AUDIT OF REVENUE

Vinay Nahar
GVN & Associates

Content of the presentation

1. **Assertions in audit and their interpretation in the audit of revenue.**
2. Understanding the entity.
3. Materiality
4. Internal controls reliance.
5. Audit methodologies to get a reasonable assurance on the assertions.

Assertions

The following assertions are to be satisfied during an audit of the financial statements:

C – Completeness – All the assets, liabilities, transactions and events that should have been recorded have been recorded.

E – Existence – Asset, liability and equity interest exists and all the transactions and events which are recorded have occurred.

A – Accuracy – Amounts and other data relating to assets, liabilities and recorded transactions and events have been recorded appropriately.

V – Valuation – Assets, liabilities and all the transactions and events have been recorded at the right amounts.

O – Obligations and rights – The entity has the rights over the assets and liabilities are obligations of the entity. The entity also has the rights and obligations to the transactions that have been recorded.

P – Presentation – Financial information is appropriately presented in the financial statements.

Assertions

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The interpretations of the assertions with respect to audit of revenue:

C – Completeness – All the invoices to the relating period have been accounted.

E – Existence – The sale of goods or services rendered for whom the invoices are raised have actually taken place.

A – Accuracy – The amount of the invoice which was recorded is accurate.

V – Valuation – The valuation interms of the amount to be invoiced for a sale of goods or the service rendered is correct

O – Obligations and rights – The obligations of the entity to perform the sale of goods or render service exists and the right to receive the consideration exists.

P – Presentation – The revenue generated is presented correctly in the financial statements.

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Understanding the entity

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The first step in audit and the most important aspect of audit to make it effective is to understand the entity.

To audit revenue of an entity the following points are to be considered while understanding the entity:

- ✓Nature of industry
- ✓History of the entity
- ✓Managerial structure
- ✓Manufacturing process / Process of rendering service
- ✓Sources of revenue
- ✓Types of distribution set up
- ✓Accounting process

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Materiality

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Materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

The concept of materiality is **applied by the auditor both in planning and performing the audit**, and in **evaluating the effect of identified misstatements on the audit** and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Materiality

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To determine the benchmark for calculating "Materiality" requires **professional judgment** of the auditor.

The auditor should **consider the intention of the investors to invest in the entity** and which part of the results of the company every year is taken into consideration to make financial decision by the general investors.

The **benchmarks** can be, depending on the facts and circumstances of the case:

- Asset
- Liability
- Equity
- Revenue
- Revenue expenditure
- Capital expenditure
- Profit before tax

Materiality

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The materiality will be a percentage of the benchmark selected.

The auditor in using his **professional judgment** has to determine the percentage to be applied on the benchmark to calculate the materiality amount. The **following factors are also to be considered** while determining the percentage:

- Whether it is a **gross or a net benchmark**. Example of gross benchmark is Revenue and net benchmark is Profit before tax. The percentage will be relatively higher when a net benchmark is chosen.
- The **inherent risk involved in the audit. If the risk of material misstatement** is high then the percentage and the materiality amount will be less, the risk and the materiality amount are inversely related.

Materiality

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The **"Performance materiality"** is to be lesser than the materiality amount determined to **mitigate the risk of aggregation.**

The **percentage to be applied on the materiality** amount to determine the performance materiality should be determined by the auditor **using his professional judgment and his past experience**.

The auditor should also **consider the risk of material misstatement in the financial statements** to determine the percentage.

Materiality

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To **ascertain the risk of material misstatement in an audit the following factors are also to be considered**:

- The intent of the share holders to invest in the entity.
- Background of the people forming the top management.
- The intent and the style of running the business of the top management.
- Major expenses, nature of markets the entity has a share in.
- Remuneration of the top management, key employee and marketing executives (is it linked to the results of the entity).
- The volatility of the market in which the entity operates.
- History of the entity
- Any other factor which would increase the risk of material misstatement in a financial statement.

If the **result of considering the above factors is "fishy"**, then the materiality amount should be relatively lower when compared to a normal result, thus a more penetrative audit is required to get a reasonable assurance than the financial statements are free from material mistakes.

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Internal controls

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One of the key aspects in the audit of revenue is to understand the internal controls in place.

The **internal control policy document** of the entity containing the internal controls and roles and responsibilities of each person associated with the management is defined, has to be taken from the management.

The **management hierarchy and roles and responsibilities** of each person associated with the management have to be clearly defined and understood.

A detailed **walk-through** of the entire transaction, for each source of revenue has to be documented for each and every aspect in the process of booking revenue; right from the stage of receiving the purchase order (request of service order) till the actual dispatch of the goods(execution of service).

Internal controls

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The **walk-through documented has to be compared with the management policy document** and seen if the actual process is as per the policy document.

The **walk – through documented should also be analyzed to check for any internal control weakness.**

The auditor should consider **segregation of duties** as one of the important criteria to assess the effectiveness of control.

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Audit methodologies

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Assertion	Application of the assertion	Audit methodology
Completeness	All the invoices to the relating period have been accounted.	Period 13, Cut off procedures and Managerial Representation
Existence	The sale of goods or services rendered for whom the invoices are raised have actually taken place.	Test of details & External confirmation
Accuracy	The amount of the invoice which are recorded, is accurate.	Test of details & External confirmation
Valuation	The valuation interms of the amount to be invoiced for a sale of goods or the service rendered is correct.	Test of details & External confirmation
Obligations and rights	The obligations of the entity to perform the actual sale of goods or render service exists and the right to receive the consideration exists.	Verification of Sale Contracts & External confirmation
Presentation	The revenue generation is presented appropriately presented in the financial statements.	Review of the financial statement

Audit methodologies

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Period 13:

In this process we identify **the credits in the bank account of the entity in the months after the existing audit period**, and then **analyzing the source of the credit**.

When the **source of credit is identified with the help of explanation provided by the management** then the credit is analyzed with respect **whether it has been accounted in the right accounting year.**

While **selecting the amounts from the subsequent period** bank account the following points are to be considered:

- Select **all the amounts above the performance materiality.**
- Select at **random a few samples which are below the performance materiality**.

If the risk of material misstatement is high then the period chosen will be relatively higher than when the risk is low.

Audit methodologies

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Cut-off procedures:

In this process **we select from the books of accounts, the last few invoices form the end of the accounting period under audit and first few invoices of the subsequent accounting period**. Then we check the relating documents of the invoice, like purchase orders, goods dispatch note and the gate outward register and actually **analyze if the said invoice is accounted in the correct accounting period.**

The a**bove process can be carried out by choosing** the last few invoice form the end of the accounting period under audit and first few invoices of the subsequent accounting period, **from the Gate outward register.**

If the risk of material misstatement is high then the samples chosen will be relatively higher than when the risk is low.

Audit methodologies

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Management representation:

A comprehensive representation letter has to be taken from the management. The representation should cover the fact that the **management gives a assurance that all the assertions about the revenue have been satisfied.**

Representation should be taken on the following additional matters

- The management has complied with the applicable accounting standards on revenue.
- There have been no frauds occurred during the year w.r.t revenue which the management is aware of.
- The revenue recognition policy has been followed by the company and it is in line with the requirement of the applicable accounting standards.

Audit methodologies

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Test of details (ToD):

While carrying out the ToD, the following points have to be considered:

"Three-way match" has to be done i.e., for a particular transaction the purchase order from the customer, the goods outward note and the invoice should be verified and the information in all the documents should be matched.

The existence of **segregation of duties.**

Proper authorities are **signing off on the documents**, for example – Purchase Order and invoice.

Professional judgment should be exercised to check the **authenticity of the documents provided.**

The documents regarding the **customer acknowledgment** of the invoice for the selected samples should be verified.

Audit methodologies

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Test of details (ToD) (contd..):

Following points are to be considered while selecting the samples for ToD:

The auditor shall determine a sample size sufficient to **reduce sampling risk to an acceptably low level.**

Professional judgment is to be used to decide on the **basis of selecting the sample size** on which ToD is to be performed. The factors to be considered include the following:

- The extent of **reliance placed on the internal controls**. The lesser the reliance the higher the sample size.
- The **risk of material misstatement** attached to the said audit.
- Testing of such number of samples on which the auditor gets a reasonable assurance that material misstatement does not exist.

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Audit methodologies

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External confirmation:

The confirmation can be sent to confirm the **yearend balance** to be received from the customer and to **confirm the number of invoices** and the amount for which the invoices are raised by the entity on the customer.

The following points are to be considered while sending external confirmations:

- The confirmation should contain the consent of the auditee, urging the customer to provide the confirmation.
- They should be printed on the auditee's letter head.
- It has to be sent from the auditor's office and not from the auditee's office.
- The proof of dispatch has to be stored.
- It should be mentioned in the confirmations that they will have to be sent back to the auditor's office. Thus the auditors address and email id should be mentioned in the confirmation.

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