**REVENUE COLLECTION**

For a start, revenue must be recognized in conformity with GAAP so an auditor can issue an unqualified opinion. A revenue generating activity generally involves a sale of a product or the rendering of a service in exchange for cash or claims to cash for the goods or services provided. The criteria for revenue recognition are as follows.

* Persuasive evidence for an arrangement that generates revenue exists.
* Delivery of the goods occurred/ services were rendered.
* The seller’s price to the buyer is fixed/ determinable.
* Collectability (of the payments in exchange for goods/ services) is reasonably assured.

**CAUTION:**  The revenue process is a high risk area and frauds are often perpetrated here. Auditing standards warns auditors that THEY SHOULD ALWAYS PRESUME THAT THERE IS A RISK OF MATERIAL MISTATEMENT DUE TO REVENUE RECOGNITION. In particular the auditor should be wary of:

1. Side arrangements, which refers to arrangements used to alter the terms and conditions of recorded sales in order to entice customers to accept the delivery of goods/ services. An example is the violation of credit policies (softening them without approval) in order to woo customers. This poses a risk to the organization.
2. Channel Stuffing (Trade loading) refers to a marketing practice that suppliers use to boost sales by inducing distributors to buy substantially more inventory that they can actually sell.

**OVERVIEW OF THE REVENUE PROCESS**

The revenue process generally involves the following:

1. Types of transactions and financial statement accounts affected.
2. Types of documents and records
3. Major functions of the revenue process
4. Key segregation of duties.

* **Types of transactions and financial statement accounts affected.**

A typical revenue process involves three transactions:

* Sale of goods/ rendering of a service for cash/ credit.
* Receipt of cash from the customer in payment for the goods/ services.
* The return of goods by customer for credit/ cash.
* **Types of document and records generated in the revenue process.**

The following documents are produced in the revenue process.

* **Customer sales order**.
* **Credit approval form** to assess the credit worthiness of the customer, resulting in a documented credit approval. Customers with poor credit rating are not approved and thus not given credit.
* **Open order report** which is a report of all customer orders that have not been completed.
* **Shipping document** prepared every time goods are shipped to customers and also commonly referred to as the bill of lading. A copy is sent to the customer and the other copy is used to initiate the billing process.
* **Sales invoice**, a document used to bill customers.
* **Sales journal**, the first accounting record made after an invoice has been issued.
* **Customer statement** that is mailed to a customer monthly or periodically showing all sales, cash receipts, balances and a credit memorandum of transactions processed through the customer account.
* **Account receivable subsidiary ledger**, which is an account and details of transactions with each customer.
* **Aged trial balance of account receivable**, which is a report that summarizes all customer balances in the accounts in various categories- 30 days, 90 days e.t.c.
* **Cash receipts journal**, a record of an entity’s cash receipts
* Credit memorandum, a record of credits for return of goods by customers
* **Write-off authorization**, a document authorizing the write-off of uncollectible accounts.
* **The major functions of the revenue process**

The revenue process serves the following functions;

* Order entry
* Credit authorization.
* Shipping
* Billing
* Cash receipts
* Accounts receivable management- ensuring that all billings, adjustments and cash collections are properly recorded in customer accounts receivables records.
* General ledger- to ensure that all revenues, collections and receivables are properly accumulated classified and summarized in the accounts.
* **Key segregation of duties**

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| **KEY SEGREGATION OF DUTIES IN THE REVENUE PROCESS AND THE POSSIBLE ERRORS OR FRAUD** | |
| **Source:** *Auditing and assurance services (Messier, Glover, Plawitt)* |  |
| **Credit function should be segregated from the billing function** | If one person has ability to grant credit to a customer and also bill that customer, sales can be made to customers who are not credit worthy resulting in bad debts. |
| **Shipping function should be segregated from the billing function** | If not segregated, it is possible for unauthorized shipments to be made and the usual billing procedures to be circumvented. This may result in unrecorded sales transactions and theft of goods. |
| **Accounts receivable function should be segregated from the general ledger function** | If not segregated, it is possible to conceal unauthorized shipments. This may result in unrecorded sales transactions and theft of goods. |
| **Cash receipt function should be segregated from the accounts receivable function** | If not segregated, it is possible for cash to be diverted and shortage of cash concealed. |

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| **KEY SEGREGATION OF DUTIES IN THE REVENUE PROCESS BY DEPARTMENTS** | | | | | | |
| **Source: IBID** | **DEPARTMENT** | | | | | |
|  | **Order entry** | **Credit** | **Shipping** | **Accounts receivable** | **Cash receipts** | **IT** |
| Receiving/ preparing orders | X |  |  |  |  |  |
| Approving credit |  | X |  |  |  |  |
| Shipping goods |  |  | X |  |  |  |
| Preparing invoice |  |  |  | X |  | X |
| Updating A/c receivable record for sales |  |  |  | X |  | X |
| Receiving customer remittances/ banking |  |  |  |  | X |  |
| Updating A/c receivable record for remittances |  |  |  | X |  | X |
| Updating A/c receivable record for sales |  |  |  | X |  | X |
| Updating A/c receivable record for aged trial balance |  |  |  | X |  | X |
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**ASSESSMENT OF POTENTIAL/ INHERENT RISK IN THE REVENUE PROCESS**

The potential risks to the revenue process relate to the components of FRAUD- Recall them?

Inherent risk factors that may affect the revenue process include:

* **Industry related factors**

These include the profitability and health of industry, level of competition, rate of technological change, e.t.c. For an entity experiencing a decline in demand for its products, the result is decline in sales revenue. The government also comes in with regulations outlawing price fixing, for example, which affect inherent risk.

* **Complexity and contentiousness of revenue recognition issues**

Whereas a majority of revenue recognition cases are straight forward, a few may have contention, e.g. revenue on long term construction contracts, mobile telephony, e.t.c.

* **Difficulty in auditing transactions and account balances**

Some accounts are difficult to audit due to the subjectivity involved, for example, provisions for bad debts. The data underlying the amount of provisions may not be reliable.

* **Misstatements in prior audits**

Misstatements in prior audits are a good indicator that the accounts may be misstated in the current period.

**PLANNING AND PERFOMING TESTS OF CONTROLS**

Here the auditor systematically examines the client’s revenue process to identify the controls that help prevent, detect and correct material misstatements. Tests of controls are those tests conducted to ensure that controls are functioning as they should. The following are some of the methods used in the tests of controls:

* Inquiry of client personnel
* Inspection of documents and records
* Observation of operation of the control
* Walkthroughs
* Re performance by the auditor of the control procedures

1. **Control procedures and tests of controls over revenue transactions**

The auditor’s decision process on the planning and performance of tests of controls involves considering the assertions and possible misstatements that can occur if the controls are not operating effectively. These assertions are;

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| **ASSERTION** | **MEANING** |
| Occurrence | All revenue and cash receipt transactions and events that have been recorded have occurred and pertain to the entity |
| Completeness | All revenue and cash receipt transactions and events that should have been recorded have been recorded |
| Authorization | All revenue and cash receipt transactions and events are properly authorized |
| Accuracy | All revenue and cash receipt transactions and events have been recorded in the correct accounting period |
| Cut off | All revenue and cash receipt transactions and events have been recorded in the proper accounts. |

**CONTROL PROCEDURES AND TESTS OF CONTROLS OVER CASH RECEIPT TRANSACTIONS**

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| Possible misstatement | Controls | Testing controls |
| Cash receipts recorded but not received or deposited in client bank account | Segregation of duties- Cash receipts and accounts receivable  Use of lock box system  Monthly bank reconciliations, independently reviewed | Observe and evaluate that proper segregation of duties exists.  Inquiry from management on lockbox policy  Review monthly bank reconciliation for indication of independent review. |
| Cash receipts lost/ stolen before recording | As above Plus  Checks restrictively endorsed when received.  Daily cash list prepared  Daily cash receipts reconciled with postings to accounts receivable subsidiary ledger.  Customer statements prepared on a regular basis; complaints handled independently. | As above plus  Observation of endorsement of checks.  Test the reconciliation of daily cash receipts with postings to accounts receivable subsidiary ledger.  Inquiry about handling of monthly customer statements and the handling of complaints. |
| Cash discounts not properly taken e.g. cash discounts to traders not qualifying. | Procedures for specifying policies for cash discounts. | Testing a sample of cash receipts and transactions for proper cash discounts. |
| Cash receipts recorded at incorrect amounts | Daily remittance report reconciled daily with control listing of remittance advice from banks.  Monthly bank reconciliations, independently reviewed | Review and testing of reconciliation.  Review monthly bank reconciliation for indication of independent review. |
| Cash receipts recorded in the wrong period  Cash receipts posted to wrong customer accounts.  Cash receipts not properly posted to general ledger. | Use lockbox system or control procedure to bank cash receipts daily.  Daily remittance report reconciled daily with postings to cash receipts journal and accounts receivable subsidiary ledger.  Customer statements prepared on a regular basis; complaints handled independently.  Monthly cash receipts journal agreed to general ledger postings.  Accounts receivable subsidiary ledger reconciled to general ledger control accounts. | Examination of cash receipts for daily deposit and inquiry into lockbox policy  Review monthly bank reconciliation for indication of independent review.  Inquiry about handling of monthly customer statements and the handling of complaints.  Review postings from cash receipts journal to general journal.  Examination of the reconciliation of accounts receivable subsidiary ledger to general ledger control account. |
| Cash receipts recorded in the wrong financial statement account | Chart of accounts | Tracing of cash receipts from listing to cash receipts journal for proper classification.  Review of cash receipts journal for unusual items. |

**CONTROL PROCEDURES AND TESTS OF CONTROLS OVER SALES RETURNS AND ALLOWANCE TRANSACTIONS**

In most case, most sales returns are few and do not represent a material item in the finanacial statements. Nevertheless, the following controls are important:

* The credit memorandum is approved by someone other than the person who initiated it. This ensures segregation of duties.
* A credit for returned goods is supported by a receiving document indicating that the goods have been returned.

In testing the controls, the auditor must check the credit memorandum for proper approval, and a receiving document for goods returned.

**SUBSTANTIVE PROCEDURES**

The auditors testing of internal controls determine the extent of substantive procedures. There are two categories of substantive procedures:

* Substantive analytical procedures that are used to examine plausible relationship among accounts receivable (in this case) and the related accounts.
* Tests of details that focus on transactions, account balances and disclosures.

**Substantive analytical procedures**

These are useful audit tests for examining the fairness of accounts such as sales, accounts receivable, allowance for uncollectible accounts, bad debts expense, sales returns and allowances. These tests provide evidence at low cost. For example, a comparison of gross profit percentage to previous years’ or industry data may provide valuable evidence on unrecorded sales or fictitious sales and related accounts receivables when the ratios are significantly higher or lower than previous years’ or industry data. The ratio will also provide information on changes in price policies. The table below summarizes the tests:

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| **Substantive analytical procedures** | **Possible misstatement detected** |
| Revenue |  |
| Comparison of gross profit % by product line with previous years’ or industry data. | Unrecorded revenue  Fictitious revenue  Changes in pricing policies  Product- pricing problems. |
| Comparison of reported revenue to budgeted revenue. |
| Analysis of the ratio of sales in the last month or week to total sales in the quarter/ year. |
| Comparisons of revenues recorded daily for periods shortly before and after the end of the audit period for unusual fluctuations such as increase just before and a decrease just after the end of the period |
| Comparison of details of units shipped with revenues and production records and a consideration of whether revenues are reasonable compared to the levels of production and sales price. |
| Comparison of the number of weeks of inventory in distribution channels with prior periods for unusual increases that may indicate channel stuffing. |
| Comparison of percentages and trends of sales into the distributor channel with industry and competitor sales trends, if any. |
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| **Accounts receivable, allowance for uncollectible accounts and bad debt expense.** | |
| Comparison of receivables turnover and days outstanding in the accounts receivable to the previous year and industry data | Under or over-statement of allowance for uncollectible accounts and bad debts expense |
| Comparison of aging categories on aged trial balance of accounts receivable to previous years. |
| Comparison of bad debt expense as a % of revenue to previous years or industry data. |
| Comparison of the allowance for uncollectible accounts as a percentage of accounts receivable or credit sales to previous year or industry data. |
| Examination of large customer accounts individually and comparison to previous year. |
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| **Sales returns and allowances and sales commission** | |
| Comparison of sales returns as a percentage of revenue to previous year or industry data | Under or over-statement of sales returns |
| Comparison of sales discounts to revenue with the previous year or industry data. | Under or over-statement of sales discounts |
| Estimation of sales commission expense by multiplying net revenue by average commission rate and comparison with previous year or industry data. | Under or over-statement of sales commission expense and related accrual |
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**TEST OF DETAILS**

**The confirmation process- accounts receivable**

Confirmation is the process of obtaining and evaluating direct communication provided by a third party in response to an auditors request for information regarding a particular item affecting financial statement assertions.

Auditing standards allow an auditor to omit conformations on accounts receivables when,

* The accounts receivable are immaterial to the financial statements.
* The use of confirmations would not be effective as an audit procedure e.g. from experience, there have been low response rates or unreliable responses.
* The auditor’s assessment of inherent risk and control risk is low, and evidence gathered from other substantive tests is sufficient to reduce audit risk to an acceptably low level.

The following factors should be considered when using confirmations as a test for accounts receivable:

* Type of confirmation request.
* Prior experience with the client or similar engagements.
* The intended respondent.

Types of confirmations

* **Negative confirmation**

This requires the customer to respond only when they disagree with the amount due to the client. They are used when we have many accounts with small balances.

* **Positive confirmation**

Here the auditor requires that the customer replies to the auditor, whether or not they agree with the amount due. Any failed replies must be followed up here.

On many audit engagements a combination of positive and negative confirmations is used. Positive is used for accounts with large balances, while negative is for accounts with small balances.

**Summary of test of details over accounts receivable, allowance for uncollectible accounts and bad debt expense**

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| **Assertion about classes of transactions** | **Substantive test of transaction** |
| Occurrence | For transactions in the sales journal, trace the invoices back to customer orders and shipping documents. |
| Completeness | Trace shipping documents to details of sales invoice to customer orders, sales journal and accounts receivable subsidiary ledger. |
| Authorization and accuracy | Compare prices and terms on a sample of sales invoices with authorized price list and terms of trade. |
| Cut-off | Compare the dates of sales invoice to dates of shipping and dates of recording in the sales journal for a sample of transactions |
| Classification | Examine sample of sales invoices for proper classification into revenue accounts |
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| **Assertions about account balances** | **Test of details of account balances** |
| Existence | 1.Confirmation of a sample accounts receivable  2.Confirm cases of exception/ non- response  3.Perform alternative procedure for account receivables (*see below alternative procedures*) |
| Rights and obligations | Bank confirmations, inquiry from management, review loan agreements, review BoD minutes for any evidence the receivables have been sold. |
| Completeness | 1. Obtain aged trial balance of accounts receivables and agree it to general ledger control accounts.  2. Trace shipping document to sales journal and accounts receivable subsidiary ledger. |
| Valuation and allocation | Examine results of confirmations of selected accounts receivables.  Examine the adequacy of the allowance for uncollectible accounts. |
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| **Assertions about presentation and disclosure** |  |
| Occurrence, and rights and obligations | 1. Determine whether any receivables have been pledged assigned or discounted. Determine if such items require disclosure. |
| Completeness | Complete a financial reporting checklist to ensure that all financial statement disclosures relating to accounts receivable and related accounts have been disclosed. |
| Classification and understandability | Review aged trial balance for material credits, long term receivables. Determine whether such items require separate disclosure.  Read the notes to accounts and ensure they are understandable. |
| Accuracy and valuation | Read the notes to accounts and ensure the information is accurate and properly presented at the appropriate amounts. |
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**Source; Messier Jr, et al- Auditing and assurance services**

**ALTERNATIVE CONTROL PROCEDURES**

When an auditor does not receive positive response to conformations, they perform the following audit procedures

* Examination of subsequent cash receipts.
* Examination of customer orders, shipping documents, and duplicate sales invoices.
* Examination of other client documentation.

**REVIEW QUESTIONS**

1. When a client does not adequately segregate duties, there is a possibility of cash being stolen before it is recorded. If as an auditor you suspect that this is possible, what audit procedures would you undertake to test this possibility (tests of controls)
2. What is inherent risk? Discuss the potential effects that industry related factors and misstatements in prior audits have on inherent risk.
3. Distinguish between positive and negative confirmation. Under what conditions is it appropriate to apply a. Positive or b. Negative confirmation.

**Suggestions for further reading/ reference**

1. Messier, William et al (2006), *Auditing and assurance services- A systematic approach*, 4th Edition, McGraw Hill Irwin, New York.