MAINLAND AUDIT ISSUES - RECOGNITION OF SALES

The Questions and Answers (Q&As) below are the first of a series of Q&As and/or articles to be developed by the Working Group on Mainland Audit Issues of the HKSA 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.

This first set of Q&As addresses some of the common issues relating to revenue recognition for Mainland enterprises, including potential sales cut-off errors, the traditional practice of recognising sales on a cash basis and accounting for sales returns. The next set of Q&As will be on audit issues relating to Value-added Tax Invoices (增値稅專用發票). Other topics that are on the Working Group's agenda include consignment sales, off-book transactions and external confirmations.

The Working Group welcomes your comments and feedback, which should be sent to *commentletters@hksa.org.hk*, for the attention of Stephen Chan, Technical Director (Ethics & Assurance).

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Q1: Sales cut-off errors seem to be quite common for Mainland enterprises. What are the common causes and how can they be addressed?

A1: In accordance with the Accounting Standard for Business Enterprises "Revenue" (企業會計準則 – 收入) issued by the Ministry of Finance of the People's Republic of China (MOF), revenue from the sale of goods should be recognised when certain specific conditions have been satisfied. Those specific conditions are similar to the provisions set out in Statement of Standard Accounting Practice 18 "Revenue" issued by the HKSA, one of which is the transfer of risks and rewards of ownership of the goods. However, some Mainland enterprises may neglect the importance of making reference to the sales terms in determining the transfer of risks and rewards and hence the timing of revenue recognition for accounting purposes.

Taking the manufacturing industry as an example, the most common issues of sales recognition mainly fall within the following two categories:

a. Sales revenue is recognised upon the shipment of goods whilst the risk of damage prior to the receipt of goods by the customers rests with the seller pursuant to the contract terms. As the transportation of goods usually takes days or even weeks for delivery, such policy would generally result in undue early recognition of sales revenue.

b. Sales revenue is recognised upon the generation of sales invoices which takes place only after the risks and rewards of ownership of goods have been transferred. Due to the inadequate control system on the timely communication between the sales department and the accounts department for goods delivered, many Mainland enterprises often experience a delay in recognising sales revenue in these circumstances.

From an audit point of view, the procedures below are examples of audit steps that can be performed in order to assess whether there is a potential sales cut-off error arising from the above circumstances. The nature, timing and specific procedures performed depend on the auditors' understanding of the client's business, their assessment of the control environment and their past audit experience.

- Enquire of management about i) the revenue recognition policy; ii) the internal controls that are in place to ensure the appropriate recognition of revenue; and iii) the documents generated or upon which the revenue recognised is based.

- Perform walkthrough test to confirm the auditors' understanding of the client's system and perform compliance tests on key controls.

- Perform cut-off tests on goods delivered before and after the year end with reference to the sales terms stipulated in the sales contract and expand sample size for cut-off tests performed on sales made to major customers as and when required.

- Perform direct circularisation of the year-end balances of accounts receivable. In case of no response, perform alternative procedures in accordance with paragraphs 33 and 34 of SAS 402 "External confirmations".

Q2: Why do many Mainland enterprises recognise sales on a cash basis and how can auditors ascertain such fact?

A2: In the past, the preparation of financial statements in the Mainland was often tax driven. In accordance with the relevant PRC tax regulations, output VAT is charged on sales and borne by the buyer. However, output VAT is payable to the tax bureau by the seller upon the recognition of sales revenue and issuance of the VAT invoices. As many Mainland enterprises would normally offer their customers a credit period for settlement, some of the enterprises may only issue VAT invoices (i.e. sales invoices) and recognise sales revenue upon the receipt of the settlement to avoid paying output VAT before the corresponding receivables are settled. However, as a result of the continual accounting reform implemented by the MOF in recent years, the separation of accounting and tax bases in preparing the statutory financial statements and tax returns respectively has been reinforced. However, it is not uncommon that many Mainland enterprises still recognise sales upon the receipt of settlement from the customers.

From an audit point of view, the specific procedures below are examples of audit steps that can be performed, in addition to those outlined in A1 above, in order to assess or detect whether a Mainland enterprise has accounted for its sales revenue on a cash basis.

- Perform analytical review on sales turnover days based on the auditors' understanding of the credit policy offered to customers for each major customer individually. This audit procedure is very effective and efficient when the enterprise only has a few major customers or the credit policy offered is almost the same for each customer. Perform analytical review on the year end balance, sales made during the year and sales turnover and investigate any unusual fluctuations for each major customer individually.

- Perform direct circularisation of annual sales transactions for selected customers if there is any suspicion that management may only have accounted for certain sales transactions or the sales made to certain customers are accounted for on a cash basis. In case of no response, perform alternative procedures in accordance with paragraphs 33 and 34 of SAS 402 "External confirmations".

- Expand the sample size for cut-off tests performed on goods delivered prior to the year end.

- Review the correspondence with the tax bureau, particularly the results of any tax review conducted by the tax bureau.

Q3: What should auditors do to ensure that sales returns arising after the balance sheet date are properly accounted for?

A3: In the Appendix to SSAP 18, it is noted that if there is uncertainty about the possibility of return, revenue is recognised when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed. It is further noted that in paragraph 16 of SSAP 18, an example is given of a retail sale when a refund is offered if the customer is not satisfied. Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors. Auditors should assess in respect of goods sold with a right of return, whether the entity's accounting treatment regarding recognition of revenue from such sales is in accordance with SSAP 18.

In accordance with the Accounting Standard for Business Enterprises "Revenue" (企業會計準則 – 收入) issued by the MOF, in preparing the PRC GAAP financial statements, sales returns of goods sold for which revenue has already been recognised should be recorded as a reduction of revenue in the period in which the goods are returned. In accordance with the Accounting Standard for Business Enterprises "Events occurring after the balance sheet date" (企業會計準則 –資産負債表日後事項), sales returns occurring between the balance sheet date and the date on which the financial statements are approved, in respect of the goods sold on or before the balance sheet date, should be treated as an adjusting event to the financial statements.

In auditing the HKGAAP financial statements of a Mainland enterprise, auditors would need to review the accounting policy in relation to recognition of revenue for goods sold with a right of return adopted by the Mainland enterprise to see if it is consistent with HKGAAP.