Auditing A Practical Approach

Third Canadian Edition

Moroney, Campbell, Hamilton, Warren

Chapter 9

AUDITING SALES AND RECEIVABLES

LEARNING OBJECTIVES (1 of 2)

- Identify the audit objectives applicable to sales and receivables
- Describe the functions and control procedures normally found in information systems for processing sales, cash receipts and sales adjustment transactions
- Outline audit strategy considerations including the risk of material misstatement and tests of controls for sales, cash receipts, and sales adjustments transactions

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LEARNING OBJECTIVES (2 of 2)

- 4. Indicate the factors relevant to determining an acceptable level of detection risk for the audit of sales and receivables
- 5. Design a substantive audit program for sales and receivables

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Audit Objectives (1 of 4)

- Key Issues
- Receivables do actually exist and are collectible, and adequate allowances have been made for receivables that are doubtful, in terms of their collectability
- Sales are genuine and are neither overstated or understated

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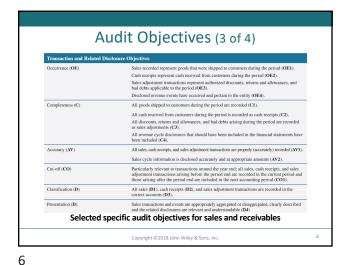
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Audit Objectives (2 of 4)

- When auditing sales and receivables, the auditor's objective is to obtain sufficient and appropriate evidence about each significant assertion for applicable classes of transactions and balance
- To meet these objectives an auditor may use a combination of tests of controls and substantive procedures

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Account Balance and Related Disclosure Objectives Existence (OE) (OES). Rights and obligations (RO) Accounts receivable represent amounts owed by customers at the end of the reporting period (OES). Rights and obligations (RO) Accounts receivable at the end of the sakes reporting period represent legal claims of the entity on customers for payment (ROI). Completeness (C) All amounts owed by customers at the end of the reporting period are included in accounts receivable (C4). Accuracy, valuation and allocation (AV) Accounts receivable represent gross claims on customers at the end of the reporting period and agree with the sum of the accounts receivable subsidiary ledger (AVS). The allowance for doubtful accounts represents are assonable estimate of the difference between gross accounts receivable are recorded in the correct account (D5). Presentation (D) Accounts receivable and the related allowance for doubtful accounts are appropriately aggregated of disaggregated, clearly described, and the related disclosures are relevant and understandable (D6). Selected specific audit objectives for sales and receivables Copyright ©2018 John Wiley & Sons, Inc.

The Process for Credit Sales Transactions

- The process of credit sales transactions involves
 - Accepting customer orders
 - Approving credit
 - · Filling & dispatching orders
 - Invoicing customers
 - · Recording the sales

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Customer Orders

- Accepting customer orders is the first step in the cycle
- This involves receiving a sales order and checking it for authenticity, acceptability of terms and conditions, and the availability of inventory
- Once accepted, the order is then recorded on a pre-numbered multi-copy sales order which shows the description of the goods, quantity ordered, and other relevant data

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Credit Approval (1 of 2)

- Approving credit is the second step of the process. This should be completed before the order moves to the warehouse
- To obtain credit, typically the customer completes a credit application and a credit report is obtained
- Once approved by the credit manager, an appropriate credit limit is set and the customer is entered into the accounts receivable master file

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Credit Approval (2 of 2)

- For each order, the amount of the order should be compared to the customer balance and the credit limit
- If the order puts the customer over their limit or if the account is overdue, the order should likely be refused
- Strong controls over credit approval and the extension of credit impact the allowance, allocation, and valuation of receivables

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Shipping Orders (1 of 2)

- Filling and shipping sales orders happens once a completed copy of the approved sales order form is sent to the warehouse
- Segregation of the responsibilities of shipping from that of approving and filling orders prevents the shipment of unauthorized shipments

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Shipping Orders (2 of 2)

- Also the goods received from the warehouse should be checked independently to determine that the approved sales order matches the goods received from the warehouse
- A pre-numbered shipping document is used to authorize the release of goods from inventory and the delivery of goods to the end customer

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Invoicing Customers (1 of 3)

- Next in the process is the invoicing of customers
- Key control objectives:
 - All goods delivered are invoiced to customers
 - · Only actual deliveries are invoiced
 - Accuracy of price and all other calculations

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Invoicing Customers (2 of 3)

Typical control procedures include:

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- Segregation of the invoicing function from shipping related functions
- Checking the shipping document and matching it against the approved sales order before an invoice is prepared
- Using an authorized price list in the preparation of the invoice

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Invoicing Customers (3 of 3)

- Typical control procedures include (continued):
 - Independent invoice checks focusing on prices used and mathematical accuracy
 - Comparing control totals for shipping documents with the totals for sales invoices

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Recording Sales (1 of 6)

- · Key Objectives:
 - · sales invoices are accurately recorded
 - · sales are recorded in the proper period
- Involves the sale invoices being entered into the sale journal, accounts receivable subsidiary ledger, and general ledger control account

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Recording Sales (2 of 6)

- Key possible control activities include:
 - Check to ensure the total of the invoices entered into the sales journal matches total sales invoices posted to the AR ledger
 - Sequential invoice numbers need to be checked for missing numbers
 - Customer statements should be sent to customers on a regular basis - contact information for an individual not involved in the execution process should be provided

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Recording Sales (3 of 6)

- Key possible control activities include (continued):
 - Independent check of the AR ledger against the balance in the control account in the GL
 - Regular performance reviews by sales executives including budget comparisons
 - Often an online computer system is used for many of the previous processes

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Recording Sales (4 of 6)

- Key possible control activities include (continued):
 - The computer can be programmed to: validate credit, check inventory levels, issue instructions to the shipping department, issue invoices, and update the accounts
 - It is critical that such a system has access controls, programmed application controls, and controls over data files.

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Recording Sales (5 of 6)

Computer Control Examples

- Access controls
 - Permit read-only access to transactions and master files to authorized individuals only

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Recording Sales (6 of 6)

Computer Control Examples (continued)

- Programmed application controls
 - Only orders for customers in the AR master file are accepted
 - Only orders for goods in the product list are accepted
 - Numerical continuity is checked
 - Transactions are processed on a regular schedule
 - Duplicates are rejected
 - Irregular and/or unreasonable quantities, amounts etc. are questioned

Cash Receipts (1 of 8)

- Involves: receiving cash, depositing cash in the bank, and recording the receipts
- Key Risks:

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- · cash paid by customers is stolen before it is recorded
- errors

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Cash Receipts (2 of 8)

- For over-the-counter receipts, often a cash register or point of sale terminal is used
- Benefits:

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- provides a visual display to customer and a receipt to the customer
- Provides an internal record of the transactions locked inside the register and a printed control of the day's receipts

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Cash Receipts (3 of 8)

- Common procedures:
 - Supervisory surveillance of over-the-counter sales transactions
 - Independent checks of cash on hand compared to totals printed by the register or terminal before the cash is forwarded to the cashier's department for deposit

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Cash Receipts (4 of 8)

- Common procedures:
 - Procedures must be in place to reconcile card sales with the cash register as part of the daily agreement process
 - At least two clerks should open the mail
 - If cheques are received, cheques should immediately be stamped for deposit only indicating the organizations name

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Cash Receipts (5 of 8)

- · Common procedures (continued):
 - Often an remittance advice is prepared indicating the payer and the payment details and then it is sent to the AR department for posting to the AR sub-ledger
 - For bank credit transfers the company should have a process in place that automatically detects such transfers and updates AR records

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Cash Receipts (6 of 8)

- Common procedures (continued):
 - All cash receipts are deposited intact daily
 - Over-the-counter and mail receipts should agree with the register total and prelist
 - Cash receipt details are used to prepare a daily cash summary and bank deposit slip

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Cash Receipts (7 of 8)

Common procedures (continued):

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- Daily cash summaries are forwarded to accounting
- Access to computer programs/accounting records should be restricted to authorized personnel
- The journalizing of cash receipts and posting of the receipts to customer accounts should be segregated

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Cash Receipts (8 of 8)

- Common procedures (continued):
 - Independent checks should be made of:
 - the agreement of the total amounts journalized and posted with the recorded amounts kept by the mailroom
 - the agreement of total amounts journalized and posted for over-the-counter and mail receipts with the daily cash summary and deposit slips
 - Bank reconciliations should be reviewed regularly by a manager

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Sales Adjustment Transactions (1 of 2)

- Involves: cash discounts, sale returns and allowances, and bad debt determination
- Key risk: possibility of fictitious sales adjustments being recorded to conceal misappropriation of cash

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Sales Adjustment Transactions (2 of 2)

- Common procedures
 - Require proper authorization of sales adjustments including the approval of bad debt write offs
 - Use of appropriate documentation (for example approved credit memo for returned/damaged items and an approved write-off memo for writing off bad debts)
 - Segregation of duties between authorizing adjustments and handling and recording of cash receipts

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Audit Strategy (1 of 2)

Strategy considerations:

- Strategy refers to the mix of tests of control & substantive tests to be applied; depends on inherent & control risk
- If controls are believed to be effective and it is efficient to do so controls a combined audit may be planned
- Involves test of controls to assess their effectiveness

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Audit Strategy (2 of 2)

- Understanding the entity and its environment
 - To assist in assessing possibility of misstatements
 - Assists auditor in developing :
 - an expectation of total revenues
 - an understanding of gross margins
 - Expectations of receivable levels
 - Revenue generation also drives many costs and therefore can lead to an understanding of the expenditure cycles

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Strategy Considerations

- Inherent risk
 - Pressure on management to overstate revenue, cash & receivables and understate bad debts
- · Other inherent risk factors include
 - High volume of transactions
 - Contentious revenue recognition issues
 - Cash is susceptible to misappropriation
 - Sales adjustments used to conceal theft

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Internal Controls (1 of 2)

- The control environment may enhance or negate the effectiveness of other internal control elements
- Management's adoption and adherence to high standards of integrity and ethics is a key control factor

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Internal Controls (2 of 2)

- A number of special policies related to personnel are often adopt for those employees that hand cash receipts – examples include mandatory holidays and job rotation
- The auditor must also understand management's risk assessment procedures and evaluate their effectiveness

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Control Risk (1 of 4)

- The auditor must obtain an understanding of the internal control structure in order to determine if the auditor believes it is possible and cost effective to assess the CR at a level less than high
- The next few slides provide an example of a partial list of "what can go wrong", potential controls, and effectiveness tests matched to transaction level audit objectives

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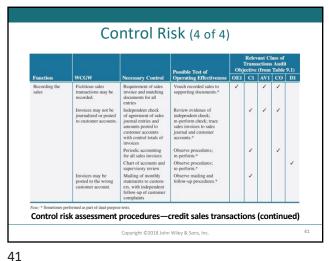
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Control Risk (2 of 4) | Function | WCGW | Necessary Control | Observations | Observation | Observat

Control Risk (3 of 4)

| Powerline | WCGW | Necessary Control | Powerline | Po

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Tests of Operating Effectiveness (1 of 6)

- Auditor must test the design effectiveness and operating effectiveness of the ICS over credit sales related transactions
- Reminder: the direction of the testing here should be backwards (vouching) along the audit trail to test controls over the occurrence, and forwards (tracing) when the objective is to test controls over completeness

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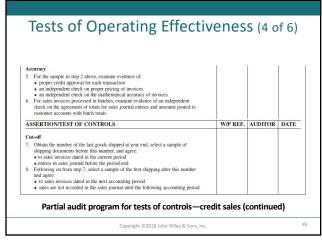
Tests of Operating Effectiveness (2 of 6)

- An auditor must document the test performed, the evidence obtained, and the conclusion(s) reached
- Control tests may provide substantive evidence as well – these type of tests are referred to as dual-purpose tests
- Two sample programs for tests of controls related to credit sales transactions and cash receipts appear on the next few slides

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Tests of Operating Effectiveness (3 of 6) W/P REF. AUDITOR DATE ASSERTION/TEST OF CONTROLS Partial audit program for tests of controls—credit sales Copyright ©2018 John Wiley & Sons, Inc

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Tests of Operating Effectiveness (5 of 6)

- Test of operating effectiveness of controls over a computer information system typically are carried out using computer assisted audit techniques (CAATs)
- · Two main categories of CAATs:
 - Programmed application related controls
 - Data related

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Tests of Operating Effectiveness (6 of 6)

- Based on the evidence obtained and results of the tests, the auditor can make a final assessment of inherent risks and control risk
- Based upon this assessment, planning for the level of substantive procedures to be performed can begin

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Level of Detection Risk

- Before the specific design of substantive procedures can take place the auditor must determine the acceptable level of detection risk for each significant related assertion
- The level of detection risk determined will then be used by the auditor to determine the nature, timing, and extent of substantive procedures needed

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Substantive Testing

- · Main focus is gross amount due from customers on credit sales, and related allowance for doubtful accounts
- The steps on the next few slides provide an example of possible substantive procedures for accounts receivable assertions

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Substantive Testing

1. Initial Procedures

- Trace opening balances
- Review activity
- Agree accounts receivable to the trial balance
- A working paper example documenting some of these procedures can be found on the next slide

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Substantive Testing

2. Analytical Procedures

- Review understanding of entity, with a focus on anticipated changes expected in sales and AR
- Identify absolute change amounts between this year and last year
- Use more sophisticated relationship tests such as ratios (for example, gross profit and average collection period) and trend analysis

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Substantive Testing

3. Tests of Details of Transactions

- Vouch accounts receivables to supporting transactions - often a sample is used
- Test sales cut off at the end of the period
- Test cash receipts cut off

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Substantive Testing

4. Tests of Details of Balances

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- Confirming accounts receivable
 - CAS 505 External Confirmations (see Figure on the next slide for an example of a confirmation control sheet)
 - Need to determine the type of confirmation to be used, the timing and extent of requests, and the proper control over the confirmation
 - Provides reliable external evidence on existence & rights assertions
- Evaluate adequacy of bad debts provision

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Substantive Testing

5. Presentation & Disclosure

- Ensure disclosure requirements are met for the variety of accounts receivables that appear
- Obtain management's representation on these matters in writing as part of the representation letter

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Conclusion

- Sales and receipts from sales are the most important transaction classes for commercial entities
- A major focus of audit effort
- Major inherent risk for auditor is overstatement of revenues & assets; major risk for entity is misappropriation of cash

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