25 through .33 imply that an auditor poses certain questions to the personnel involved, audit committee, and management on whether they know of any actual, suspected, or alleged fraud. Notably, the AICPA in its 2021 peer review guidance clarified that the area of greatest fraud risk under AU-C 240 is still revenue recognition, implying that auditors must consider it a material risk unless they can prove otherwise (Thorps).

The essence of the impact of AU-C 240 on the overall audit quality is that it explicitly makes professional judgment be connected to particular documentation requirements. Auditors should not just detect the existence of fraud, but they are supposed to precisely respond to risks of fraud by direct testing procedures. The standard outline dictated those paragraphs. 35 to .45 involve responses such as lack of prediction in audit procedures selection, consideration of whether journal entries indicate manipulation, and assessing accounting estimates for bias. The absence of this standard would mean that auditors would not have a framework to deal with one of the most prevalent threats to sound financial reporting.

Part 2: Overview of ASC 606 — Revenue from Contracts with Customers

ASC 606 is a financial accounting standard codified as part of the Accounting Standards Codification, addressing the principles according to which companies recognize revenue associated with customer contracts. The standard substituted an unequivocal set of industry-specific guidelines with an all-inclusive five-part model: recognize the contract, discover the performance tasks, establish the price of every transaction, distribute the cost of every transaction, and accept income when every performance task is met. The main principle, which is outlined in ASC 606-10-10-2, is the fact that an entity must realize revenue in a way that reflects the transfer of goods or services to the customers in the amount that the entity is likely to be entitled to claim.

The major rules of measurement and recognition that prevail in ASC 606 entail a lot of professional judgment. ASC 606-10-25-14 to 25-22 covers recognition of different performance obligations where the same contract is involved, and it is rather complicated when the company combines products and services. ASC 606-10-32-28 up to 32-41 regulates allocation of transaction prices using stand-alone selling prices, which have to be estimated in cases where

observable prices are not available to companies. According to the findings of Corporate Compliance Insights reported in 2023, in 2022, about 40% of the deficiencies in PCAOB inspections were related to revenue recognition, which underscores the fact that the judgment-based nature of ASC 606 is still a challenge that both auditors and preparers are grappling with (Zauli).

ASC 606 is significant in financial reporting, as it fosters comparability in the industry and increases transparency to the investors. Before its adoption, two similar companies can record the same transaction in different ways depending on the applied legacy standard. The codification also added strong disclosure techniques in the form of ASC 606-10-50 disaggregation of revenues and data on contract balances, as well as descriptions of major judgments performed in the application of the standard.

Part 3: Connection Between AU-C 240 and ASC 606

The connection between AUC 240 and ASC 606 is causal and direct. AS 606 exposes the most fraudulent financial reporting area because revenue, as the largest line on the income statement, is usually the most susceptible to fraud due to its substantial reliance on management judgment. AU-C 240 expressly assumes that revenue recognition involves fraud risk, and therefore the auditors should design and document those procedures unless it is obvious otherwise. The two standards thus work in concert: ASC 606 dictates how accounting should be done, whereas AN-C 240 dictates how auditors can assess whether the management has used the treatment in an honest and accurate manner.

There are a few risks at the crossroad between these two standards. The management can also intentionally recognize revenue through purporting to fulfill a performance obligation that was earlier fulfilled before it was so fulfilled, and it can also manipulate the stand-alone selling

prices that are applied to the transaction prices on the bundled contracts. According to AU-C 240 paragraphs .26 and .32, auditors should specifically request information on the existence of pressure that may lead someone to manipulate earning opportunities, including debt commitments or analyst conditions related to revenue goals. Auditors would subsequently develop substantive procedures such as contract-level testing, inspection of shipping documents or acceptance records, or recalculation of revenue allocations to determine whether recorded amounts meet the prescribed ASC 606-10-25 and 606-10-32.

This process needs professional judgment. Auditors should consider whether the estimates made by the management regarding variable consideration under ASC 606-10-32-11 are reasonable and whether the timing of the recognition of the revenues matches the actual transfer of control. They also have to determine the existence of journal entries made around period-end that indicate that there is manipulation as stipulated by paragraph 32 of the auditors' committee C.240. Signed customer contracts, invoices, delivery confirmations, and models used by the management to allocate them are all considered with the professional cynicism required of the professional skepticism required by audit standard 240, list-augers evidence.

Part 4: Real-World Example — Microsoft Corporation

Microsoft Corporation presents an excellent real-life scenario of the interaction of the ASC 606 and the AU-C 240 in practice. Microsoft revealed that revenue recognition is a critical audit matter identified by its independent auditor, Deloitte & Touche LLP, in its fiscal year 2024 Annual Report on Form 10-K, which was submitted to the Securities and Exchange Commission. Deloitte reported a substantial judgment required in identifying stand-alone selling prices of Microsoft bundled products and services, especially in its cloud and licensing segment, and the

timing of recognizing multi-element arrangements under ASC 606-10-25 (Microsoft Corporation).

The audit report prepared by Deloitte also indicated that in addressing these risks, it conducted the following procedures: testing the reasonableness of stand-alone selling prices by comparing them to observable transactions, testing a sample of contracts to determine whether there was an adequate identification and fulfillment of performance obligations, and testing the mathematical accuracy of revenue allocations. These processes relate directly to the provisions of the AU-C 240, which requires specific responses to hypothetical fraud risk in revenues. Total revenue recognized by Microsoft in fiscal year 2024 totaled \$245.1 billion, which means that any minor error in recognition would result in a material misstatement, and this is the reason why auditors should ensure that both standards are applied with vigorousness.

Works Cited

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