

Chapter 14--Auditing the Revenue Cycle

The overall objective of the sales and collection cycle is to evaluate whether the account balances affected by the cycle are fairly presented in accordance with GAAP.

Nature of the Sales and Collection Cycle

Numerous documents and records are included in the revenue cycle:

Customer order

Sales order—frequently used to show credit approval and authorization for shipment.

Shipping document—the original is sent to the customer and one or more copies are retained. Used as a signal to bill the customer. One type of shipping document is a bill of lading (a written contract between the carrier and the seller).

Sales invoice—a document indicating the description and quantity of goods sold, price, freight costs, insurance, terms, etc. Sales invoice information in the computer is the basis for recording sales transactions and updating the A/R master file.

Sales journal

Credit memo—a document indicating a reduction in the amount due from a customer because of returned goods or an allowance.

Remittance advice—a document that accompanies the sales invoice mailed to the customer and can be returned to the seller with payment. It is used to indicate customer name, sales invoice #, and invoice amount.

Cash receipts journal—daily entries in this journal are supported by remittance advices.

Uncollectible account authorization form

A/R master file—updated from the sales, sales returns and allowances, and cash receipts computer transactions files.

A/R trial balance

Monthly statement

An understanding of the functions that occur in a client firm for the sales and collection cycle is useful for understanding how an audit of the cycle is conducted.

1. processing customer orders--starting point for the entire cycle
2. granting credit--before goods are shipped, a properly authorized person must approve credit for the customer.
3. shipping goods--first critical point where company assets are given up. A shipping document is essential to the proper billing of shipments to customers.
4. billing customers--the most important aspects of billing are making sure that all shipments made have been billed, no shipment has been billed more than once, and each one is billed for the proper amount. In most accounting systems, customer billing involves simultaneous updating of the sales transaction file and A/R master file.
5. processing and recording cash receipts--the most important concern here is theft. All cash must be deposited in the bank at the proper amount on a timely basis and recorded in the cash receipts transaction file.
6. processing and recording sales returns and allowances
7. charging off uncollectible A/R
8. providing for bad debts

Internal Controls and Tests of Transactions for Sales

Tests of transactions are usually performed at an interim date if the IC structure is effective, but they can also be done after the balance sheet date.

ICs in sales are designed to achieve these seven objectives (refer to Table 11-1):

Key Controls

If the internal controls necessary to satisfy any one of the objectives are inadequate the likelihood of misstatements related to that objective is increased (regardless of controls for the other objectives).

Tests of Controls

For each internal control there exists a related test of control to verify its effectiveness.

In most audits, it is somewhat easy to determine the nature of the test of the control from the nature of the control (e.g., if the IC is to initial customer orders after they have been approved for credit, the test of control is to examine the customer order for a proper initial).

The auditor may evaluate the client's exception reports and use test data to be sure the client's programs operate correctly. For testing sales orders, the auditor can enter test data to evaluate program results for:

Another computer audit test is to perform sequence checks to detect a missing or duplicate sales order.

Substantive Tests of Transactions

Some procedures are used in every audit regardless of circumstances while others depend on the adequacy of controls and results of tests of controls. The substantive tests of transactions are related to the objective in the first column of Table 11-1 and are designed to determine whether any monetary errors of the type relating to that objective exist in the transaction.

The audit procedures used are affected by the ICs and tests of controls for that objective. Materiality and results of the prior year also affect the procedures used.

For example, there is a higher risk of misstatement in A/R. Certain procedures in auditing A/R are high cost. Usually a larger share of financial statement materiality is allocated to A/R. It is critical to understand the relationships among the columns in Table 11-1. The first column includes the 7 internal controls and tests of transactions audit objectives.

General objectives are the same for any class of transactions but specific objectives vary for sales, cash receipts, etc.

Col. 2 lists one or more illustrative ICs for each IC objective. Any given control must be related to one or more specific objectives. The common tests of controls in

column 3 relate to a given IC. A test of control has no meaning unless it tests a particular control. The common substantive tests of transactions in the last column are evidence to support a specific audit objective in column 1. The substantive tests of transactions are not directly related to the key control or test of control columns, but the extent of substantive tests of transactions depends, in part, on which controls exist and on results of tests of controls.

More Detailed Discussion of Individual Internal Controls in Table 11-1

Many firms prepare a multicopy prenumbered sales invoice at the time a customer order is received. There is almost no chance of a failure to bill a customer if all invoices are accounted for periodically. If the client requires a duplicate sales invoice be attached to every sales order to prevent failure to bill, a test of control is to account for a sequence of sales orders and check each one for a duplicate sales invoice being attached.

Prenumbered Documents

Prenumbered documents are meant to prevent both the failure to bill or record sales and the occurrence of duplicate billings and recordings. Tests of controls means the auditor focuses on omitted and duplicate numbers outside the normal sequence.

Proper Authorization

The auditor is concerned about authorization at 3 points:

- 1- credit must be properly authorized before a sale occurs
- 2- goods should be shipped only after proper authorization
- 3- prices must be authorized

The first two controls are meant to prevent the loss of company assets by shipping to fictitious customers or those who will fail to pay. It is easy to test for the effectiveness of ICs for authorization by examining documents for proper approval at these three points. Some computer systems have credit limits in the A/R master file.

Adequate segregation of duties

Anyone responsible for inputting sales and cash receipts transaction information into the computer should be denied access to cash. It is also desirable to separate credit-granting functions from the sales function. Credit checks offset the tendency of sales personnel to optimize volume at the expense of debt writeoffs.

Personnel responsible for doing internal comparisons should be independent

from entering original data (e.g., comparison of batch control totals to summary reports and A/R master file totals to the general ledger balance should be done by a person different from the one who inputs sales and cash receipt transactions).

Internal Verification Procedures

The use of independent persons for checking the processing and recording of sales is critical.

Substantive Tests of Sales Transactions

Recorded sales are valid

For this objective, the auditor is concerned with two types of misstatements: sales being included in the journals for which no shipment was made and shipments being made to fictitious customers. Appropriate substantive tests of transactions for invalid transactions depends on where the auditor believes misstatements are likely to occur.

Sales are properly authorized

It is necessary to test by substantive procedures whether the firm's general credit, shipping, and pricing policies are being followed. This is especially true of pricing sales.

An example here would be:

Existing sales transactions are recorded

Substantive tests may be necessary here if adequate controls do not exist. This will be the case if the client does no internal tracing from the shipping documents to the sales journal. An effective procedure to test for unbilled shipments is to trace selected shipping documents to related duplicate sales invoices and the sales journal. Tracing from source documents to the journals is a test for omitted transactions. Auditing from the journals back to the supporting documents is a test for invalid transactions.

Validity objective--starting point is a journal

Completeness objective--starting point is a shipping document

When designing audit procedures for validity and completeness, the starting point for tracing the document is critical. This is referred to as the direction of tests.

Recorded sales are properly valued

This deals with shipping the amount of goods ordered, correctly billing for the amount of goods shipped, and correctly recording the amount billed. A typical substantive test is to start with entries in the sales journal and compare the total of selected transactions with A/R master file entries and duplicate sales invoices. If a control is effective, the sample size for substantive tests of transactions can be reduced.

Recorded sales are properly classified

Here the auditor examines supporting documents to determine the proper classification of a transaction and compares this to the actual account to which it is charged.

Sales are recorded on a timely basis

Transactions could be omitted from the accounting records or sales could be recorded in the wrong period if they are not recorded on a timely basis. Significant differences between the dates on shipping invoices and duplicate sales invoices could indicate a cutoff problem.

Sales transactions are properly included in the master file and correctly summarized.

It is necessary to perform some clerical accuracy tests by footing the journals and tracing the totals and details to the general ledger and the master file to check whether there are misstatements in the computer program. The distinction between the summarization and other objectives is that summarization includes footing journals, master file records, and ledgers and tracing from one to the other among the three.

Control Activities--Cash Receipts Transactions

Common Documents (not already covered)

Prelist--listing of cash receipts received in the mail

Cash count sheet--listing of cash and checks in a cash register

Daily cash summary--report showing total over-the-counter and mail receipts received by the cashier for deposit

Cash Receipts Functions

1. Receiving cash receipts

Entails two risks:

2. Depositing cash in the bank

All cash receipts should be deposited daily.

3. Recording the receipts

Controls should ensure that only valid transactions and all actual receipts are entered (e.g.-restricting access to accounting records) and segregation of counting cash receipts and journalizing.

Control Activities--Sales Adjustment Transactions

This entails such things as granting cash discounts and sales returns and allowances. It also includes determining uncollectible accounts.

The potential for misstatements resulting from errors and fraud in processing these transactions is considerable in some firms. A main concern here is the possibility of fictitious sales adjustments transactions being recorded to hide fraud. Several useful control activities include:

Substantive Tests of Accounts Receivable

The auditor must first determine the acceptable level of detection risk for each important assertion to select substantive tests for A/R and uncollectible accounts. Factors relevant to assessed levels of control risk and inherent risk must be considered in selecting an appropriate level of detection risk for each assertion.

Factors relevant to assessed levels of IR and CR must be considered in selecting an appropriate level of detection risk for each assertion.

Control risk assessments for A/R assertions are dependent on related control risk assessments for transaction classes (e.g., credit sales, cash receipts and sales adjustments) that affect the A/R balance. Assessment for transaction class assertions affect the same account balance assertions for accounts affected by the transactions except:

CR assessments for the existence or occurrence and completeness assertions for a transaction class that decreases an account balance affect the assessments for the opposite account balance assertions (e.g. assessments for existence or occurrence for cash receipts and sales adjustments affect the combined assessment for the A/R completeness assertion).

Appropriate IR assessments and planned assessed levels of CR for account balance assertions are used in the audit risk model to arrive at planned DR and the planned level of substantive tests. Revised levels of DR and substantive tests for an assertion may be necessary if actual CR differs from planned CR assessments.

Designing Substantive Tests

A listing of possible substantive tests that might be included in an audit program developed by the auditor appears in Fig. 14-9 of your textbook. This figure does not represent a formal audit program.

Initial Procedures

The starting point for verifying A/R and the related allowance account is tracing the current period's beginning balances to the ending audited balances in the prior year's working papers (when applicable). Next, the current period's activity in the general ledger control account and related allowance account should be reviewed for any significant entries that are unusual in nature or amount. A listing of all customer balances, called an A/R trial balance, is obtained. This listing should be footed and the total compared with the total of the subsidiary ledger or master file from which it was prepared and the general ledger control account balance.

As you know from some of the cases and AAERs we have studied, when the client furnishes the trial balance, a sample of the customers and balances shown on the trial balance should be compared with those in the subsidiary ledger or master file and vice versa to determine that the trial balance is an accurate and complete representation of the underlying accounting records.

Look at Fig. 14-10 for an example of an aged trial balance of receivables working paper.

Tests of Details of Transactions

Vouch Recorded Receivables to Supporting Transactions

In doing this test, a sample of debits to customers' accounts can be vouched to supporting sales invoices and matching documents to provide evidence pertaining to the existence or occurrence, rights and obligations, and valuation or allocation assertions. Credits can be vouched to remittance advices and sales adjustment authorizations.

Perform Cutoff Tests for Sales and Sales Returns

The sales cutoff test is designed to obtain reasonable assurance that sales and A/R are recorded in the accounting period in which the transactions occurred and the corresponding entries for inventories and cost of goods sold are made in the same

period. Sales should be recorded in the period in which legal title to the goods passes to the buyer.

The sales cutoff test is made as of the balance sheet date. For sales of goods from inventory, the test involves comparison of a sample of recorded sales from the last few days of the current period and the first few days of the next period with shipping documents to determine whether the transactions were recorded in the proper period.

The sales cutoff test provides evidence concerning the existence or occurrence and completeness assertions for A/R and sales. For a calendar year firm, if January sales are recorded in December, there is a misstatement of the E or O assertion. Conversely, if December sales are not recorded until January, there is a misstatement of the completeness assertion.

Take a look at the materials at the end of this chapter's outline to see why cutoff tests are so important. We want to consider "Two Real-World Examples of Fraud."

Perform Cash Receipts Cutoff Test

The cash receipts cutoff test is designed to obtain reasonable assurance that cash receipts are recorded in the accounting period in which received. A proper cutoff at the balance sheet date is essential to the correct presentation of both cash and A/R. This test relates to the E or O and completeness assertions for both cash and A/R.

Evidence concerning the promptness of the cutoff can be obtained by personal observation or a review of documentation. An alternative to personal observation is to review supporting documentation such as the daily cash summary and validated deposit slip for the last day of the year. The objective of the review is to determine that the deposit slip total agrees with the receipts shown on the daily cash summary.

Tests of Details of Balances

Confirm A/R

SAS 67–The Confirmation Process states that there is a presumption that the auditor will request the confirmation of A/R during an audit unless A/R are immaterial to the financial statements, the use of confirmations would be an ineffective audit procedure, or the auditor's combined assessment of inherent risk and control risk is low, and that assessment, together with the evidence from analytical procedures or other substantive tests, is adequate to reduce audit risk to an acceptably low level for the relevant financial statement assertions.

There are two forms of confirmation request: the positive form, which requires the debtor to respond whether or not the balance shown is correct and the negative form, which requires the debtor to respond only when the amount shown is incorrect. The positive form usually produces the better evidence, because under the negative form,

the failure to receive a response can only lead to a presumption that the balance is correct, whereas the customer may have overlooked the request or neglected to return an exception.

The form selection rests with the auditor. In making the decision, the auditor considers the acceptable level of detection risk and the makeup of the customer balances. The positive form is used when detection risk is low or individual customer balances are relatively large. The negative form, according to GAAS, should be used only when all three of the following conditions are present: (1) the acceptable level of detection risk for the related assertions is moderate or high; (2) a large number of small balances is involved; and (3) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

The extent of requests, or sample size, is inversely related to each of the following factors: (1) the acceptable level of DR for the assertions to which the confirmation evidence will apply; (2) the extent to which other substantive tests contribute to achieving that detection risk; and (3) tolerable misstatement for A/R.

If you do not recall the term “tolerable misstatement” from Chapter 8, then we will review it. Tolerable misstatement is the minimum misstatement that can exist in an account balance for it to be considered materially misstated.

Negative confirmations require larger sample sizes than positive confirmations.

Given the possibility for fraud, the auditor must control every step in the confirmation process. This means determining that the amount, name, and address on the confirmation agree with the corresponding data in the customer’s account, maintaining custody of the confirmations until they are mailed, using the firm’s own return address envelopes for the confirmations, personally depositing the requests in the mail, and insisting that the returns be sent directly to the auditor.

When no response has been received after the second or third positive confirmation request to a customer, the two main alternative procedures that may be used are examining subsequent collections and vouching open invoices comprising customer balances. The matching of collections back to open or unpaid invoices comprising the customers’ balances at the confirmation date establishes the collectibility of the accounts.

The confirmation of A/R is the primary source of evidence in meeting the E or O assertion. The test also provides evidence on the rights and obligations assertion.

Evaluate Adequacy of Allowance of Uncollectible Accounts

This test of balances involves footing and crossfooting the aged trial balance of A/R and agreeing that total to the general ledger balance (if different than others used), testing the aging of the amounts shown in the aging categories, and assessing the

reasonableness of the percentages used to compute the allowance component used for each aging category.