

Mainland audit issues – consignment sales

The Questions and Answers (Q&As) below are developed by the Working Group on Mainland Audit Issues of the Institute's Auditing and Assurance Standards Committee (AASC) to raise practising members' awareness of the common audit issues that may be encountered by auditors in the audits of the financial statements of Mainland enterprises that are prepared under HKGAAP framework. They should be read in the light of Hong Kong Standards on Auditing.

This set of Q&As addresses some of the common issues on the recognition of consignment sales by Mainland enterprises and the audit procedures that may be performed by auditors to address those issues.

The Working Group welcomes your comments and feedback, which should be sent to commentletters@hkicpa.org.hk, for the attention of Stephen Chan, Director of Standard Setting.

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Q1: *What are the common phenomenon that may indicate risks of material misstatement of consignment sales in the financial statements of Mainland enterprises?*

A1: Consignment sales are special sales arrangements under which the recipient (consignee) undertakes to sell goods on behalf of the shipper (consignor).

In accordance with the Accounting Standard for Business Enterprise ("ASBE") – "Revenue (企業會計準則 – 收入)" issued by the Ministry of Finance of the PRC, revenue from sales of goods should only be recognised when certain specific conditions have been satisfied. The specific conditions to recognise sales are basically the same as the requirements set out in Hong Kong Accounting Standard 18 "Revenue" ("HKAS 18") issued by the Institute where the fundamental condition is the transfer of significant risks and rewards associated with the ownership of goods.

The basic accounting principles under ASBE, and HKAS 18 as well, require that consignment sales should only be recognised by the consignor until goods are sold by the consignee to ultimate customers, because not until then the significant risks and rewards of ownership of goods are not transferred.

The common phenomenon that may indicate risks of material misstatement of consignment sales include:

- Some Mainland enterprises recognise consignment sales upon being informed by the consignee that the consignment goods have been eventually sold to ultimate customers. As it takes time for the consignee to prepare and provide the consignor with the information of consignment goods that have been sold, this accounting practice may result in a delay in the recognition of consignment sales.

- On the other hand, some Mainland enterprises may not have a proper policy to identify and separate consignment sales from normal sales. This may result in an early recognition of consignment sales at the time when goods are delivered to the consignee even before the risks and rewards associated with the ownership of goods have been substantively transferred to ultimate customers.
- Some Mainland enterprises may not have a proper policy to identify and separate their own stocks with consignment stocks from the consignor (both physically and in the books of account). The inaccuracy of stock records may result in misstatement in consignment sales in the books of the consignee. It may also lead to wrong data being sent to the consignor and eventually lead to a misstatement of sales and cost of sales in the books of the consignor.
- Another issue is that some enterprises may not have a proper policy to account for customs duties chargeable in the country of the consignees. Sometimes, an enterprise may send goods to a consignee located in the Mainland China where import duties are in place. Generally, import duties are borne by the consignor, subject to the terms under the consignment agreement, and will be paid by the consignee in advance on behalf of the consignor. However, it is not uncommon that such import duties are not recognised by the consignor as “costs” or a reduction in revenue at the accounting period of occurrence. This may result in an overstatement of revenue or an understatement of cost of sales.
- As mentioned above, a consignee normally pays on behalf of a consignor for customs duty and subsequently reimburses the same from the consignor. It is not uncommon that such reimbursement is wrongly recognised by the consignee as revenue instead of offsetting with the “payment in advance”. This may result in an overstatement of revenue.

Q2: *What procedures auditors may perform in order to identify potential material misstatement of consignment sales?*

A2: In order to ensure that consignment sales transactions are properly accounted for, the following possible audit procedures should be considered in developing an appropriate audit approach:

Specifically for consignor’s accounts:

- Discuss with management concerning internal controls that are in place to (i) identify the existence of consignment sales; (ii) ensure proper recognition of consignment sales and associated customs duties (iii) ensure that the documents generated and based upon to support the consignment sales are authorised and properly kept.
- Obtain an understanding of the client’s consignment sales arrangement by reviewing consignment sales agreements with certain major consignees.
- Perform walkthrough test to confirm the auditors’ understanding of the client’s system and perform compliance test on those key internal controls in respect of consignment sales.

- Perform analytical review on consignee receivable balances and review delivery/sales records, immediately before and after year end, provided by the consignee to identify any cut-off error.
- Perform analytical review on accrued customs duties by assessing the reasonableness of the relationship amongst the amount of customs duties recognised, the rates of relevant customs duties, and the amount of imported goods to be subjected to customs duties.
- Review correspondence with consignees, particularly in relation to any sales and/or sales return transaction notices and detect for any delay in the recognition of consignment transactions.
- Review periodic consigned goods reports provided by consignee to match with the internal documentation of the client. Ensure that any variance noted is properly explained.
- Attend inventory count to ensure the existence of consignment stocks, if the amount is material. Review consignment stock report of the consignee and compare with the inventory count results to ensure the accuracy of consignment stock balance.
- Review and obtain explanation for any long outstanding consignee receivable balances. Long outstanding consignee receivables may indicate that there has been early recognition of consignment sales.
- Perform direct circularisation to selected consignees for sales transaction balances and consignment stock balances at any particular time to ensure the accuracy of the records kept by the consignor.

Specifically for consignee's accounts:

- Discuss with management concerning internal controls that are in place to (i) identify the existence of consignment sales; (ii) ensure that the consignee separates its own sales from those related to consignors (iii) the consignee separates its own stocks from those related to consignors.
- Obtain an understanding of the client's consignment sales arrangement by reviewing consignment sales agreements with certain major consignors.
- Perform walkthrough test to confirm the auditors' understanding of the client's system and perform compliance tests on those key internal controls in respect of consignment sales.
- Perform analytical review on the amount receivable from consignors in respect of payment on behalf of consignors related to customs duties by assessing the reasonableness of the relationship amongst the amount of customs duties recognised, the rates of relevant customs duties, and the amount of imported goods to be subjected to customs duties.
- Review correspondence with consignors, particularly in relation to any sales and/or sales return transaction notices and detect for any delay in the recognition of consignment transactions.

- Review periodic consigned goods reports provided by consignors to match with the internal documentation of the client. Ensure any variances noted were properly explained.

Q3: *In assessing whether consignment sales should be recorded by the consignee on a “gross” or “net” basis, what is the audit evidence that auditors would seek in order to assess whether consignment sales have been properly recorded?*

A3: It is not uncommon that some Mainland enterprises may fail to understand the importance of considering the economic substance of the consignment agreement and may simply recognise the gross amount collected on behalf of others as revenue.

In accordance with ASBE – “Revenue”, revenue is defined as the gross inflow of economic benefits arising in the course of the ordinary activities of an enterprise, from such events as the sales of goods, the rendering of services and the use by others of enterprise assets. Amounts collected on behalf of third parties or clients are excluded from revenue. The meaning of revenue adopted under ASBE is basically the same as that prescribed by HKAS 18.

From an audit point of view, auditors should examine detailed consignment agreements and the substance of the sales transactions to determine whether the consignment sales should be recorded by the consignee on a “gross” or “net” basis. The following are some common evidence supporting “gross” basis reporting:

- Where the company is a primary obligor in the arrangement;
- Where the company is required to bear the general inventory risk;
- Where the company is required to bear the customer’s credit risk;
- Where the company has the ability to determine the final selling price;
- Where the company is highly involved in determining product specifications.