



Deloitte.

EXCERPT FROM YEAR-END AUDIT COMMITTEE MATERIALS



ABC Software

Public Accounting Firm
New York, New York

Significant Risks

Significant Risk	Description	Planned Audit Response
Revenue recognition	The risk of management override of controls is a presumed fraud risk.	<ul style="list-style-type: none">• Identify unusual trends in account balances and ratios.• Engage in periodic fraud discussions with certain members of senior management and others, including the internal auditors, internal counsel, and the audit committee.• Consider the potential for bias in judgments and estimates, including performing retrospective analysis of significant accounting estimates. We will evaluate the business rationale for any significant unusual transactions.• Use a software tool to profile journal entries.• Test internal controls over the journal entry process.• Test journal entries that exhibit characteristics of possible management override of controls, as identified using electronic data interrogation techniques.

Case 23-4h3: ABC Software

Significant Risks

Significant Risk	Description	Planned Audit Response
Revenue recognition	<p>The Company recognizes revenue upon transfer of control of promised goods or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those goods or services. Significant judgment is exercised by the Company in determining revenue recognition for the Company's customer contracts, and includes the following:</p> <ul style="list-style-type: none">• Determination of whether promised goods or services (e.g., hardware, software licenses) are capable of being distinct and are distinct in the context of the Company's customer contracts, which leads to whether they should be accounted for as individual or combined performance obligations.• Determination of stand-alone selling prices for each distinct performance obligation and for goods and services that are not sold separately.• Determination of when revenue is recognized for each distinct performance obligation either over time or at a point in time.	<ul style="list-style-type: none">• Testing the effectiveness of controls related to the identification of distinct performance obligations, determination of the stand-alone selling prices, and the determination of the timing of revenue recognition.• Evaluating management's significant accounting policies related to revenue recognition for reasonableness.• Selecting a sample of recorded revenue transactions and performed the following procedures:<ul style="list-style-type: none">– Obtaining and reading customer source documents and the contract for each selection, including master agreements and related amendments to evaluate if relevant contractual terms have been appropriately considered by management.– Evaluating management's application of their accounting policy and tested revenue recognition for specific performance obligations by comparing management's conclusions to the underlying master agreement and any related amendments.– Testing the mathematical accuracy of management's calculations of revenue and the associated timing of revenue recognized in the financial statements.• For a selection of arrangements with original equipment manufacturers (OEMs), confirming accounts receivable and total billings as of and for the year ended December 31, 20X0, directly with the OEM.• Confirming a sample of individual revenue orders for the year ended December 31, 20X0, to evaluate the accuracy of management's records.• Evaluating the reasonableness of management's estimate of stand-alone selling prices for goods and services that are not sold separately by performing the following:<ul style="list-style-type: none">– Assessing the appropriateness of the Company's methods and mathematical accuracy of the determined stand-alone selling prices.– Testing the completeness and accuracy of the source data used in management's calculations.



Critical Accounting Policies, Practices, and Estimates

- Critical accounting policies and practices are those accounting policies and practices that are both (1) most important to the portrayal of the Company's financial condition and results and (2) require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year. The rules and regulations of the U.S. Securities and Exchange Commission require all critical accounting policies and practices to be disclosed in the "Management's Discussion and Analysis" section of the Company's annual report on Form 10-K. On the basis of our assessment, we did not propose any significant modifications to those policies and practices identified as critical.
- Critical accounting estimates are accounting estimates in which the nature of the estimates is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and the impact of the estimates on financial condition or operating performance is material.



Critical Accounting Policies, Practices, and Estimates (cont.)

- The Company's critical accounting policies, practices, and estimates included in the MD&A section of its Form 10-K include:
 - *Business combinations* — See the Significant Unusual Transactions slide for further detail in the current-year application of business combinations.
 - *Revenue recognition* — The Company recognizes revenue upon transfer of control of promised goods or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those goods or services. The Company offers customers an enterprise cloud platform, which can be pre-installed on its hardware or delivered separately, as well as related technical support subscriptions and professional services. Revenue from goods was \$500 million and support, entitlements, and other services was \$300 million for the year ended December 31, 20X0. Significant judgment is exercised by the Company in determining revenue recognition for the Company's customer contracts.
 - *Income taxes* — Because the Company operates in multiple states, income tax calculations can be complex, and judgment is required in the application of such tax laws. For the year ended December 31, 20X0, the Company has \$20 million recorded in deferred tax assets.



Significant Unusual Transactions

A significant unusual transaction is a significant transaction that is outside the normal course of business for the Company or that otherwise appears to be unusual because of its timing, size, or nature.

During the year ended December 31, 20X0, we are aware of the following significant unusual transaction:

XYZ Software Acquisition

On March 1, ABC acquired a 100 percent ownership in XYZ Software (XYZ), which was accounted for as a business combination in accordance with FASB Accounting Standards Codification Topic 805, *Business Combinations*. XYZ was acquired for a net purchase price of \$1 billion. The Company used the discounted expected future cash flow method to measure the fair value of the intangible assets. The significant estimate assumptions used to estimate fair value included revenue growth rates and discount rates.

To audit the transaction, the audit team spent significant time obtaining an understanding of the transaction; evaluating the design, and testing the operating effectiveness of, controls over the Company's accounting for the acquisition, including the valuation of the intangible assets, including management's controls over forecasts of future cash flows and selection of the discount rate. In addition, we evaluated the Company's valuation methods, tested the significant assumptions used in the valuation, as well as testing all relevant data supporting the accounting and assessing the reasonableness of management's forecasts. Because of the complex nature of the transaction, we required involvement of outside valuation specialists to assist with our audit procedures, including evaluating the reasonableness of the valuation and discount rate. The involvement of specialists included assistance with testing the source information and developing a range of independent estimates.



Independence

As separately communicated to you in our letter dated October 15, 20X0, there was a breach of an applicable independence requirement identified by the Company during the period of our audit. Please refer to such letter for the details related to the breach and our related conclusions.

We have concluded that our objectivity and impartiality with respect to all issues encompassed within our engagement have not been impaired, and we believe that a reasonable and informed third party with knowledge of all relevant facts and circumstances would conclude that we are capable of exercising objective and impartial judgment on all issues encompassed within our engagement. Except for the breach expressly identified and discussed with you as set forth in our separate communication dated October 15, 20X0, we would be independent in compliance with PCAOB Rule 3520, *Auditor Independence*.



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