AUDITING SALES – REMINDERS

This article identifies examples of fraud relating to sales. It also highlights matters that an auditor may want to consider when auditing sales of an entity. The topics examined in this article are:

- fraud
- analytical procedures
- identifying significant risks
- developing an understanding of internal controls
- identifying assertions and corresponding procedures
- performing other procedures with respect to auditing sales

Sales are almost always material to an entity's financial statements. From experience, it has been found that the majority of fraud and audit failures arise from manipulations of sales — usually the overstatement of sales. So, how does an auditor ensure that the sales of an entity have been properly audited? Below, you will find some reminders for audit teams to consider.

FRAUD

The auditor should always presume that there is a risk of fraud. The most likely type of fraud is the overstatement of sales. It is important for audit teams to brainstorm and assess the risks of material misstatement relating to the fraud of sales. Some examples of fraud with respect to sales include:

- fictitious shipments or invoices
- customized side agreements, which give some customers unique rights as compared to the majority of customers
- sales on consignment recorded as sales before the goods are sold
- sales that occur after year-end being recorded as occurring before year-end
- unfinished goods recorded as sold
- goods delivered earlier than the date the customer requested
- delivery of more products than ordered by the customer
- recording sales of replacement products without recording a reversal of the original sale
- credit notes issued after year-end for fictitious sales before year-end
- manipulation of complex sales calculations to create the desired sales amount

Many of these schemes would occur at or around the year-end date.

ANALYTICAL PROCEDURES

Analytical procedures completed at the planning stage of an audit can highlight possible misstatements relating to sales that would require further investigation. Unusual or unexpected relationships that have been identified in performing analytical procedures may indicate risks of material misstatement due to fraud. The most commonly applied analytical procedure during the planning stage of an audit is the comparison of sales from the prior year to the current year.

Examples of procedures that can be used in planning for the sales audit are:

- Comparing the entity's sales with industry trends and general economic conditions. Sales that are higher or lower than expected when compared to economic conditions or industry trends will need to be further investigated.
- Using ratio analysis, such as the gross profit percentage, to compare the entity's sales to the prior year or industry average. Large changes, particularly increases, in the gross profit percentage may indicate that there are problems with the recording of sales or costs of sales. If there are multiple product lines with different markups, then the analysis is best done on a disaggregated basis.
- Using trend analysis for the purposes of examining the sales pattern over the year. If an increase in sales appears to occur around year-end, this could require further investigation, as there may be cut-off issues.

SIGNIFICANT RISK

As part of the risk assessment process when planning the sales audit, the practitioner needs to determine whether any of the risks identified are significant risks. For this determination, the following must be considered as per Canadian Auditing Standard (CAS) 315.28:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Once this determination has been made, the practitioner needs to obtain an understanding of the entity's controls and control activities relevant to the significant risk.

Practitioners should consider the sales cycle carefully, as significant risks may exist due to the higher incidents of fraud in this area.

DEVELOP AN UNDERSTANDING OF INTERNAL CONTROLS

When an auditor is developing an understanding of internal controls and control activities, the auditor is gathering information about the internal controls, not testing the effectiveness of these controls. An understanding of internal controls as they would relate to sales requires:

- Documenting the procedures and controls that the entity has in place for sales.
- Establishing whether the design of the controls can prevent fraud or misstatement.
- Gathering evidence that the controls established by the entity have been implemented. (Usually, walk through tests are conducted.)

Then, the auditor can combine this understanding with results of the fraud brainstorming and other planning procedures to establish the inherent and control risk of misstatement with respect to sales.

High inherent risk can arise in situations, such as when the sales recognition process is complicated or difficult to record (for example, revenue recognition for construction sales). High control risk can arise when the design of the control does not seem to be adequate in preventing misstatements in sales.

Low control risk could allow the auditor to use control testing for sales. Once control testing is complete, the control risk can be reassessed.

Examples of increased inherent risk include:

- difficult revenue recognition policies (e.g. percentage of completion)
- possible unusual sales terms (e.g. related party transactions)
- sales made on terms that could result in significant returns (e.g. more than 30 days return policy or unlimited returns)

The control environment has an impact on these risks and as such the auditor must consider:

- management's integrity (usually assessed from past experience with management)
- financial condition of the entity (e.g. going concern issues)
- financial pressures on the entity (e.g. debt covenants to be met)
- management incentives to achieve financial results (e.g. bonuses based on sales levels or profits for the year)

Once established by the auditor, these risks need to be broken down at the assertion level in order to develop appropriate audit procedures to address them.

ASSERTIONS AND PROCEDURES

The auditor needs to link the planned audit tests with the identified risks. For example, when performing tests of detail, the higher the risk the more extensive the testing will need to be in order to reduce the level of risk of misstatement in the audit to an acceptable level. The risks identified in the planning stage will determine the extent of testing required. It will also determine whether control tests, combined with substantive procedures or substantive procedures alone will be appropriate. The following table provides suggested procedures that could be used for each assertion with respect to auditing sales:

Financial report assertion	Specific audit objective	Common audit procedures that could be used to achieve objectives
Existence	All sales are legitimate and occurred in the financial year	• Vouch entries in sales journal or subsidiary ledger to support documentation of sale (invoice and delivery note) • Substantive analytical procedures • Control tests for relevant controls • Subsequent receipts review • Confirmation of specific transactions with customers
Completeness	Sales are complete and accounts receivable include all amounts owed by customers at the balance sheet date	• Substantive analytical procedures • Control tests for relevant controls • Test from supporting documentation (invoice and delivery note) to sales journal or subsidiary ledger

Financial report assertion	Specific audit objective	Common audit procedures that could be used to achieve objectives
Accuracy	Sales are recorded correctly and in the correct period	• Cut-off (tests of sales transactions, sales returns and other sales adjustments at or near year-end) • Control tests for relevant controls • Verify prices, quantity and computation on sales invoices, prices verified to master price list, quantity verified to shipping documentation
Disclosure	Sales are correctly classified and major revenue categories are separately disclosed	• Ensure related party sales are adequately disclosed • Review the draft financial statements

Information obtained to assess the risk and understanding of the control environment will also affect the design of audit procedures, for example:

- The nature of the accounting system, controls used, and documents generated by the entity when processing sales.
- The nature of the fraud risk factors identified.
- The design of controls and types of misstatements that are likely to occur.

OTHER PROCEDURES

The audit of sales affects the audit of accounts receivable, and some tests can be designed to assist in reducing the risk of material misstatement in both areas. For example, the positive confirmation of accounts receivable balances will help in the confirmation of the existence of sales for those sales still unpaid by the debtors, while the work done on proving the accuracy of the accounting records for sales will assist in reducing the risks related to the accuracy of accounts receivable balances. Audit procedures can be performed in combination to reduce the risk of material misstatement to an acceptable level at the assertion level.

CONCLUSION

The above summary should remind auditors what things to consider when auditing sales.

RESOURCES

For further guidance, members are encouraged to contact a Practice Advisor:

Phone: 416 962.1841, ext. 4456 or 1 800 387.0735, ext. 4456.

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