What to Look for When You Audit Revenue

By: Maire Loughran **Updated:** 03-26-2016 **From The Book:** Auditing For Dummies

Revenue is important to the audit because it's one of the two major business processes. (Purchasing is the other.) It's also the major account in which you look for instances of financial misstatements. However, ferreting out common instances that lead to material revenue misstatements is fairly easy.

Because most financial statements under audit have to comply with generally accepted accounting principles (GAAP), auditing revenue is a two-part process:

- **Sample and test the income statement revenue accounts:** Revenue accounts on the income statement reflect all income earned during the period, regardless if cash changes hands.

- **Sample and test the balance sheet account: accounts receivable:** Your client's accounts receivable account shows the amount of money that customers owe your client for goods and services provided.

In addition to verifying the balances in the revenue and accounts receivable accounts, you have to be on the lookout for revenue recognition issues during your audit, such as channel stuffing and side agreements:

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Channel stuffing: This issue occurs when a company entices its customers to buy more product than they could possibly need. This type of behavior probably doesn't seem too logical. Why would a company do this, and why would a vendor agree?

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Channel stuffing normally occurs at year-end. Plain and simple, it's just a way for a company to artificially inflate revenue. When this situation occurs, the unspoken agreement between the company and vendor is that the vendor can return the unneeded product after the first of the year for a full refund.

Vendors agree to accept too much product for many different reasons. Maybe they participate in channel stuffing themselves, or maybe they receive favorable purchasing terms from the company in exchange for the consideration.

- **Side agreements:** A side agreement is a verbal agreement that changes a sale's terms. For example, a vendor orders 5,000 widgets at $100 per widget with the expectation that before the invoice is due to be paid, the price per widget will be reduced to $50. This is another way to artificially (and temporarily) inflate a company's gross receipts — especially at year-end.

The savvy auditor can sniff out these issues — and other issues related to the revenue process — with solid audit procedures. Your first step is to understand how revenue is recognized.

About This Article

This article is from the book: Auditing For Dummies

About the book author: Maire Loughran is a self-employed certified public accountant (CPA) who has prepared compilation, review, and audit reports for fifteen years. Additionally, she is a university professor of undergraduate- and graduate-level accounting classes.

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