

Auditing A Practical Approach

Third Canadian Edition

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Chapter 9

AUDITING SALES AND RECEIVABLES

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LEARNING OBJECTIVES (1 of 2)

1. Identify the audit objectives applicable to sales and receivables
2. Describe the functions and control procedures normally found in information systems for processing sales, cash receipts and sales adjustment transactions
3. 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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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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Audit Objectives (3 of 4)

Transaction and Related Disclosure Objectives

Occurrence (OE)	Sales recorded represent goods that were shipped to customers during the period (OE1). Cash receipts represent cash received from customers during the period (OE2). Sales adjustment transactions represent authorized discounts, returns and allowances, and bad debts applicable to the period (OE3). Disclosed revenue events have occurred and pertain to the entity (OE4).
Completeness (C)	All goods shipped to customers during the period are recorded (C1). All cash received from customers during the period is recorded as cash receipts (C2). All discounts, returns and allowances, and bad debts arising during the period are recorded as sales adjustments (C3). All revenue cycle disclosures that should have been included in the financial statements have been included (C4).
Accuracy (AV)	All sales, cash receipts, and sales adjustment transactions are properly (accurately) recorded (AV1). Sales cycle information is disclosed accurately and at appropriate amounts (AV2).
Cut-off (CO)	Particularly relevant to transactions around the year end: all sales, cash receipts, and sales adjustment transactions arising before the period end are recorded in the current period and those arising after the period end are included in the next accounting period (CO1).
Classification (D)	All sales (D1), cash receipts (D2), and sales adjustment transactions are recorded in the correct accounts (D3).
Presentation (D)	Sales transactions and events are appropriately aggregated or disaggregated, clearly described and the related disclosures are relevant and understandable (D4).

Selected specific audit objectives for sales and receivables

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Audit Objectives (4 of 4)

Account Balance and Related Disclosure Objectives

Existence (OE)	Accounts receivable represent amounts owed by customers at the end of the reporting period (OE5).
Rights and obligations (RO)	Accounts receivable at the end of the sales reporting period represent legal claims of the entity on customers for payment (RO1).
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 (AV3). The allowance for doubtful accounts represents a reasonable estimate of the difference between gross accounts receivable and their net realizable value (AV4).
Classification	Accounts receivable are recorded in the correct account (D5).
Presentation (D)	Accounts receivable and the related allowance for doubtful accounts are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (D6).

Selected specific audit objectives for sales and receivables

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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:
 - 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

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Cash Receipts (1 of 8)

- **Involves:** receiving cash, depositing cash in the bank, and recording the receipts
- **Key Risks:**
 - 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:
 - 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):
 - 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 adopted 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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Control Risk (2 of 4)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 9.1)				
				OE1	CI	AV1	CO	DI
Accepting customer orders	Sales may be made to unauthorized customers.	Determination that the customer is on the approved customer list Approved sales order form for each sale	Observe procedure; re-perform. Examine approved sales order forms.	✓				
Approving credit	Sales may be made without credit approval.	Credit department performs a credit check on all new customers Customer's credit limit checked before each sale	Inquire about procedures for checking credit on new customers. Examine evidence of credit limit check before each sale.			✓		

Control risk assessment procedures—credit sales transactions

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Control Risk (3 of 4)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 9.1)				
				OE1	CI	AV1	CO	DI
Filling sales orders	Goods may be released from the warehouse for unauthorized orders.	Approved sales order is required for all goods released to shipping	Observe warehouse personnel filling orders.	✓				
Shipping	Goods shipped may not agree with goods ordered.	Independent check by shipping clerk to agree goods shipped from warehouse with approved sales order	Examine evidence of performance of independent check.	✓	✓			
	Unauthorized shipments may be made.	Segregation of duties for filling and shipping orders Preparation of shipping document for each shipment	Observe the segregation of duties. Inspect shipping document.	✓				
Invoicing customers	Invoices may be made for fictitious sales or duplicate invoices may be made.	Matching of shipping document and approved sales order for each invoice	Vouch invoices to shipping document and approved sales orders. ^a	✓				
	Some shipments may not be invoiced.	Matching of sales invoice with each shipping document	Trace shipping document to sales invoices. ^a		✓		✓	
	Sales invoices may have incorrect prices.	Periodic accounting for all shipping documents Independent check on pricing of invoices	Observe procedure; re-perform. Inspect copy of invoice for evidence of performance. Re-perform the check on the accuracy of pricing. ^a		✓			✓

Control risk assessment procedures—credit sales transactions (continued)

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Control Risk (4 of 4)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 9.1)				
				OEI	CI	AVI	CO	DI
Recording the sales	Fictitious sales transactions may be recorded.	Requirement of sales invoice and matching documents for all entries	Vouch recorded sales to supporting documents.*	✓		✓		
	Invoices may not be journalized or posted to customer accounts.	Independent check of agreement of sales journal entries and amounts posted to customer accounts with control totals of invoices	Review evidence of independent check; re-perform check; trace sales invoices to sales journal and customer accounts.*		✓	✓	✓	
		Periodic accounting for all sales invoices	Observe procedures; re-perform.*		✓		✓	
	Invoices may be posted to the wrong customer account.	Chart of accounts and supervisory review Mailing of monthly statements to customers, with independent follow-up of customer complaints	Observe procedures; re-perform.* Observe mailing and follow-up procedures.*		✓			✓

Note: * Sometimes performed as part of dual-purpose tests.

Control risk assessment procedures—credit sales transactions (continued)

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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)

Planned tests of controls — Credit sales transactions Year ending December 31, 2020			
ASSERTION/TEST OF CONTROLS	W/P REF.	AUDITOR	DATE
Occurrence 1. Observe procedures, including segregation of duties, for: • approving sales orders • filing sales orders • shipping sales orders • invoicing customers • mailing monthly statements to customers and following up on customer complaints 2. Select a sample of sales transactions from the sales journal and verify transaction dates, customer names, and amounts by vouching entries to the following matching supporting documents: • sales invoices • shipping documents • approved sales orders Completeness 3. Examine evidence of the use of and accounting for pre-numbered sales orders, shipping documents, and sales invoices. Scan the sequence of sales invoice numbers in the sales journal. 4. Select a sample of approved sales orders and trace to matching: • shipping documents • sales invoices • entries in the sales journal			

Partial audit program for tests of controls—credit sales

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Tests of Operating Effectiveness (4 of 6)

Accuracy

5. For the sample in step 2 above, examine evidence of:
 - proper credit approval for each transaction
 - an independent check on proper pricing of invoices
 - an independent check on the mathematical accuracy of invoices
6. For sales invoices processed in batches, examine evidence of an independent check on the agreement of totals for sales journal entries and amounts posted to customer accounts with batch totals.

ASSERTION/TEST OF CONTROLS	W/P REF.	AUDITOR	DATE
Cut-off			
7. Obtain the number of the last goods shipped at year end, select a sample of shipping documents before this number, and agree: <ul style="list-style-type: none"> • to sales invoices dated in the current period • entries in sales journal before the period end 			
8. Following on from step 7, select a sample of the first shipping after this number and agree: <ul style="list-style-type: none"> • to sales invoices dated in the next accounting period • sales are not recorded in the sales journal until the following accounting period 			

Partial audit program for tests of controls—credit sales (continued)

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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

- 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 process
 - 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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