

Practical Guidance No.5

Topic: Occurrence of revenue from sale of goods

Introduction

1. Revenue is used not only by the company's management but also by various other external stakeholders such as investors and analysts to evaluate the financial performance and assess the risk of the company. Auditors may also use the revenue line item of the auditee's income statement for audit planning purposes like determining the materiality threshold, risk assessment of the auditee etc. As such, revenue is undoubtedly one of the most important sources of information in the financial statements.
2. One of the common financial statement assertions in audit that relates to revenue is occurrence (i.e. transactions that have been recorded by the company actually occurred and pertained to the company).
3. The aim of this Practical Guidance is to provide auditors with some guidance when auditing the **revenue** of a company engaging in **sales of goods** pertaining to trading and retailing businesses to ensure the **occurrence** of revenue.

Guiding Principle

4. Singapore Financial Reporting Standard ("FRS") 18 *Revenue* paragraph 14 states that revenue from the sale of goods should be recognised when all the following conditions have been satisfied:
 - (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - (c) the amount of revenue can be measured reliably;
 - (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.
5. FRS 18 also further explains that "the assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction" (paragraph 15) and "if the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised" (paragraph 16).
6. The clarified Singapore Standard on Auditing 500 *Audit Evidence* states that when designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence (paragraph 7).

Practical application

7. For the purpose of this practice guidance, only the condition of “transfer of the significant risks and rewards of ownership of the goods” in FRS 18 paragraph 14 would be discussed in detail as the rest of the 4 conditions would usually be met with regards to the **revenue** of a company engaging in **sales of goods** pertaining to trading and retailing businesses. However, in evaluating revenue recognition, the auditors should be mindful of the need for the other 4 conditions to be satisfied as well.
8. When verifying the occurrence of revenue recognised for the sale of goods, auditors would:
 - (i) examine the circumstances of the transaction to establish when “the entity has transferred to the buyer the significant risks and rewards of ownership of the goods” [FRS 18 paragraph 14(a)] based on the understanding of the sales arrangement in order to ascertain the correct point of recognition of revenue in accordance with FRS 18; and
 - (ii) inspect the relevant and reliable documents to ensure that sales recognised are genuine and not fictitious.
9. The following illustrates when revenue should be recognised for local trading sales, retail sales and overseas trading sales where installation and inspection of goods are insignificant to the contracts.

Local trading sales

10. The risks and rewards of ownership of the goods for local trading sales are usually transferred to the buyer when the seller has delivered the goods and the buyer has physically received the goods. To verify the occurrence and existence of local trading sales, auditors would need to inspect relevant and reliable documents which include delivery orders or sales invoices with evidence of customers’ acknowledgement of receipts of goods. This is because only with the customers’ acknowledgement of receipt of goods will the auditors be able to ascertain that the sales transactions recognised have occurred and are genuine and not fictitious in nature. Auditors would also need to be mindful of whether there are any side agreements entered or clauses in the sales agreements or invoices which may impact the appropriate point of revenue recognition.
11. However, some small and medium enterprises in Singapore may not have the practice of issuing delivery orders and/ or requiring the customers to sign as evidence of receipts on the delivery orders or invoices. This poses a challenging situation for auditors when performing sales transaction test to verify occurrence of the sales. In the absence of such relevant and reliable documents, auditors could instead perform alternative audit procedures such as testing the corresponding cash receipts relating to the sales and ensuring that the source of the receipts is from the debtors with whom the sales were made. This alternative procedure is appropriate on the assumption that buyers usually only make payments for their purchases when goods have been received in good condition.

Retail sales

12. Retail sales are generally sold on cash on delivery terms. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. The risks and rewards of ownership of the goods would be transferred to the buyers when the buyers physically received the goods and cash is received by the seller. The point of sales ("POS") system is usually used to capture the receipts of payments from customers detailing the goods that have been sold. Usually at the end of each business day, the company would perform a reconciliation of physical cash, credit cards charge slips and Network for Electronics Transfers ("NETs") receipts to the total sales per the POS system. The total sales captured in the POS system would then be manually posted to the accounting system.
13. To satisfy the occurrence of sales captured and to ensure the integrity of the sales report generated by the POS system, auditors would need to understand the controls; and identify, evaluate and test the key controls of the POS system before reliance could be placed by auditors on the POS system and the sales report generated from it. As such, audit procedures such as agreeing the total sales captured in the POS system to the total sales in the general ledger without testing the POS system would not be considered sufficient appropriate audit evidence obtained to verify the occurrence of retail sales, as the sales report from the POS system is an internally generated document, where no evidence of receipt of goods by the customers can be established and the integrity of the reports would not have been tested in a substantive audit approach. To overcome this, auditors could instead ascertain the occurrence of such retail sales transactions by verifying the following relevant and reliable documents:
- (i) Physical cash collected – bank-in slips or bank statements;
 - (ii) Credit cards receipts – statements by credit card companies on the daily receipts collected on behalf of the company and bank statements for the payment made by credit card companies to the company; and
 - (iii) NETs receipts – statement by NETs on the daily receipts collected on behalf of the company and bank statements for the payments made by the bank to the company.

Overseas trading sales

14. Overseas trading sales would usually require the company to transport the goods to a destination designated by the buyers for them to receive the goods. To alleviate the confusion of the responsibility of buyers and sellers, the incoterms published by The International Chamber of Commerce are commonly used. When the incoterms are used, buyers and sellers would mutually understand the point where risk and rewards of the ownership is transferred is in accordance with the incoterms of shipment entered into between the buyer and the seller, unless both parties have an agreement which specifically determine the point where the transfer of risk and rewards of the ownership is transferred. If incoterms are used, the auditor should examine the incoterms when performing the sales cut-off test to determine if the company had recorded and recognised sales in the correct accounting period during the year-end audit.

15. Auditors would need to inspect the delivery documents such as bills of lading or airway bills in which the incoterms are stipulated, to ensure that revenue recorded and recognised in the books of the company are genuine in nature.
16. One of the challenges encountered by auditors is when goods are shipped directly to the customers by the company's suppliers as companies may not maintain copies of the shipping documents when direct shipment arrangements were made from the company's suppliers to the customers. Companies should obtain and retain the evidence to support these sales through direct shipments. By not doing so, it would pose a challenge to the auditors when verifying these direct shipment sales made by the company. In such circumstances, the auditors would need to carry out a sales transaction test by requesting the company to obtain the related shipping documents for the samples selected from its suppliers, customers or logistic company providing the transportation of the goods, for verification purposes.

Conclusion

17. Auditors need to bear in mind the importance of sighting to relevant and reliable documents when performing sales transaction tests to address the financial statements assertion of occurrence of sales.

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