

GUIDANCE NOTE ON AUDIT OF REVENUE*

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*The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)+ issued by the Institute.*

1. Para 2.1 of the 'Preface to the Statements on Standard Auditing Practices', issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, AASs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Revenue, paragraph 11.1 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn.

Introduction

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term 'revenue' covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the view point of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

** Now known as the Auditing and Assurance Standards Board (AASB).

+ Now known as the Auditing and Assurance Standards (AASs).

Audit of Revenue

4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

- ◆ Sale of goods.
- ◆ Rendering of services.
- ◆ Use by others of entity resources yielding interest, royalties and dividends.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence*). In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Occurrence	–	that recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.
Completeness	–	that there is no unrecorded revenue.
Measurement	–	that revenue is recorded in the proper amounts and is allocated to the proper period.
Presentation and Disclosure	–	that revenue is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

Internal Control Evaluation

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of

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internal control relating to revenue:¹

- (a) The systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sale.
- (b) Accounting procedures relating to recognition of revenue.
- (c) Existence of periodic reports on actual performance vis-à-vis budgets.

Verification

7. Verification of revenue may be carried out by employing the following procedures:

- (a) examination of records;
- (a) analytical review procedures.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

Examination of Records

8. The auditor should examine whether the basis of recognition of revenue by the entity is in accordance with the recognised accounting principles as laid down in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India.

9. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to sales and sale returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the despatch documents (such as railway receipts) pertaining to a few days immediately before the year-end and verify that the related sale invoices have been recorded as sales of the current year.

¹ The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.

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10. The auditor should examine selected entries in the sales journal with reference to the related sale invoices, dispatch documents and other supporting documents such as the customers' orders, credit approval notes, etc. He should compare the actual price charged with the authorised price lists or with the authorisation by the appropriate official of the entity, as the case may be. The auditor should also trace the selected entries to the customers' account.

11. The auditor should also examine selected despatch documents with reference to related sale invoices and the sales journal.

12. The auditor should examine selected entries in the sales return journal with reference to the receiving reports in respect of goods returned, credit notes and entries in the customers' accounts. Similarly, the auditor should examine selected credit notes with reference to entries in the sales return journal, receiving reports in respect of goods returned, and entries in the customers' accounts.

13. In respect of goods sent on approval, the auditor should particularly examine that revenue in respect of such goods is not recognised until (a) the goods have been formally accepted by the buyer, or (b) the buyer has done an act adopting the transaction, or (c) the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue should not be recognised until the related goods are sold to a third party.²

15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

16. In respect of export sales, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic sales.

² Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of "substance over form".

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- (a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*³.
- (b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.⁴

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest, dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

18. The auditor should also verify realisations subsequent to the date of the balance sheet to identify items of unrecorded revenue.

Examination of Presentation and Disclosure

19. The auditor should satisfy himself that the revenue has been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Analytical Procedures

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to revenue:

- (a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.
- (b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.
- (c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.

³ This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is "Effects of Changes in Foreign Exchange Rates".

⁴ Reference may be made in this regard to AAS 11, *Representations by Management*.

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- (d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.
- (e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.
- (f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.
- (g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.
- (h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.
- (i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. Similarly, he may relate the wage payments to the quantum of output, and so on.

It may be clarified that the foregoing is only an illustrative list of analytical procedures, which an auditor may employ in carrying out an audit of revenue. The exact nature of analytical procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

Special Considerations in the Case of a Company

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for

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such goods, materials or services or the prices at which transactions for similar goods or services have been made with other parties.⁵

Documentation

22. The auditor should maintain adequate working papers regarding audit of revenue.

⁵ Reference may be made in this regard to Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.