PART 3

APPLICATION OF THE AUDIT PROCESS TO THE SALES AND COLLECTION CYCLE

CHAPTERS 14 – 17

The four chapters of **Part 3** apply the concepts you learned in Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts in the cycle.

For you to appreciate how auditing is done in practice, you need to understand how auditing concepts are applied to specific auditing areas. We'll first look at one important part of every audit, the sales and collection cycle, to examine the practical application of auditing concepts.

- **Chapter 14** will help you learn the methodology for designing tests of controls and substantive tests of transactions audit procedures for sales, cash receipts, and the other classes of transactions in the sales and collection cycle.
- **Chapter 15** deals with nonstatistical and statistical sampling methods for tests of controls and substantive tests of transactions.
- **Chapter 16** presents the methodology for designing audit procedures for the audit of accounts receivable and other account balances in the sales and collection cycle.
- **Chapter 17** covers audit sampling for tests of details of balances.

CHAPTER 14

AUDIT OF THE SALES AND COLLECTION CYCLE: TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

14-1 Identify the accounts and the classes of transactions in the sales and collection cycle.

14-2 Describe the business functions and the related documents and records in the sales and collection cycle.

14-3 Understand internal control, and design and perform tests of controls and substantive tests of transactions for sales.

14-4 Apply the methodology for controls over sales transactions to controls over sales returns and allowances.

14-5 Understand internal control, and design and perform tests of controls and substantive tests of transactions for cash receipts.

14-6 Apply the methodology for controls over the sales and collection cycle to write-offs of uncollectible accounts receivable.

The Choice Is Simple – Rely On Internal Control Or Resign From The Audit

City Finance is the largest client managed out of the Pittsburgh office of a Big Four firm. It is a financial services conglomerate with almost 1,000 offices in the United States and Canada, as well as correspondent offices overseas. The company's records contain more than a million accounts receivable and it processes millions of sales and other transactions annually.

The company's computer data center is in a large, environmentally controlled room that contains several large computer servers and a great deal of ancillary equipment. There are two complete online systems, one serving as a backup for the other, as systems failure would preclude operations in all of the company's branches.

The company has an unusual system of checks and balances in which branch office transaction records are reconciled to data processing controls daily, which, in turn, are reconciled to outside bank account records monthly. Whenever this reconciliation process indicates a significant out-of-balance condition, procedures are initiated to resolve the problem as quickly as possible. A large internal audit staff oversees any special investigative efforts.

Because City Finance is a large public company, it must file its annual financial report including management's report on internal control over financial reporting on Form 10-K with the Securities and Exchange Commission within 60 days after its fiscal year-end. In addition, the company likes to announce annual earnings and issue its annual report as soon after year-end as reasonably feasible. Under these circumstances, there is always a great deal of pressure on the CPA firm to complete the audit quickly.

The CPA firm must conduct an integrated audit of the financial statements and internal control over financial reporting in accordance with PCAOB Standard 5. In the case of City Finance, there is no question that the auditor must rely extensively on internal control in the integrated audit and extensively test internal control over financial reporting. Even if the auditing standards requirements did not exist, it would be difficult to complete the audit within the reporting deadlines without extensively relying on key controls. In all honesty, if City Finance did not have excellent internal controls, the CPA firm admits that an audit of the financial statements just could not be done.

The circumstances of City Finance in the opening story illustrate an audit in which extensive reliance on internal controls in the sales and collection cycle will likely require the auditor to do extensive tests of controls and substantive tests of transactions. In other situations not involving the audit of an accelerated filer public company, the auditor may rely far less on internal controls but, as was shown in Chapter 10, will still need to understand the internal controls over sales and cash receipts. Auditors need to know when they should rely extensively on internal controls and when they shouldn't. This chapter studies assessing control risk and designing tests of controls and substantive tests of transactions for each of the classes of transactions in the sales and collection cycle.

Before we study assessing control risk and designing tests of controls and substantive tests of transactions for each class of transactions in detail, we will cover two related topics.

1. You need to know the sales and collection cycle classes of transactions and account balances in a typical company. We discussed these earlier, but we review them again here.
2. Because a considerable portion of the audit of transactions in the sales and collection cycle involves documents and records, it is essential to understand the typical documents and records used in the cycle.

ACCOUNTS AND CLASSES OF TRANSACTIONS IN THE SALES AND COLLECTION CYCLE

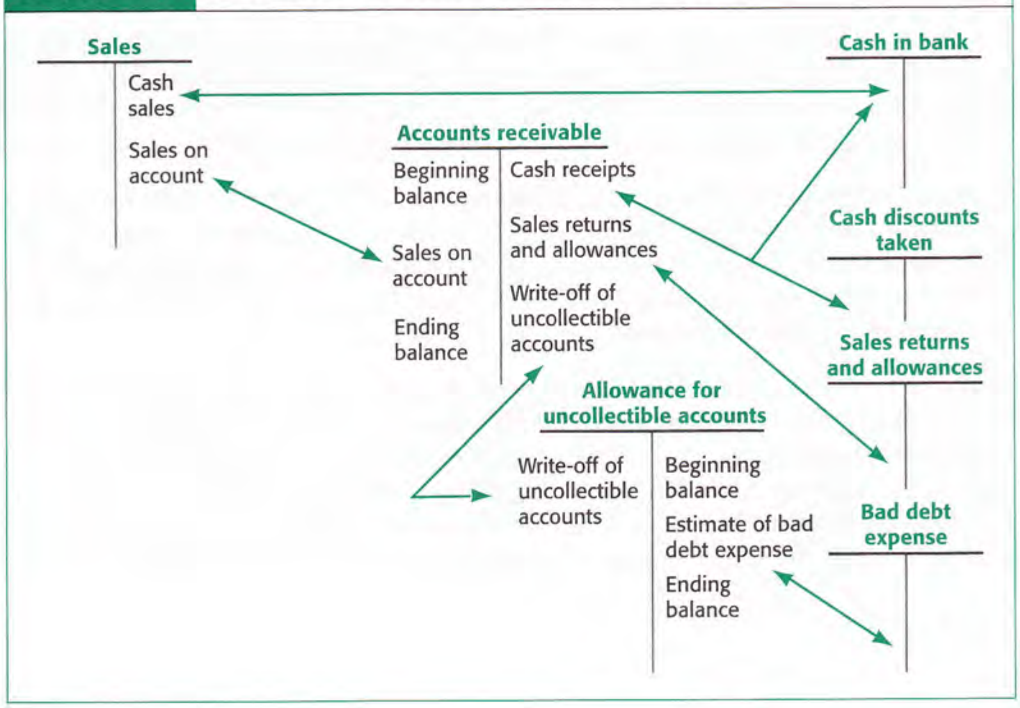
OBJECTIVE 14-1

Identify the accounts and the classes of transactions in the sales and collection cycle.

The overall objective in the audit of the sales and collection cycle is to evaluate whether the account balances affected by the cycle are fairly presented in accordance with accounting standards. Figure 14-1 shows typical accounts included in the sales and collection cycle using T accounts. The nature of the accounts may vary, of course, depending on the industry and client involved. There are differences in the nature and account titles for a service industry, a retail company, and an insurance company, but the key concepts remain the same. To provide a frame of reference for understanding the material in this chapter, let's assume we're dealing with a wholesale merchandising company.

Figure 14-1 shows the way accounting information flows through the various accounts in the sales and collection cycle. This figure shows that there are five **classes of transactions in the sales and collection cycle**:

FIGURE 14-1 Accounts in the Sales and Collection Cycle



1. Sales (cash and sales on account)
2. Cash receipts
3. Sales returns and allowances
4. Write-off of uncollectible accounts
5. Estimate of bad debt expense

Figure 14-1 also shows that, with the exception of cash sales, every transaction and amount is ultimately included in one of two balance sheet accounts, accounts receivable or allowance for uncollectible accounts. For simplicity, we assume that the same internal controls exist for both cash and credit sales.

BUSINESS FUNCTIONS IN THE CYCLE AND RELATED DOCUMENTS AND RECORDS

OBJECTIVE 14-2

Describe the business functions and the related documents and records in the sales and collection cycle.

The **sales and collection cycle** involves the decisions and processes necessary for the transfer of the ownership of goods and services to customers after they are made available for sale. It begins with a request by a customer and ends with the conversion of material or service into an account receivable, and ultimately into cash.

The eight **business functions for the sales and collection cycle** are shown in the third column of Table 14-1. They occur in every business in the recording of the five classes of transactions in the sales and collection cycle. Under "Business Functions," observe that the first four processes are for recording sales, while every other class of transactions includes only one business function. In this section, we'll explain each of the eight business functions and describe typical documents and records for each function, which appear in the fourth column of Table 14-1. Before auditors can assess control risk and design tests of controls and substantive tests of transactions, they need to understand the business functions and documents and records in a business.

TABLE 14-1 Classes of Transactions, Accounts, Business Functions, and Related Documents and Records for the Sales and Collection Cycle

Classes of Transactions	Accounts	Business Functions	Documents and Records
Sales	Sales Accounts receivable	Processing customer orders Granting credit Shipping goods Billing customers and recording sales	Customer order Sales order Customer order or sales order Shipping document Sales invoice Sales transaction file Sales journal or listing Accounts receivable master file Accounts receivable trial balance Monthly statement
Cash receipts	Cash in bank (debits from cash receipts) Accounts receivable	Processing and recording cash receipts	Remittance advice Prelisting of cash receipts Cash receipts transaction file Cash receipts journal or listing
Sales returns and allowances	Sales returns and allowances Accounts receivable	Processing and recording sales returns and allowances	Credit memo Sales returns and allowances journal
Write-off of uncollectible accounts	Accounts receivable Allowance for uncollectible accounts	Writing off uncollectible accounts receivable	Uncollectible account authorization form General journal
Bad debt expense	Bad debt expense Allowance for uncollectible accounts	Providing for bad debts	General journal

Processing Customer Orders

A customer's request for goods initiates the entire cycle. Legally, it is an offer to buy goods under specified terms. The receipt of a customer order often results in the immediate creation of a sales order.

Customer Order A customer order is a request for merchandise by a customer. It may be received by telephone, letter, a printed form that has been sent to prospective and existing customers, through salespeople, electronic submission of the customer order through the Internet, or other network linkage between the supplier and the customer.

Sales Order A sales order is a document for communicating the description, quantity, and related information for goods ordered by a customer. This is often used to indicate credit approval and authorization for shipment.

Granting Credit

Before goods are shipped, a properly authorized person must *approve credit* to the customer for sales on account. Weak practices in credit approval often result in excessive bad debts and accounts receivable that may be uncollectible. An indication of credit approval on the sales order often serves as the approval to ship the goods. In some companies, the computer automatically approves a credit sale based on preapproved credit limits maintained in a customer master file. The computer allows the sale to proceed only when the proposed sales order total plus the existing customer balance is less than the credit limit in the master file.

Shipping Goods

This critical function is the first point in the cycle at which the company gives up assets. Most companies recognize sales when goods are shipped. A shipping document is prepared at the time of shipment, which can be done automatically by a computer, based on sales order information. The shipping document, which is often a multicopy bill of lading, is essential to the proper billing of shipments to customers. Companies that maintain perpetual inventory records also update them based on shipping records.

Shipping Document A shipping document is prepared to initiate shipment of the goods, indicating the description of the merchandise, the quantity shipped, and other relevant data. The company sends the original to the customer and retains one or more copies. The shipping document serves as a signal to bill the customer and may be in electronic or paper form.

One type of shipping document is a bill of lading, which is a written contract between the carrier and the seller of the receipt and shipment of goods. Often, bills of lading include only the number of boxes or pounds shipped, rather than complete details of quantity and description. (For the purpose of this textbook, however, we will assume that complete details are included on bills of lading.)

The bill of lading is often transmitted electronically, once goods have been shipped, and automatically generates the related sales invoice as well as the entry in the sales journal. Many companies use bar codes and handheld computers to record removal of inventory from the warehouse. This information is used to update the perpetual inventory records.

Billing Customers and Recording Sales

Because billing customers is the means by which the customer is informed of the amount due for the goods, it must be done correctly and on a timely basis. The most important aspects of billing are:

- All shipments made have been billed (completeness)
- No shipment has been billed more than once (occurrence)
- Each one is billed for the proper amount (accuracy)

Billing the proper amount is dependent on charging the customer for the quantity shipped at the authorized price, which includes consideration for freight charges, insurance, and terms of payments.

OVERSTATED REVENUES KEEP EARNINGS HEALTHY

Richard Scrushy, a former respiratory therapist, built HealthSouth Corp. into a $4 billion hospital empire. However, by 1997 the company faced declining government reimbursements, and operating margins and profits plunged. The SEC alleged that HealthSouth Corp. overstated its assets by at least $1.4 billion between 1999 and 2002 to meet analysts' forecasts. According to the SEC complaint, almost all of the earnings reported by the company were attributable to the misstated assets.

Instead of increasing revenues directly, the company decreased "contractual adjustments," a contra revenue account that decreased reported revenue. The contractual adjustments represent differences between the amount billed and recorded as revenue and the amount that healthcare insurers will pay for treatment. The amounts recorded in this account were based on estimates and were more difficult for auditors to verify than revenue entries.

The entries that increased net revenue were balanced by entries that increased fixed assets. The adjustments were made through a series of entries to make them difficult to detect. Fixed assets at each facility were increased by a fictitious line item called "AP Summary." These fixed asset amounts exceeded $800 million and were over 10 percent of recorded assets. The amount of fictitious fixed assets varied by facility to decrease suspicion. Further, the company was aware that the auditors only examined fixed asset additions at each facility that exceeded a dollar threshold and was careful not to exceed this limit.

Scrushy was ultimately acquitted for his alleged involvement. However, several senior executives who worked under Scrushy pled guilty and were sentenced for their involvement in the fraud.

Despite Scrushy's acquittal in the criminal trial related to the fraud, he was found guilty in 2007 in a separate government corruption scandal for allegedly bribing a former governor of Alabama and was sentenced to seven years in prison. In 2009, he was also found liable in a subsequent civil trial related to the HealthSouth fraud with a state court judge ultimately ordering him to repay $2.9 billion to shareholders.

Sources: 1. *Securities and Exchange Commission vs. HealthSouth Corporation and Richard M. Scrushy*; 2. Charles Haddad, Arlene Weintraub, and Brian Grow, "Too Good to Be True," *BusinessWeek* (April 14, 2003), pp. 70–72; 3. Jack Healy, "Ex-Chief of HealthSouth Loses Civil Suit," *The New York Times* (June 18, 2009).

In most systems, billing of the customer includes preparation of an electronic record or a multicopy sales invoice and real-time updating of the sales transactions file, accounts receivable master file, and general ledger master file for sales and accounts receivable. The accounting system uses this information to generate the sales journal and, along with cash receipts and miscellaneous credits, to prepare the accounts receivable trial balance.

Sales Invoice A sales invoice is a document or electronic record indicating the description and quantity of goods sold, the price, freight charges, insurance, terms, and other relevant data. The sales invoice is the method of indicating to the customer the amount of a sale and the payment due date. Companies send the original to the customer, and retain one or more copies. Typically, the computer automatically prepares the sales invoice after the customer number, quantity, destination of goods shipped, and sales terms are entered. The computer calculates the invoice extensions and total sales amount using the information entered, along with prices in the inventory master file.

Sales Transaction File This is a computer-generated file that includes all sales transactions processed by the accounting system for a period, which could be a day, week, or month. It includes all information entered into the system and information for each transaction, such as customer name, date, amount, account classification or classifications, salesperson, and commission rate. The file can also include returns and allowances, or there can be a separate file for those transactions.

The information in the sales transaction file is used for a variety of records, listings, or reports, depending on the company's needs. These may include a sales journal, accounts receivable master file, and transactions for a certain account balance or division.

Sales Journal or Listing This is a listing or report generated from the sales transaction file that typically includes the customer name, date, amount, and account classification or classifications for each transaction, such as division or product line. It also identifies whether the sale was for cash or accounts receivable. The journal or listing is usually for a month but can cover any period of time. Typically, the journal or listing includes totals of every account number for the time period. The same transactions included in the journal or listing are also posted simultaneously to the general ledger and, if they are on account, to the accounts receivable master file. The journal or listing can also include returns and allowances or there can be a separate journal or listing of those transactions.

Accounts Receivable Master File This is a computer file used to record individual sales, cash receipts, and sales returns and allowances for each customer and to maintain customer account balances. The master file is updated from the sales, sales returns and allowances, and cash receipts computer transaction files. The total of the individual account balances in the master file equals the total balance of accounts receivable in the general ledger. A printout of the accounts receivable master file shows, by customer, the beginning balance in accounts receivable, each sales transaction, sales returns and allowances, cash receipts, and the ending balance.

In this book, we use the term *master file* to refer to either the computer file or a printout of that file, but it is sometimes called the accounts receivable subsidiary ledger or subledger.

Accounts Receivable Trial Balance This list or report shows the amount receivable from each customer at a point in time. It is prepared directly from the accounts receivable master file and is usually an *aged* trial balance that includes the total balance outstanding and the number of days the receivable has been outstanding, grouped by category of days (such as less than 30 days, 31 to 60 days, and so on).

Monthly Statement This is a document sent by mail or electronically to each customer indicating the beginning balance of their accounts receivable, the amount and date of each sale, cash payments received, credit memos issued, and the ending balance due. It is, in essence, a copy of the customer's portion of the accounts receivable master file.

Processing and Recording Cash Receipts

The four sales transaction functions are necessary for getting the goods into the hands of customers, correctly billing them, and reflecting the information in the accounting records. The remaining four functions involve the collection and recording of cash, sales returns and allowances, write-off of uncollectible accounts, and providing for bad debt expense.

Processing and recording cash receipts includes receiving, depositing, and recording cash. Cash includes currency, checks, and electronic funds transfers. The most important concern is the possibility of theft. Theft can occur before receipts are entered in the records or later. It is important that all cash receipts are deposited in the bank at the proper amount on a timely basis and recorded in the cash receipts transaction file. This file is used to prepare the cash receipts journal and update the accounts receivable and general ledger master files.

Remittance Advice A remittance advice is a document mailed to the customer and typically returned to the seller with the cash payment. It indicates the customer name, the sales invoice number, and the amount of the invoice. A remittance advice is used as a record of the cash received to permit the immediate deposit of cash and to improve control over the custody of assets. If the customer fails to include the remittance advice with the payment, it is common for the person opening the mail to prepare one at that time.

Prelisting of Cash Receipts This is a list prepared when cash is received by someone who has no responsibility for recording sales, accounts receivable, or cash and who has no access to accounting records. It is used to verify whether cash received was recorded and deposited at the correct amounts and on a timely basis.

Many companies use a bank to process cash receipts from customers. Some companies use a lockbox system in which customers mail payments directly to an address maintained by the bank. The bank is responsible for opening all receipts, maintaining records of all customer payments received at the lockbox address, and depositing receipts into the company's bank account on a timely basis. In other cases, receipts are submitted electronically from a customer's bank account to a company bank account through the use of electronic funds transfer (EFT). When customers purchase goods by credit card, the issuer of the credit card uses EFT to transfer funds into the company's bank account. For both lockbox systems and EFT transactions, the bank provides information to the company to prepare the cash receipt entries in the accounting records.

Cash Receipts Transaction File This is a computer-generated file that includes all cash receipts transactions processed by the accounting system for a period, such as a day, week, or month. It includes the same type of information as the sales transaction file.

Cash Receipts Journal or Listing This listing or report is generated from the cash receipts transaction file and includes all transactions for a time period. The same transactions, including all relevant information, are included in the accounts receivable master file and general ledger.

Processing and Recording Sales Returns and Allowances

When a customer is dissatisfied with the goods, the seller often accepts the return of the goods or grants a reduction in the charges. The company prepares a receiving report for returned goods and returns them to storage. Returns and allowances are recorded in the sales returns and allowances transaction file, as well as the accounts receivable master file. Credit memos are issued for returns and allowances to aid in maintaining control and to facilitate record keeping.

Credit Memo A credit memo indicates a reduction in the amount due from a customer because of returned goods or an allowance. It often takes the same general form as a sales invoice, but it supports reductions in accounts receivable rather than increases.

Sales Returns and Allowances Journal This is the journal used to record sales returns and allowances. It performs the same function as the sales journal. Many companies record these transactions in the sales journal rather than in a separate journal.

Writing Off Uncollectible Accounts Receivable

Regardless of the diligence of credit departments, some customers do not pay their bills. After concluding that an amount cannot be collected, the company must write it off. Typically, this occurs after a customer files for bankruptcy or the account is turned over to a collection agency. Proper accounting requires an adjustment for these uncollectible accounts.

Uncollectible Account Authorization Form This is a document used internally to indicate authority to write an account receivable off as uncollectible.

Providing for Bad Debts

Because companies cannot expect to collect on 100% of their sales, accounting principles require them to record bad debt expense for the amount they do not expect to collect. Most companies record this transaction at the end of each month or quarter.

METHODOLOGY FOR DESIGNING TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS FOR SALES

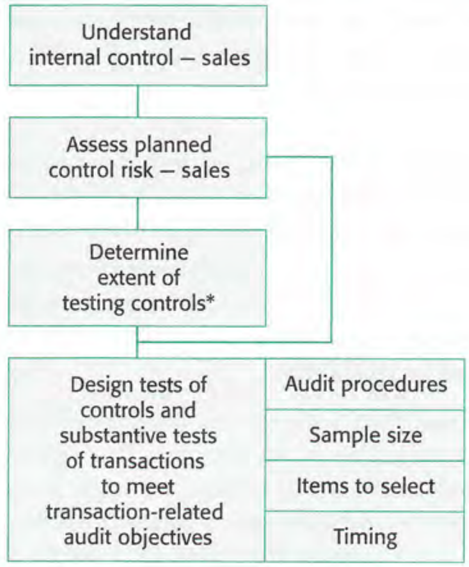
OBJECTIVE 14-3

Understand internal control, and design and perform tests of controls and substantive tests of transactions for sales.

In this chapter, we've discussed account balances, classes of transactions, business functions, and related documents and records for the sales and collection cycle. Now, we will study the design of tests of controls and substantive tests of transactions for each of the five classes of transactions in the cycle.

Figure 14-2 (p. 466) illustrates the methodology for obtaining an understanding of internal control and designing tests of controls and substantive tests of transactions for sales. The content of the figure was introduced and explained in Chapter 13. We will organize the following discussion around this illustration and apply it to sales and cash receipts for Hillsburg Hardware Co.

FIGURE 14-2 **Methodology for Designing Tests of Controls and Substantive Tests of Transactions for Sales**



*Extent of testing of controls is determined by planned reliance on controls. For accelerated filer public companies, testing must be sufficient to issue an opinion on internal control over financial reporting.

Understand Internal Control – Sales

How do auditors obtain an understanding of internal control? Using one typical approach for sales, auditors study the client's flowcharts, make inquiries of the client using an internal control questionnaire, and perform walkthrough tests of sales. We will examine the flowchart of the sales and cash receipts function for Hillsburg Hardware Co. in Figure 14-3 to demonstrate the design of tests of controls and substantive tests of transactions audit procedures.

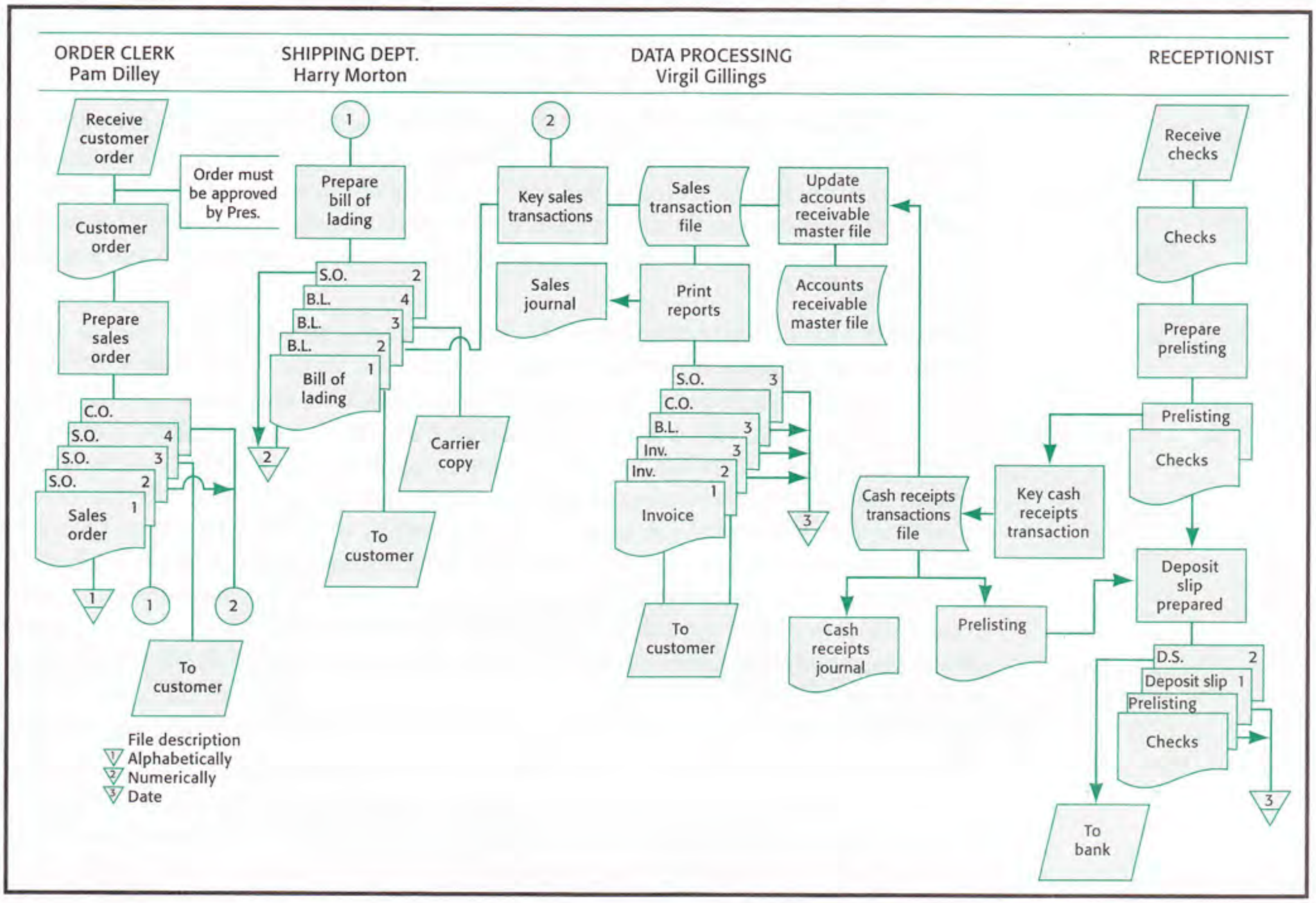
Assess Planned Control Risk – Sales

The auditor uses the information obtained in understanding internal control to assess control risk. Four steps are essential steps to this assessment.

1. The auditor needs a framework for assessing control risk. The six transaction-related audit objectives provide this framework. These are shown for sales for Hillsburg Hardware in Figure 10-5 (p. 326). These six objectives are the same for every audit of sales.
2. The auditor must identify the key internal controls and deficiencies for sales, also shown in Figure 10-5. These will differ for every audit because every client has different internal controls. The controls and deficiencies for Hillsburg Hardware Co. were identified from the flowchart in Figure 14-3 and the internal control checklist in Figure 10-4 (p. 323).
3. After identifying the controls and deficiencies, the auditor associates them with the objectives, as shown with C's and D's in appropriate columns in Figure 10-5.
4. The auditor assesses control risk for each objective by evaluating the controls and deficiencies for each objective. This step is critical because it affects the auditor's decisions about both tests of controls and substantive tests. It is a highly subjective decision. The bottom row of Figure 10-5 labeled "Assessed control risk" shows the auditor's conclusions about assessed control risk for Hillsburg Hardware.

We next examine key control activities for sales. Knowledge of these control activities assists in identifying the key controls and deficiencies for sales.

FIGURE 14-3 Hillsburg Hardware – Flowchart of Sales and Cash Receipts



NOTES

1. All correspondence is sent to the president.
2. All sales order numbers are accounted for weekly by the controller.
3. All bills of lading numbers are accounted for weekly by the controller.
4. Sales amount recorded on sales invoice is based on standard price list. The price list is stored in the inventory master file and can be changed only with authorization of the vice president of sales.
5. Duplicate sales invoice is compared with bill of lading daily by Pam Dilley for descriptions and quantities and the sales invoice is reviewed for reasonableness of the extensions and footing. She initials a copy of the invoice before the original is mailed to the customer.
6. Sales are batched daily by Pam Dilley. The batch totals are compared with the sales journal weekly.
7. Statements are sent to customers monthly.
8. Accounts receivable master file total is compared with general ledger by the controller on a monthly basis.
9. Unpaid invoices are filed separately from paid invoices.
10. The receptionist stamps incoming checks with a restrictive endorsement immediately upon receipt.
11. There are no cash sales.
12. Deposits are made daily.
13. Cash receipts are batched daily by the receptionist. The batch totals are compared with the cash receipts journal weekly.
14. The bank account is reconciled by the controller on a monthly basis.
15. All bad debt expense and write-off of bad debts are approved by the president after being initiated by the controller.
16. Financial statements are printed monthly by the controller and reviewed by the president.
17. All errors are reviewed daily by the controller immediately after the updating run. Corrections are made the same day.

Adequate Separation of Duties Proper separation of duties helps prevent various types of misstatements due to both errors and fraud. To prevent fraud, management should deny cash access to anyone responsible for entering sales and cash receipts transaction information into the computer. The credit-granting function should be separated from the sales function, because credit checks are intended to offset the natural tendency of sales personnel to optimize volume even at the expense of high bad debt write-offs. Personnel responsible for doing internal comparisons should be independent of those entering the original data. For example, comparison of batch control totals with summary reports and comparison of accounts receivable master file totals with the general ledger balance should be done by someone independent of those who input sales and cash receipt transactions.

Proper Authorization The auditor is concerned about authorization at *three key points*:

1. Credit must be properly authorized before a sale takes place.
2. Goods should be shipped only after proper authorization.
3. Prices, including basic terms, freight, and discounts, 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 for the goods. Price authorization is meant to ensure that the sale is billed at the price set by company policy. Authorization may be done for each individual transaction or general authorization may be given for specific classes of transactions. General authorizations are often done automatically by computer.

Adequate Documents and Records Because each company has a unique system of originating, processing, and recording transactions, auditors may find it difficult to evaluate whether each client's procedures are designed for maximum control. Nevertheless, adequate record-keeping procedures must exist before most of the transaction-related audit objectives can be met. Some companies, for example, automatically prepare a multicopy prenumbered sales invoice at the time a customer order is received. Copies of this document are used to approve credit, authorize shipment, record the number of units shipped, and bill customers. This system greatly reduces the chance of the failure to bill a customer if all invoices are accounted for periodically, but controls have to exist to ensure the sale isn't recorded until shipment occurs. Under a system in which the sales invoice is prepared only after a shipment has been made, the likelihood of failure to bill a customer is high unless some compensating control exists. In many organizations, all sales documents are electronic and no paper documents are prepared.

Prenumbered Documents Prenumbering is meant to prevent both the *failure* to bill or record sales and the occurrence of *duplicate* billings and recordings. Of course, it does not do much good to have prenumbered documents unless they are properly accounted for. To use this control effectively, a billing clerk will file a copy of all shipping documents in sequential order after each shipment is billed, while someone else will periodically account for all numbers and investigate the reason for any missing documents.

Monthly Statements Sending monthly statements is a useful control because it encourages customers to respond if the balance is incorrectly stated. These statements should be controlled by persons who have no responsibility for handling cash or recording sales or accounts receivable to avoid the intentional failure to send the statements. For maximum effectiveness, all disagreements about the account balance should be directed to a designated person who has no responsibility for handling cash or recording sales or accounts receivable.

Internal Verification Procedures Computer programs or independent personnel should check that the processing and recording of sales transactions fulfill each of the six transaction-related audit objectives. Examples include accounting for the numerical sequence of prenumbered documents, checking the accuracy of document preparation, and reviewing reports for unusual or incorrect items.

Determine Extent of Testing Controls

After auditors identify the key internal controls and control deficiencies, they assess control risk, often using a matrix format similar to Figure 10-5 on page 326. For audits of accelerated filer public companies, the auditor must perform extensive tests of key controls and evaluate the impact of the deficiencies on the auditor's report on internal control over financial reporting. The extent of testing of controls in audits of non-accelerated filers and nonpublic companies depends on the effectiveness of the controls and the extent to which the auditor believes they can be relied on to reduce control risk. In determining the extent of reliance to place on controls, the auditor also considers the cost of the increased tests of controls compared to the potential reduction in substantive tests. A lower assessed level of control risk will result in increased testing of controls to support the lower control risk, with a corresponding increase in detection risk and decrease in the amount of substantive tests.

Design Tests of Controls for Sales

For each key control, one or more tests of controls must be designed to verify its effectiveness. In most audits, it is relatively easy to determine the nature of the test of the control from the nature of the control. For example, if the internal control is to initial customer orders after they have been approved for credit, the test of control is to examine the customer order for proper initials.

The first three columns of Table 14-2 (p. 470) illustrate the design of tests of controls for sales for Hillsburg Hardware Co. Column three shows one test of control for each key internal control in column two. Observe that this table is organized by transaction-related audit objective. For example, the second key internal control for the occurrence objective is "sales are supported by authorized shipping documents and approved customer orders." The test of control is to "examine sales invoice for supporting bill of lading and customer order." For this test, the auditor should start with sales invoices and examine documents in support of the sales invoices rather than going in the opposite direction. If the auditor traced from shipping documents to sales invoices, it is a test of completeness. (Direction of tests is discussed further on page 473.)

As shown in the third column of Table 14-2 for the completeness objective, a common test of control for sales is to account for a sequence of various types of documents. For example, accounting for a sequence of shipping documents and tracing each one to the duplicate sales invoice and recording in the sales journal provides evidence of completeness.

To simultaneously provide evidence of both the occurrence and completeness objectives, an auditor can check the sequence of sales invoices selected from the sales journal and watch for duplicate and omitted numbers or invoices outside the normal sequence. Assume the auditor selects sales invoices #18100 to #18199. The completeness objective for this procedure will be satisfied if all 100 sales invoices are recorded. The occurrence objective will be satisfied if there is no duplicate recording of any of the invoice numbers. As indicated in Table 14-2, the lack of verification to prevent the possibility of duplicate recording of sales invoices is a deficiency at Hillsburg Hardware Co.

The appropriate tests of controls for separation of duties are ordinarily restricted to the auditor's observations of activities and discussions with personnel. For example, it is possible to observe whether the billing clerk has access to cash when incoming mail is opened or cash is deposited. It is usually also necessary to ask personnel what their responsibilities are and if there are any circumstances where their responsibilities are different from the normal policy. For example, the employee responsible for billing customers may state that he or she does not have access to cash. Further discussion may reveal that he or she actually takes over the cashier's duties when the cashier is on vacation.

Several of the tests of controls in Table 14-2 can be performed using the computer. For example, the auditor can test whether credit is properly authorized by the computer by attempting to initiate transactions that exceed a customer's credit limit. If the control is working effectively, the proposed sales order should be rejected. The occurrence of sales can be similarly tested by attempting to input nonexistent customer numbers, which should be rejected by the computer. This key control will reduce the likelihood of fictitious sales.

Design Substantive Tests of Transactions for Sales

In deciding substantive tests of transactions, auditors commonly use some procedures on every audit regardless of the circumstances, whereas others are dependent on the adequacy of the controls and the results of the tests of controls. In the fifth column of Table 14-2, the substantive tests of transactions are related to the transaction-related

TABLE 14-2 **Transaction-Related Audit Objectives, Key Existing Controls, Tests of Controls, Deficiencies, and Substantive Tests of Transactions for Sales – Hillsburg Hardware Co.**

Transaction-Related Audit Objective	Key Existing Controls*	Test of Controls†	Deficiencies*	Substantive Tests of Transactions†
Recorded sales are for shipments actually made to nonfictitious customers (occurrence).	Credit is approved automatically by computer by comparison to authorized credit limits (C1). Sales are supported by authorized shipping documents and approved customer orders (C2). Batch totals of quantities shipped are compared with quantities billed (C6). Statements are sent to customers each month (C9).	Examine customer order for evidence of credit approval (13e). Examine sales invoice for supporting bill of lading and customer order (13b). Examine file of batch totals for initials of data control clerk (8). Observe whether monthly statements are sent (6).	There is a lack of internal verification for the possibility of sales invoices being recorded more than once (D1).	Account for a sequence of sales invoices (12). Review sales journal and master file for unusual transactions and amounts (1). Trace sales journal entries to supporting documents, including duplicate sales invoice, bill of lading, sales order, and customer order (14).
Existing sales transactions are recorded (completeness).	Shipping documents are prenumbered and accounted for weekly (C5). Batch totals of quantities shipped are compared with quantities billed (C6).	Account for a sequence of shipping documents (10). Examine file of batch totals for initials of data control clerk (8).		Trace selected shipping documents to the sales journal to be sure that each one is included (11).
Recorded sales are for the amount of goods shipped and are correctly billed and recorded (accuracy).	Sales are supported by authorized shipping documents and approved customer orders (C2). Batch totals of quantities shipped are compared with quantities billed (C6). Unit selling prices are obtained from the price list master file of approved prices (C7). Statements are sent to customers each month (C9).	Examine sales invoice for supporting documents (13b). Examine file of batch totals for initials of data control clerk (8). Examine the approved price list for accuracy and proper authorization (9). Observe whether monthly statements are sent (6).		Trace entries in sales journal to sales invoices (13b). Recompute prices and extensions on sales invoices (13b). Trace details on sales invoices to • shipping documents (13c) • sales order (13d) • customer order (13e)
Sales transactions are correctly included in the accounts receivable master file and are correctly summarized (posting and summarization).	Computer automatically posts transactions to the accounts receivable master file and general ledger (C10). Accounts receivable master file is reconciled to the general ledger on a monthly basis (C11). Statements are sent to customers each month (C9).	Examine evidence that accounts receivable master file is reconciled to the general ledger (7). Examine evidence that accounts receivable master file is reconciled to the general ledger (7). Observe whether monthly statements are sent (6).		Trace selected sales invoices from the sales journal to the accounts receivable master file and test for amount, date, and invoice number (13a). Use audit software to foot and cross-foot the sales journal and trace totals to the general ledger (2).
Sales transactions are correctly classified (classification).	Account classifications are internally verified (C8).	Examine document package for internal verification (13b).		Examine duplicate sales invoice for proper account classification (13b).
Sales are recorded on the correct dates (timing).	Shipping documents are prenumbered and accounted for weekly by the accountant (C5).	Account for a sequence of shipping documents (10).	There is a lack of control to test for timely recording (D2).	Compare date of recording of sale in sales journal with duplicate sales invoice and bill of lading (13b and 13c).

*Controls (C) and Deficiencies (D) are from the control matrix for sales in Figure 10-5 (p. 326). Controls C3 and C4 from the control matrix are not included here.
†The number in parentheses after each test of control and substantive test of transaction refers to an audit procedure in the performance format audit program in Figure 14-6 (p. 480).

audit objectives in the first column and are designed to determine whether any monetary misstatements for that objective exist in the transaction. The audit procedures used are affected by the internal controls and tests of controls for that objective. Performance materiality, results of the prior year, and the other factors discussed in Chapter 9 also influence the procedures used.

Determining the proper substantive tests of transactions procedures for sales is relatively difficult because they vary considerably depending on the circumstances. Table 14-2 addresses the substantive tests of transactions procedures in the order of the sales transaction-related audit objectives. Note that some audit procedures fulfill more than one transaction-related audit objective [for example, audit procedure (13b) is included for three objectives].

The following paragraphs discuss substantive tests of transaction audit procedures that are done only when there are specific circumstances that require special audit attention, such as when there is a deficiency in internal control.

Recorded Sales Occurred For this objective, the auditor is concerned with the possibility of *three types of misstatements*:

1. Sales included in the journals for which no shipment was made.
2. Sales recorded more than once.
3. Shipments made to nonexistent customers and recorded as sales.

The first two types of misstatements can be due to an error or fraud. The last type is always a fraud. The potential consequences of all three are significant because they lead to an overstatement of assets and income.

Unintentional overstatements of sales are typically more easily discovered than fraudulent overstatements. An unintentional overstatement normally also results in an overstatement of accounts receivable, which the client can detect by sending monthly statements to customers. Unintentional misstatements at year-end can often be easily found by the auditor through confirmation procedures. With fraudulent overstatements, the perpetrator will attempt to conceal the overstatement, making it more difficult for auditors to find. Substantive tests of transactions may be necessary to discover overstated sales in these circumstances.

The appropriate substantive tests of transactions for testing the occurrence objective depend on where the auditor believes misstatements are likely. Many auditors do substantive tests of transactions for the occurrence objective only if they believe that a control deficiency exists. Therefore, the nature of the tests depends on the nature of the potential misstatement as follows:

Recorded Sale for Which There Was No Shipment The auditor can vouch selected entries in the sales journal to related copies of shipping and other supporting documents to make sure they occurred. If the auditor is concerned about the possibility of a fictitious duplicate copy of a shipping document, it may be necessary to trace the amounts to the perpetual inventory records as a test of whether inventory was reduced.

Sale Recorded More Than Once Duplicate sales can be determined by reviewing a numerically sorted list of recorded sales transactions for duplicate numbers. The auditor can also test for the proper cancellation of shipping documents. Proper cancellation decreases the likelihood that a shipping document will be used to record another sale.

Shipment Made to Nonexistent Customers This type of fraud normally occurs only when the person recording sales is also in a position to authorize shipments. Deficient internal controls make it difficult to detect fictitious shipments, such as shipments to other locations of the company. To test for nonexistent customers, the auditor can trace customer information on the sales invoice to the customer master file. These revenue frauds are often referred to as "sham sales."

Another effective approach to detecting the three types of misstatements of sales transactions just discussed is to trace the *credit* in the accounts receivable master file to its source. If the receivable was actually collected in cash or the goods were returned, a sale must have originally occurred. If the credit was for a bad debt write-off or a credit memo, or if the account was still unpaid at the time of the audit, this could indicate an inappropriately recorded sales transaction. The auditor must examine shipping and customer order documents to determine if there is adequate support that a sales transaction actually occurred.

Auditing standards indicate that the auditor should normally identify improper revenue recognition as a fraud risk. However, substantive tests of transactions should be necessary for improper revenue recognition only if the auditor is concerned about fraud due to inadequate controls.

Existing Sales Transactions Are Recorded In many audits, no substantive tests of transactions are done for the completeness objective. This is because overstatements of assets and income from sales transactions are more likely than understatements, and overstatements also represent a greater source of audit risk. If controls are inadequate, which is likely if the client does no independent internal tracing from shipping documents to the sales journal, substantive tests are necessary.

To test for unbilled shipments, auditors can trace selected shipping documents from a file in the shipping department to related duplicate sales invoices and the sales journal. To conduct a meaningful test using this procedure, the auditor must be confident that all shipping documents are included in the file. This can be done by accounting for a numerical sequence of the documents. Generalized audit software tools, such as ACL or IDEA, can be used to efficiently identify duplicates and gaps in the numerical sequence of electronic records.

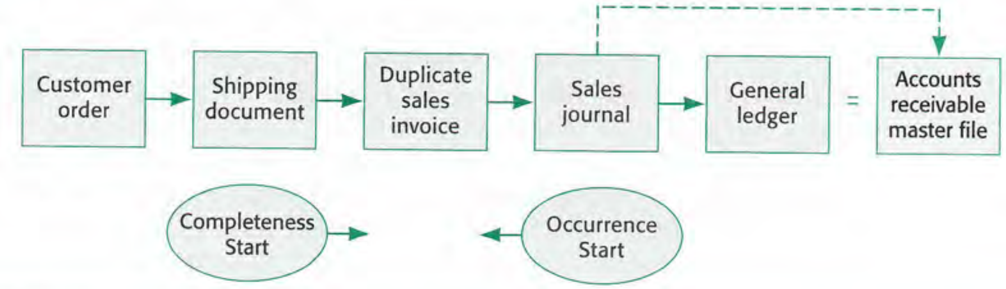
COSO REPORT IDENTIFIES TECHNIQUES TO FRAUDULENTLY MISSTATE REVENUE

A study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) analyzed fraudulent financial reporting by U.S public companies over the period 1998–2007. The study found that 61 percent of the 347 alleged cases examined involved companies fraudulently misstating revenues using a variety of techniques including the following:

- *Sham sales.* To conceal the fraud, management often falsified inventory records, shipping records, and invoices to record a sale. In some cases, the company recorded sales for goods merely shipped to another company location.
- *Conditional sales.* These transactions were recorded as revenues even though the sales involved unresolved contingencies or the terms of the sale were amended afterwards by side letter agreements.
- *Round-tripping or recording loans as sales.* In some cases, management recorded loan proceeds as revenues. In other cases, companies recorded sales by shipping goods to alleged customers and then providing funds to the customers to pay back to the company.
- *Bill and hold transactions.* Several companies improperly recorded revenue by billing customers in advance with an agreement to "hold" goods until the customer was ready for receipt of those goods.
- *Premature revenues before all the terms of the sale were completed.* Generally this involved recording sales after the goods were ordered but before they were shipped to the customer.
- *Improper cutoff of sales.* To increase revenues, the accounting records were held open beyond the balance sheet date to record sales of the subsequent accounting period in the current period.
- *Improper use of the percentage of completion method.* Revenues were overstated by accelerating the estimated percentage of completion for projects in process.
- *Unauthorized shipments.* Revenues were overstated by shipping goods never ordered by the customer or by shipping defective products and recording revenues at full, rather than discounted, prices.
- *Consignment sales.* Revenues were recorded for consignment shipments or shipments of goods for customers to consider on a trial basis.

Source: *Fraudulent Financial Reporting: 1998–2007, An Analysis of U.S. Public Companies*, COSO, New York, 2010 (www.coso.org).

FIGURE 14-4 **Direction of Tests for Sales**



Direction of Tests Auditors need to understand the difference between tracing from source documents to the journals and vouching from the journals back to source documents. The former tests for *omitted transactions* (completeness objective); the latter tests for *nonexistent transactions* (occurrence objective).

To test for the occurrence objective, the auditor starts by selecting a sample of invoice numbers *from* the journal and vouches them *to* duplicate sales invoices, shipping documents, and customer orders as illustrated in Figure 14-4. In testing for the completeness objective, the auditor typically starts by selecting a sample of shipping documents and traces them *to* duplicate sales invoices and the sales journal as a test of omissions.

When designing audit procedures for the occurrence and completeness objectives, the starting point for the test is essential. This is called the **direction of tests** illustrated in Figure 14-4. For example, if the auditor is concerned about the occurrence objective but tests in the wrong direction (from shipping documents to the journals), a serious audit deficiency exists. In testing for the other four transaction-related audit objectives, the direction of tests is usually not relevant. For example, the accuracy of sales transactions can be examined by testing from a duplicate sales invoice to a shipping document or vice versa.

Sales Are Accurately Recorded The accurate recording of sales transactions concerns:

- Shipping the amount of goods ordered
- Accurately billing for the amount of goods shipped
- Accurately recording the amount billed in the accounting records

Auditors typically do substantive tests of transactions in every audit to ensure that each of these three aspects of accuracy are done correctly by recalculating information in the accounting records and comparing information on different documents. Auditors commonly compare prices on duplicate sales invoices with an approved price list, recalculate extensions and footings, and compare the details on the invoices with shipping records for description, quantity, and customer identification. Often, auditors also examine customer orders and sales orders for the same information.

The comparison of tests of controls and substantive tests of transactions for the accuracy objective is a good example of how audit time can be saved when effective internal controls exist. Obviously, the test of control for this objective takes almost no time because it involves examining only an initial or other evidence of internal verification. If this control is effective, the sample size for substantive tests of transactions can be reduced, yielding a significant savings.

When sales invoices are automatically calculated and posted by a computer, the auditor may be able to reduce substantive tests of transactions for the accuracy objective. If the auditor determines that the computer is programmed accurately and the price list master file is authorized and correct, detailed invoice computations can be reduced or eliminated. In this case, the auditor focuses on determining that effective computer controls exist to ensure that the computer is properly programmed and has not been altered since it was last tested by the auditor. Tests of controls would focus on the authorization and accuracy of changes to the price list master file.

Sales Transactions Are Correctly Included in the Master File and Correctly Summarized The proper inclusion of all sales transactions in the accounts receivable master file is essential because the accuracy of these records affects the client's ability to collect outstanding receivables. Similarly, the sales journal must be correctly totaled and posted to the general ledger if the financial statements are to be correct. In most engagements, auditors perform some clerical accuracy tests, such as footing the journals and tracing the totals and details to the general ledger and the master file, to check whether there are errors or fraud in the processing of sales transactions. The extent to which such tests are needed is determined by the quality of internal controls. Generalized audit software allows for efficient testing of the accuracy of electronic journals and records.

Tracing from the sales journal to the master file is typically done as a part of fulfilling other transaction-related audit objectives, but footing the sales journal and tracing the totals to the general ledger are done as separate procedures.

Posting and summarization tests differ from those for other transaction-related audit objectives because they include footing journals, master file records, and ledgers, and tracing from one to the other among these three.

When footing and comparisons are restricted to these three records, the transaction-related audit objective is posting and summarization. When the journals, master files, or ledgers are traced to or from a document, the objective is one of the other five objectives, depending on what is being verified. To illustrate, when an auditor compares an amount on a duplicate sales invoice with either the sales journal or master file entry, it is an accuracy audit objective procedure. When an auditor traces an entry from the sales journal to the master file, it is a posting and summarization procedure.

Recorded Sales Are Correctly Classified Although it is less of a problem in sales than in some transaction cycles, auditors must still be concerned that transactions are charged to the correct general ledger account. With cash and credit sales, company personnel should not debit accounts receivable for a cash sale or credit sales for collection of a receivable. They should also not classify sales of operating assets, such as buildings, as sales. For those companies using more than one sales classification, such as companies issuing segmented earnings statements, proper classification is essential.

Auditors commonly test sales for proper classification as part of testing for accuracy. They examine supporting documents to determine the proper classification of a given transaction and compare this with the actual account to which it is charged.

Sales Are Recorded on the Correct Dates Sales should be billed and recorded as soon after shipment takes place as possible to prevent the unintentional omission of transactions from the records and to make sure that sales are recorded in the proper period. Timely recorded transactions are also less likely to contain misstatements. When auditors do substantive tests of transactions procedures for accuracy they commonly compare the date on selected bills of lading or other shipping documents with the date on related duplicate sales invoices, the sales journal, and the accounts receivable master file. Significant differences indicate potential cutoff problems in the test of year-end balances.

Summary of Methodology for Sales

Figure 14-2 (p. 466) is an overview of how auditors design tests of controls and substantive tests of transactions for sales. Table 14-2 (p. 470) is a matrix that shows how auditors decide tests of controls and substantive tests of transactions for sales after controls and control deficiencies have been identified. The following is a discussion of Table 14-2.

Transaction-Related Audit Objectives (Column 1) The transaction-related audit objectives for sales in Table 14-2 are derived from the framework presented in earlier chapters. Although certain internal controls satisfy more than one objective, auditors should consider each objective separately to facilitate a better assessment of control risk.

Key Existing Controls (Column 2) Management designs the internal controls for sales to achieve the six transaction-related audit objectives. If the controls necessary to satisfy any one of the objectives are inadequate, the likelihood of misstatements related to that objective is increased, regardless of the controls for the other objectives. (The methodology for determining existing controls was addressed on pages 325–327 in Chapter 10.)

The controls in column 2 were identified by the auditor earlier in the audit and come from the auditor's control risk matrix such as the one illustrated in Figure 10-5 (p. 326). A control is included in more than one row in Table 14-2 if there is more than one *C* for that control on the control risk matrix.

Tests of Controls (Column 3) For each internal control in column 2, the auditor designs a test of control to verify its effectiveness. Observe that the tests of controls in Table 14-2 relate directly to the internal controls. For each control, there should be at least one test of control, but there can be more than one.

Deficiencies (Column 4) Deficiencies identified by the auditor indicate the absence of effective controls. The auditor should evaluate control deficiencies by considering potential misstatements that could occur and any compensating controls. An auditor can respond to a deficiency in internal control in a financial statement audit by expanding substantive tests of transactions to determine whether the deficiency resulted in a significant number of misstatements.

Substantive Tests of Transactions (Column 5) These tests help auditors determine whether monetary misstatements exist in sales transactions. In Table 14-2, the substantive tests of transactions directly relate to the objectives in the first column.

It is essential for auditors to understand the relationships among the columns in Table 14-2.

- The first column includes the six transaction-related audit objectives. The general objectives are the same for any class of transactions, but the specific objectives vary for sales, cash receipts, or any other classes of transactions.
- Column 2 lists one or more illustrative internal controls *for each transaction-related audit objective*. Each control must be related to one or more audit objectives.
- Column 3 includes one test of control that tests the *internal control in column 2*. A test of control has no meaning unless it tests a specific control. The table contains one test of control in column 3 for each internal control in column 2, but the auditor can decide to use more than one test of control for a given control.
- Column 4 includes internal control deficiencies. They represent a lack of effective internal controls and are determined using the same approach used for identifying controls.
- The last column includes common substantive tests of transactions that support *a specific transaction-related 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 key controls exist, the results of the tests of controls, and any internal control deficiencies for the transaction-related audit objective.

Design and Performance Format Audit Procedures

The information presented in Table 14-2 (p. 470) is intended to help auditors design audit programs that satisfy the transaction-related audit objectives in a given set of circumstances. This methodology helps the auditor design an effective and efficient audit program that responds to the unique risks of material misstatements at each client.

After the appropriate audit procedures for a given set of circumstances have been designed, they must, of course, be performed. However, it is likely to be inefficient to do the audit procedures as they are stated in the design format of Table 14-2. In converting from a **design format audit program** to a **performance format audit program**, procedures are combined. This achieves the following:

- Eliminates duplicate procedures.
- Makes sure that when a given document is examined, all procedures to be performed on that document are done at that time.
- Enables the auditor to do the procedures in the most effective order. For example, by footing the journal and reviewing the journal for unusual items first, the auditor gains a better perspective in doing the detailed tests.

Figure 14-6 (p. 480) illustrates a performance format audit program for sales and cash receipts for Hillsburg Hardware. It is a summary of the audit procedures in Tables 14-2 and 14-3 (p. 479). The numbers for the audit procedures in Figure 14-6 correspond to the numbers at the end of the tests of control and substantive audit procedures in Tables 14-2 and 14-3. These numbers are included to help you see the relationship between the two tables and Figure 14-6.

SALES RETURNS AND ALLOWANCES

OBJECTIVE 14-4

Apply the methodology for controls over sales transactions to controls over sales returns and allowances.

The transaction-related audit objectives and the client's methods of controlling misstatements are essentially the same for processing credit memos as those described for sales, with two differences. The first is *materiality.* In many instances, sales returns and allowances are so immaterial the auditor can ignore them.

The second difference is *emphasis on the occurrence objective*. For sales returns and allowances, auditors usually emphasize testing recorded transactions to uncover any theft of cash from the collection of accounts receivable that was covered up by a fictitious sales return or allowance. (Although auditors usually emphasize the occurrence objective for sales returns and allowances transactions, the *completeness* objective is especially important in tests of account balances to determine if sales and returns are understated at year-end.)

Naturally, other objectives should not be ignored. But because the objectives and methodology for auditing sales returns and allowances are essentially the same as for sales, we do not include a detailed study of them. If you need to audit sales returns and allowances, you should be able to apply the same logic to arrive at suitable controls, tests of controls, and substantive tests of transactions to verify the amounts.

METHODOLOGY FOR DESIGNING TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS FOR CASH RECEIPTS

OBJECTIVE 14-5

Understand internal control, and design and perform tests of controls and substantive tests of transactions for cash receipts.

Auditors use the same methodology for designing tests of controls and substantive tests of transactions for cash receipts as they use for sales. Cash receipts tests of controls and substantive tests of transactions audit procedures are developed around the same framework used for sales, but of course the specific objectives are applied to cash receipts. Given the transaction-related audit objectives, the auditor follows this process:

- Determine key internal controls for each audit objective
- Design tests of control for each control used to support a reduced control risk

SALES RETURN FRAUD

While retailers often have lenient sales return policies to retain good customers, many are building more checks and balances into their return policies to reduce instances of sales return fraud. According to the National Retail Foundation (NRF), sales return fraud cost retailers over $14.4 billion in 2011. Unfortunately for honest consumers, retailers are forced to raise prices to absorb losses from fraudulent sales return techniques, resulting in what some call a "hidden crime tax."

The most common sales return fraud technique involves consumers who steal merchandise from a store and then come back later to return those goods, often using counterfeit receipts. Other techniques involve the return of goods purchased by fraudulent payment, such as a stolen credit card, or through a practice known as "wardrobing" whereby consumers return merchandise that has been slightly used, such as formal wear worn once to a social function and then returned for full refund.

To tackle the growing problem of sales return fraud, retailers are tightening their return policies, such as scanning driver's licenses every time a return is made to keep track of individuals who might be making a large number of returns within a short period of time. Some retailers are hiring investigators to search the Internet for stolen merchandise or for Web sites that are selling counterfeit receipts.

Sources: 1. "Return Fraud Survey 2011," National Retail Federation (November 2011) (www.nrf.com); 2. "The Biggest Crime You've Never Heard of – Return Fraud – and How the Criminals Do It" (www.SixWise.com).

- Design substantive tests of transactions to test for monetary misstatements for each objective

As in all other audit areas, the tests of controls depend on the controls the auditor identifies, the extent they will be relied on to reduce assessed control risk, and whether the company being audited is publicly traded.

Figure 14-5 (p. 478) presents the control risk matrix for cash receipts for Hillsburg Hardware. It is based on the information in the sales and cash receipts flowchart in Figure 14-3 (p. 467).

Table 14-3 lists key internal controls, common tests of controls, and common substantive tests of transactions to satisfy each of the transaction-related audit objectives for cash receipts for Hillsburg Hardware Co. Table 14-3 follows the same format used for sales as shown in Table 14-2. The tests of controls and substantive tests of transactions for cash receipts are combined with those for sales in the performance format audit program in Figure 14-6.

Because the methodology for cash receipts is similar to that for sales, our discussion is not as detailed as our discussion of the internal controls, tests of controls, and substantive tests of transactions for the audit of sales. Instead, we focus on the substantive audit procedures that are most likely to be misunderstood.

An essential part of the auditor's responsibility in auditing cash receipts is to identify deficiencies in internal control that increase the likelihood of fraud. To expand on Table 14-3, we emphasize those audit procedures that are designed primarily for the discovery of fraud. We omit discussion of some procedures only because their purpose and the methodology for applying them should be apparent from the description provided in Table 14-3.

Determine Whether Cash Received Was Recorded

The most difficult type of cash embezzlement for auditors to detect is when it occurs *before the cash is recorded* in the cash receipts journal or other cash listing, especially if the sale and cash receipt are recorded simultaneously. For example, if a grocery store clerk takes cash and intentionally fails to record the sale and receipt of cash on the cash register, it is extremely difficult to discover the theft. To prevent this type of fraud, internal controls such as those included in the second objective in Table 14-3 are implemented by many companies. The type of control will, of course, depend on the type of business. For example, the controls for a retail store in which the cash is received by the same person who sells the merchandise and enters cash receipts in a cash register should be different from the controls for a company in which all receipts are received through the mail several weeks after the sales have taken place.

FIGURE 14-5 **Control Risk Matrix for Hillsburg Hardware Co. – Cash Receipts**

	INTERNAL CONTROL	Recorded cash receipts are for funds actually received by the company (occurrence).	Cash received is recorded in the cash receipts journal (completeness).	Cash receipts are deposited and recorded at the amounts received (accuracy).	Cash receipts are correctly included in the accounts receivable master file and are correctly summarized (posting and summarization).	Cash receipts transactions are correctly classified (classification).	Cash receipts are recorded on the correct dates (timing).
		CASH RECEIPTS TRANSACTION-RELATED AUDIT OBJECTIVES					
CONTROLS	Accountant independently reconciles bank account (C1).	C		C			
CONTROLS	Prelisting of cash receipts is prepared (C2).		C				
CONTROLS	Checks are restrictively endorsed (C3).		C				
CONTROLS	Batch totals of cash receipts are compared with computer summary reports (C4).	C	C	C			
CONTROLS	Statements are sent to customers each month (C5).		C	C	C		
CONTROLS	Cash receipts transactions are internally verified (C6).					C	
CONTROLS	Procedures require recording of cash on a daily basis (C7).						C
CONTROLS	Computer automatically posts transactions to the accounts receivable master file and to the general ledger (C8).				C		
CONTROLS	Accounts receivable master file is reconciled to the general ledger on a monthly basis (C9).				C		
DEFICIENCY	Prelisting of cash is not used to verify recorded cash receipts (D1).		D				
	Assessed control risk	Low	Medium	Low	Low	Low	Low

C = Control; D = Significant deficiency or material weakness

It is normal practice to trace from prenumbered remittance advices or prelists of cash receipts to the cash receipts journal and subsidiary accounts receivable records as a substantive test of the recording of actual cash received. This test will be effective only if a cash register tape or some other prelisting was prepared at the time cash was received.

Prepare Proof of Cash Receipts

A useful audit procedure to test whether all recorded cash receipts have been deposited in the bank account is a **proof of cash receipts**. In this test, the total cash receipts recorded in the cash receipts journal for a given period, such as a month, are reconciled with the actual deposits made to the bank during the same period. A difference in the

TABLE 14-3 **Transaction-Related Audit Objectives, Key Existing Controls, Tests of Controls, Deficiencies, and Substantive Tests of Transactions for Cash Receipts – Hillsburg Hardware Co.**

Transaction-Related Audit Objective	Key Existing Controls*	Test of Controls†	Deficiencies*	Substantive Tests of Transactions†
Recorded cash receipts are for funds actually received by the company (occurrence).	Accountant independently reconciles bank account (C1). Batch totals of cash receipts are compared with computer summary reports (C4).	Observe whether accountant reconciles bank account (3). Examine file of batch totals for initials of data control clerk (8).		Review cash receipts journal and master file for unusual transactions and amounts (1). Trace cash receipts entries from the cash receipts journal entries to the bank statement (19). Prepare a proof of cash receipts (18).
Cash received is recorded in the cash receipts journal (completeness).	Prelisting of cash receipts is prepared (C2). Checks are restrictively endorsed (C3). Batch totals of cash receipts are compared with computer summary reports (C4). Statements are sent to customers each month (C5).	Observe prelisting of cash receipts (4). Observe endorsement of incoming checks (5). Examine file of batch totals for initials of data control clerk (8). Observe whether monthly statements are sent (6).	Prelisting of cash is not used to verify recorded cash receipts (D1).	Obtain prelisting of cash receipts and trace amounts to the cash receipts journal, testing for names, amounts, and dates (15). Compare the prelisting with the duplicate deposit slip (16).
Cash receipts are deposited and recorded at the amounts received (accuracy).	Accountant independently reconciles bank account (C1). Batch totals of cash receipts are compared with computer summary reports (C4). Statements are sent to customers each month (C5).	Observe whether accountant reconciles bank account (3). Examine file of batch totals for initials of data control clerk (8). Observe whether monthly statements are sent (6).		Obtain prelisting of cash receipts and trace amounts to the cash receipts journal, testing for names, amounts, and dates (15). Prepare proof of cash receipts (18).
Cash receipts are correctly included in the accounts receivable master file and are correctly summarized (posting and summarization).	Statements are sent to customers each month (C5). Computer automatically posts transactions to the accounts receivable master file and general ledger (C8). Accounts receivable master file is reconciled to the general ledger on a monthly basis (C9).	Observe whether monthly statements are sent (6). Examine evidence that accounts receivable master file is reconciled to general ledger (7). Examine evidence that accounts receivable master file is reconciled to general ledger (7).		Trace selected entries from the cash receipts journal to the accounts receivable master file and test for dates and amounts (20). Trace selected credits from the accounts receivable master file to the cash receipts journal and test for dates and amounts (21). Use audit software to foot and cross-foot the sales journal and trace totals to the general ledger (2).
Cash receipts transactions are correctly classified (classification).	Cash receipts transactions are internally verified (C6).	Examine evidence of internal verification (15).		Examine prelisting for proper account classification (17).
Cash receipts are recorded on the correct dates (timing).	Procedures require recording of cash on a daily basis (C7).	Observe unrecorded cash at a point in time (4).		Compare date of deposit per bank statement to the dates in the cash receipts journal and prelisting of cash receipts (16).

*Controls (C) and Deficiencies (D) are from control matrix for cash receipts in Figure 14-5.

†The number in parentheses after each test of control and substantive test of transaction refers to an audit procedure in the performance format audit program in Figure 14-6 (p. 480).

FIGURE 14-6 **Audit Program for Tests of Controls and Substantive Tests of Transactions for Sales and Cash Receipts for Hillsburg Hardware Co. (Performance Format)**

HILLSBURG HARDWARE CO.

Tests of Controls and Substantive Tests of Transactions Audit Procedures for Sales and Cash Receipts

(Sample size and the items in the sample are not included.)

General

1. Review journals and master file for unusual transactions and amounts.
2. Use audit software to foot and cross-foot the sales and cash receipts journals and trace the totals to the general ledger.
3. Observe whether accountant reconciles the bank account.
4. Observe whether cash is prelisted and the existence of any unrecorded cash.
5. Observe whether restrictive endorsement is used on cash receipts.
6. Observe whether monthly statements are sent.
7. Observe whether accountant compares master file total with general ledger account.
8. Examine file of batch totals for initials of data control clerk.
9. Examine the approved price list in the inventory master file for accuracy and proper authorization.

Shipment of Goods

10. Account for a sequence of shipping documents.
11. Trace selected shipping documents to the sales journal to be sure that each one has been included.

Billing of Customers and Recording the Sales in the Records

12. Account for a sequence of sales invoices in the sales journal.
13. Trace selected sales invoice numbers from the sales journal to
    a. accounts receivable master file and test for amount, date, and invoice number.
    b. duplicate sales invoice and check for the total amount recorded in the journal, date, customer name, and account classification. Check the pricing, extensions, and footings. Examine underlying documents for indication of internal verification.
    c. bill of lading and test for customer name, product description, quantity, and date.
    d. duplicate sales order and test for customer name, product description, quantity, date, and indication of internal verification.
    e. customer order and test for customer name, product description, quantity, date, and credit approval.
14. Trace recorded sales from the sales journal to the file of supporting documents, which includes a duplicate sales invoice, bill of lading, sales order, and customer order.

Processing Cash Receipts and Recording the Amounts in the Records

15. Obtain the prelisting of cash receipts and trace amounts to the cash receipts journal, testing for names, amounts, dates, and internal verification.
16. Compare the prelisting of cash receipts with the duplicate deposit slip, testing for names, amounts, and dates. Trace the total from the cash receipts journal to the bank statement, testing for a delay in deposit.
17. Examine prelisting for proper account classification.
18. Prepare a proof of cash receipts.
19. Trace cash receipt entries from the cash receipts journal to the bank statement, testing for dates and amounts of deposits.
20. Trace selected entries from the cash receipts journal to entries in the accounts receivable master file and test for dates and amounts.
21. Trace selected credits from the accounts receivable master file to the cash receipts journal and test for dates and amounts.

two may be the result of deposits in transit and other items, but the amounts can be reconciled and compared. This procedure is not useful in discovering cash receipts that have not been recorded in the journals or time lags in making deposits, but it can help uncover recorded cash receipts that have not been deposited, unrecorded

WHY THE DELAY?

Ann Mundy was an internal auditor for Speedtrack Convenience Stores. Each store was responsible for making daily deposits into a local bank account and providing a daily sales report to the central office. While reviewing monthly bank reconciliations, she observed that all the deposits in transit at month-end cleared the next day, except for the deposit at one store, which cleared a day later. She did not think this was unusual and did not investigate further.

The following month, Ann was performing the same procedure and obtained the same results. All the deposits cleared the next day, except for the deposit for one store, which cleared a day later. The delayed deposit was for the same store that had a delayed deposit the previous month. Upon investigation, Ann discovered that the store manager had stolen the receipts for one day. Because stores had to report daily sales, the manager reported the sales for the next day as having occurred the previous day. The manager had to repeat this process every day to hide the theft, which made it appear that there was an extra day delay in the deposit clearing the bank. The manager was immediately fired, and Speedtrack instituted new procedures that required same-day reporting of sales and procedures to investigate immediately any delay in cleared deposits.

deposits, unrecorded loans, bank loans deposited directly into the bank account, and similar misstatements. Ordinarily, this somewhat time-consuming procedure is used only when the controls are deficient. In rare instances, when controls are extremely weak, the period covered by the proof of cash receipts may cover the entire year.

Test to Discover Lapping of Accounts Receivable

Lapping of accounts receivable is the postponement of entries for the collection of receivables to *conceal an existing cash shortage*. The embezzlement is perpetrated by a person who handles cash receipts and then enters them into the computer system. He or she defers recording the cash receipts from one customer and covers the shortages with receipts of another. These in turn are covered from the receipts of a third customer a few days later. The employee must continue to cover the shortage through repeated lapping, replace the stolen money, or find another way to conceal the shortage.

This embezzlement can be easily prevented by separation of duties and a mandatory vacation policy for employees who both handle cash and enter cash receipts into the system. It can be detected by comparing the name, amount, and dates shown on remittance advices with cash receipts journal entries and related duplicate deposit slips. Because this procedure is relatively time-consuming, it is ordinarily performed only when specific concerns with embezzlement exist because of a deficiency in internal control.

AUDIT TESTS FOR THE WRITE-OFF OF UNCOLLECTIBLE ACCOUNTS

OBJECTIVE 14-6

Apply the methodology for controls over the sales and collection cycle to write-offs of uncollectible accounts receivable.

The same as for sales returns and allowances, the auditor's primary concern in the audit of the write-off of uncollectible accounts receivable is the possibility of client personnel covering up an embezzlement by writing off accounts receivable that have already been collected (the occurrence transaction-related audit objective). The major control for preventing this fraud is proper authorization of the write-off of uncollectible accounts by a designated level of management only after a thorough investigation of the reason the customer has not paid.

Normally, verification of the accounts written off takes relatively little time. Typically, the auditor examines approvals by the appropriate persons. For a sample of accounts written off, it is also usually necessary for the auditor to examine correspondence in the client's files establishing their uncollectibility. In some cases, the auditor also examines credit reports such as those provided by Dun & Bradstreet. After the auditor has concluded that the accounts written off by general journal entries are proper, selected items should be traced to the accounts receivable master file to test whether the write-off was properly recorded.

The estimation of bad debt expense, which is the fifth class of transactions in the sales and collection cycle, obviously relates to the write-off of uncollectible accounts. However, because the estimation of bad debts is based on the year-end accounts receivable balances, the auditor evaluates the estimate for uncollectible accounts as part of the tests of details of ending accounts receivable balances, which we discuss in Chapter 16.

ADDITIONAL INTERNAL CONTROLS OVER ACCOUNT BALANCES AND PRESENTATION AND DISCLOSURE

Our preceding discussion emphasized internal controls, tests of controls, and substantive tests of transactions for the five classes of transactions that affect account balances in the sales and collection cycle. If the internal controls for these classes of transactions are determined to be effective and the related substantive tests of transactions support the conclusions, the likelihood of misstatements in the financial statements is reduced.

In addition, internal controls directly related to account balances and presentations and disclosures may exist, even if they have not been identified or tested as a part of tests of controls or substantive tests of transactions. For the sales and collection cycle, these are most likely to affect the realizable value and rights and obligations balance-related objectives and the four presentation and disclosure objectives.

Realizable value is an essential balance-related audit objective for accounts receivable because collectibility of receivables is often a major financial statement item. It has been an issue in a number of accountants' liability cases. Therefore, auditors commonly set inherent risk as high for the realizable value objective. Ideally, clients establish several controls to reduce the likelihood of uncollectible accounts. We've already discussed credit approval by an appropriate person. Two other controls are:

- The preparation of a periodic aged accounts receivable trial balance for review and follow-up by appropriate management personnel.
- A policy of writing off uncollectible accounts when they are no longer likely to be collected.

Rights and obligations and presentation and disclosure are rarely a significant problem for accounts receivable, although it is important that the client adequately discloses its policies for revenue recognition. Therefore, competent accounting personnel are typically sufficient controls for these audit objectives.

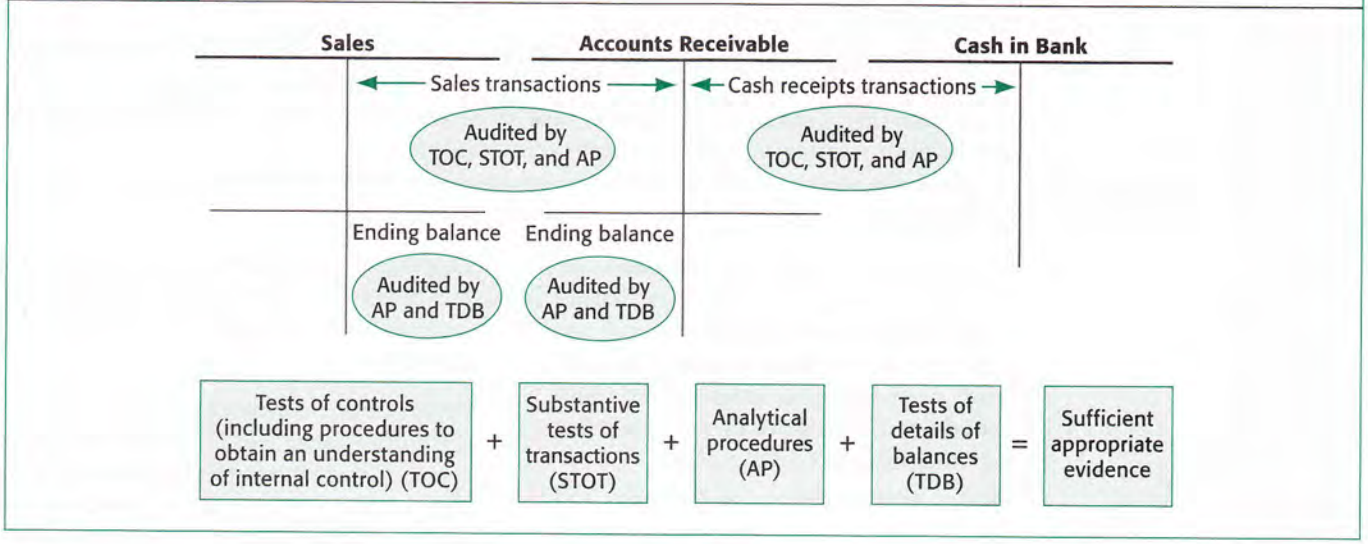
EFFECT OF RESULTS OF TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS

The results of the tests of controls and substantive tests of transactions have a significant effect on the remainder of the audit, especially on substantive tests of details of balances. The parts of the audit most affected by the tests of controls and substantive tests of transactions for the sales and collection cycle are the balances in accounts receivable, cash, bad debt expense, and allowance for doubtful accounts.

Furthermore, if the test results are unsatisfactory, it is necessary to do additional substantive testing of sales, sales returns and allowances, write-off of uncollectible accounts, and processing cash receipts. Auditors of accelerated filer public companies must also consider the impact of the unsatisfactory test results on the audit of internal control over financial reporting.

At the completion of the tests of controls and substantive tests of transactions, auditors must analyze each exception, for both public and nonpublic company audits, to determine its cause and the implication of the exception on assessed control risk, which may affect the supported detection risk and related remaining substantive

FIGURE 14-7 **Types of Audit Tests for the Sales and Collection Cycle (see Figure 14-1 on page 460 for accounts)**



tests. The methodology and implications of exceptions analysis are explained more fully in the next chapter.

The most significant effect of the results of the tests of controls and substantive tests of transactions in the sales and collection cycle is on the confirmation of accounts receivable. The type of confirmation, the size of the sample, and the timing of the test are all affected. The effect of the tests on accounts receivable, bad debt expense, and allowance for uncollectible accounts is considered in Chapter 16.

Figure 14-7 illustrates the major accounts in the sales and collection cycle and the types of audit tests used to audit these accounts. This figure was introduced in the preceding chapter (p. 424) and is presented here for further review.

SUMMARY

This chapter deals with designing tests of controls and substantive tests of transactions for each of the five classes of transactions in the sales and collection cycle, including sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts receivable, and bad debt expense.

The methodology for designing tests of controls and substantive tests of transactions is, in concept, the same for each of the five classes of transactions and includes the following steps:

- Understand internal control
- Assess planned control risk
- Determine the extent of testing controls
- Design tests of controls and substantive tests of transactions to meet transaction-related audit objectives

In designing tests of controls for each class of transactions, auditors focus on testing internal controls that they intend to rely upon to reduce control risk. First, the auditor identifies internal controls, if any exist, for each transaction-related audit objective. After assessing control risk for each objective, the auditor then determines the extent of tests of controls that must be performed.

If the auditor is reporting on the effectiveness of internal control over financial reporting, extensive tests of controls must be performed to provide the basis for the auditor's report. For audits of non-accelerated filers and nonpublic companies, the decision to perform tests of controls is based on the effectiveness of controls and the extent to which the auditor intends to rely on them to reduce control risk.

The auditor also designs substantive tests of transactions for each class of transactions to determine whether the monetary amounts of transactions are correctly recorded. Like tests of controls, substantive tests of transactions are designed for each transaction-related audit objective.

After the design of tests of controls and substantive tests of transactions for each audit objective and each class of transactions is completed, the auditor organizes the audit procedures into a performance format audit program. The purpose of this audit program is to help the auditor complete the audit tests efficiently.

ESSENTIAL TERMS

Business functions for the sales and collection cycle—the key activities that an organization must complete to execute and record business transactions for sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts, and bad debt expense

Classes of transactions in the sales and collection cycle—the categories of transactions for the sales and collection cycle in a typical company: sales, cash receipts, sales returns and allowances, write-off of uncollectible accounts, and bad debt expense

Design format audit program—the audit procedures resulting from the auditor's decisions about the appropriate audit procedures for each audit objective; this audit program is used to prepare a performance format audit program

Direction of testing—the starting point for testing the occurrence and completeness transaction-related audit objectives; vouching from journals to source documents tests for occurrence and tracing from source documents to journals tests for completeness

Lapping of accounts receivable—the postponement of entries for the collection of receivables to conceal an existing cash shortage

Performance format audit program—the audit procedures for a class of transactions organized in the format in which they will be performed; this audit program is prepared from a design format audit program

Proof of cash receipts—an audit procedure to test whether all recorded cash receipts have been deposited in the bank account by reconciling the total cash receipts recorded in the cash receipts journal for a given period with the actual deposits made to the bank

Sales and collection cycle—involves the decisions and processes necessary for the transfer of the ownership of goods and services to customers after they are made available for sale; it begins with a request by a customer and ends with the conversion of material or service into an account receivable, and ultimately into cash

REVIEW QUESTIONS

14-1 (Objective 14-2) Describe the nature of the following documents and records and explain their use in the sales and collection cycle: bill of lading, sales invoice, credit memo, remittance advice, and monthly statement to customers.

14-2 (Objective 14-2) Explain the importance of proper credit approval for sales. What effect do adequate controls in the credit function have on the auditor's evidence accumulation?

14-3 (Objective 14-2) Distinguish between the sales journal and the accounts receivable master file. What type of information is recorded in each and how do these accounting records relate?

14-4 (Objective 14-2) BestSellers.com sells fiction and nonfiction books and e-books to customers through the company's Web site. Customers place orders for books via the Web site by providing their name, address, credit card number, and expiration date. What internal controls could BestSellers.com implement to ensure that shipments of books occur only for customers who have the ability to pay for those books? At what point will BestSellers.com be able to record the sale as revenue?

14-5 (Objective 14-3) List the transaction-related audit objectives for the audit of sales transactions. For each objective, state one internal control that the client can use to reduce the likelihood of misstatements.

14-6 (Objective 14-3) State one test of control and one substantive test of transactions that the auditor can use to verify the following sales transaction-related audit objective: Recorded sales are stated at the proper amounts.

14-7 (Objective 14-3) List the most important duties that should be segregated in the sales and collection cycle. Explain why it is desirable that each duty be segregated.

14-8 (Objective 14-3) Explain how prenumbered shipping documents and sales invoices can be useful controls for preventing misstatements in sales.

14-9 (Objective 14-3) What three types of authorizations are commonly used as internal controls for sales? For each authorization, state a substantive test that the auditor could use to verify whether the control was effective in preventing misstatements.

14-10 (Objective 14-3) Explain the purpose of footing and cross-footing the sales journal and tracing the totals to the general ledger.

14-11 (Objective 14-4) What is the difference between the auditor's approach in verifying sales returns and allowances and that for sales? Explain the reasons for the difference.

14-12 (Objective 14-5) Explain why auditors usually emphasize the detection of fraud in the audit of cash receipts. Is this consistent or inconsistent with the auditor's responsibility in the audit? Explain.

14-13 (Objective 14-5) List the transaction-related audit objectives for the verification of cash receipts. For each objective, state one internal control that the client can use to reduce the likelihood of misstatements.

14-14 (Objective 14-5) List several audit procedures that the auditor can use to determine whether all cash received was recorded.

14-15 (Objective 14-5) Explain what is meant by a proof of cash receipts and state its purpose.

14-16 (Objective 14-5) Explain what is meant by lapping and discuss how the auditor can uncover it. Under what circumstances should the auditor make a special effort to uncover lapping?

14-17 (Objective 14-6) What audit procedures are most likely to be used to verify accounts receivable written off as uncollectible? State the purpose of each of these procedures.

14-18 (Objectives 14-3, 14-5) State the relationship between the confirmation of accounts receivable and the results of the tests of controls and substantive tests of transactions.

14-19 (Objectives 14-3, 14-5) Under what circumstances is it acceptable to perform tests of controls and substantive tests of transactions for sales and cash receipts at an interim date?

14-20 (Objective 14-3) Diane Smith, CPA, performed tests of controls and substantive tests of transactions for sales for the month of March in an audit of the financial statements for the year ended December 31, 2013. Based on the excellent results of both the tests of controls and the substantive tests of transactions, she decided to significantly reduce her substantive tests of details of balances at year-end. Evaluate this decision.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

14-21 (Objectives 14-3, 14-4, 14-5, 14-6) The following questions deal with internal controls in the sales and collection cycle. Choose the best response.

a. The accounting system will not post a sales transaction to the sales journal without a valid bill of lading number. This control is most relevant to which transaction-related objective for sales?

(1) Accuracy
(2) Occurrence
(3) Completeness
(4) Posting and summarization

b. The accounting system automatically obtains the unit price based on scans of bar codes for merchandise sold. This control is most relevant to which transaction-related objective for sales?
   (1) Accuracy
   (2) Occurrence
   (3) Completeness
   (4) Posting and summarization

c. Which of the following controls would be most effective in detecting a failure to record cash received from customers paying on their accounts?
   (1) A person in accounting reconciles the bank deposit to the cash receipts journal.
   (2) Transactions recorded in the cash receipts journal are posted on a real-time basis to the accounts receivable master file.
   (3) Monthly statements are sent to customers and any discrepancies are resolved by someone independent of cash handling and accounting.
   (4) Deposits of cash received are made daily.

d. Proper authorization of write-offs of uncollectible accounts should be approved in which of the following departments?
   (1) Accounts receivable
   (2) Credit
   (3) Accounts payable
   (4) Treasurer

14-22 (Objectives 14-3, 14-4) For each of the following types of misstatements (parts a. through d.), select the control that should have prevented the misstatement:

a. A manufacturing company received a substantial sales return in the last month of the year, but the credit memorandum for the return was not prepared until after the auditors had completed their testing. The returned merchandise was included in the physical inventory.
   (1) Receiving reports are prepared for all materials received and such reports are accounted for on a timely basis.
   (2) Aged trial balance of accounts receivable is prepared.
   (3) Credit memoranda are prenumbered and all numbers are accounted for.
   (4) A reconciliation of the trial balance of customers' accounts with the general ledger control is prepared periodically.

b. Which of the following controls most likely will be effective in offsetting the tendency of sales personnel to maximize sales volume at the expense of high bad debt write-offs?
   (1) Employees responsible for authorizing sales and bad debt write-offs are denied access to cash.
   (2) Employees involved in the credit-granting function are separated from the sales function.
   (3) Shipping documents and sales invoices are matched by an employee who does not have the authority to write off bad debts.
   (4) Subsidiary accounts receivable records are reconciled to the control account by an employee independent of the authorization of credit.

c. A sales invoice for $5,200 was computed correctly but, by mistake, was entered as $2,500 to the sales journal and posted to the accounts receivable master file. The customer remitted only $2,500, the amount on his monthly statement.
   (1) Sales invoice numbers, prices, discounts, extensions, and footings are independently checked.
   (2) The customers' monthly statements are verified and mailed by a responsible person other than the bookkeeper who prepared them.
   (3) Prelistings and predetermined totals are used to control postings.
   (4) Unauthorized remittance deductions made by customers or other matters in dispute are investigated promptly by a person independent of the accounts receivable function.

d. Shipments occurring in December 2013 did not get recorded until the first few days of January 2014.
   (1) The system automatically assigns bill of lading numbers and ensures no duplicates are issued.

(2) As goods leave the shipping dock, the system generates a bill of lading and associated sales invoice, which is automatically recorded in the sales journal.
(3) The accounting system requires entry of a valid bill of lading number provided by the shipping department before a sales transaction is accepted for entry.
(4) The system prevents the creation of a bill of lading without a customer order dated prior to the shipping date.

14-23 (Objectives 14-1, 14-3) The following questions deal with audit evidence for the sales and collection cycle. Choose the best response.

a. An auditor is performing substantive tests of transactions for sales. One step is to trace a sample of debit entries from the accounts receivable master file back to the supporting duplicate sales invoices. What will the auditor intend to establish by this step?
   (1) Sales invoices represent existing sales.
   (2) All sales have been recorded.
   (3) All sales invoices have been correctly posted to customer accounts.
   (4) Debit entries in the accounts receivable master file are correctly supported by sales invoices.
b. Which audit procedure is most effective in testing credit sales for overstatement?
   (1) Trace a sample of postings from the sales journal to the sales account in the general ledger.
   (2) Vouch a sample of recorded sales from the sales journal to shipping documents.
   (3) Prepare an aging of accounts receivable.
   (4) Trace a sample of initial sales orders to sales recorded in the sales journal.
c. To determine whether internal control relative to the revenue cycle of a wholesaling entity is operating effectively in minimizing the failure to prepare sales invoices, an auditor would most likely select a sample of transactions from the population represented by the
   (1) sales order file.
   (2) customer order file.
   (3) shipping document file.
   (4) sales invoice file.

DISCUSSION QUESTIONS AND PROBLEMS

14-24 (Objectives 14-2, 14-3, 14-4, 14-5) Items 1 through 9 are selected questions of the type generally found in internal control questionnaires used by auditors to obtain an understanding of internal control in the sales and collection cycle. In using the questionnaire for a client, a "yes" response to a question indicates a possible internal control, whereas a "no" indicates a potential deficiency.

1. Are customer orders evaluated for credit approval by someone independent of sales?
2. Are online sales automatically recorded in the sales system?
3. Are unit prices obtained from a pre-approved and restricted master file of unit prices?
4. Is the bill of lading information forwarded in a timely fashion to accounting to ensure recording in the sales journal?
5. Is the numerical sequence of bills of ladings accounted for to identify duplicates or missing documents?
6. Are entries in the sales journal restricted to those that are supported by a valid bill of lading?
7. Are sales invoice amounts independently verified for correctness?
8. Are individuals responsible for handling cash collections independent of accounting and shipping functions?
9. Are entries in the sales journal timely recorded in the accounts receivable master file?

Required

a. For each of the preceding questions, state the transaction-related audit objectives being fulfilled if the control is in effect.
b. For each control, list a test of control to test its effectiveness.
c. For each of the preceding questions, identify the nature of the potential financial misstatements.
d. For each of the potential misstatements in part c., list a substantive audit procedure to determine whether a material misstatement exists.

14-25 (Objectives 14-2, 14-3) Auditing standards require the auditor to obtain an understanding of the entity and its environment as a basis for assessing the risks of material misstatements. Business models differ across organizations and industries leading to unique business processes needed to account for transactions. While the core business functions for the sales and collection cycle discussed in this chapter are generally relevant to all organizations, the underlying business processes and related documents and records are often unique to each organization. Below are four descriptions of different businesses.

1. The Starbucks Coffee Company sells regular and specialty coffees and teas in over 15,000 stores spanning more than 50 countries. Customers use cash, debit or credit cards, and pre-paid Starbucks cards to purchase individual drinks that are served to them within minutes.
2. Amazon.com is one of the world's largest online retailers of all kinds of products. While consumers can find a wide variety of products available at Amazon.com, the company is known for its huge selection of new and used books that can be purchased on its Web site.
3. Most people have a personal physician who provides medical care when needed, including annual physicals and other medical services. Patients make appointments to be seen by their physician, who examines the patient and prescribes treatments and medications when needed. Insured patients often pay a co-payment with the balance paid by the insurance company.
4. The majority of universities generate a significant portion of their revenue from tuition. Universities bill students in advance for classes that will be taken in an upcoming term. For full-time students, most universities charge a set tuition amount after students enroll in a minimum number of courses per term.

Required Analyze each of the above independent business scenarios to answer each of the following questions:

a. Using the eight business functions for the sales and collection cycle illustrated in Table 14-1 on page 461 as a guide, briefly describe the underlying business processes related to each of the eight functions for the sales and cash collections for the above independent scenarios.

b. What documents or other source evidence would you use to test the occurrence transaction-related audit objective for sales for each of the four scenarios?

c. For which of the four scenarios would the sales returns and allowances business function not be applicable?

d. For which of the four scenarios would the write-off of uncollectible accounts and bad debt expense business functions not be applicable?

14-26 (Objectives 14-3, 14-4, 14-5) The following are commonly performed tests of controls and substantive tests of transactions audit procedures in the sales and collection cycle:

1. Account for a sequence of shipping documents and examine each one to make sure that a duplicate sales invoice is attached.
2. Account for a sequence of sales invoices and examine each one to make sure that a duplicate copy of the shipping document is attached.
3. Compare the quantity and description of items on shipping documents with the related duplicate sales invoices.
4. Trace recorded sales in the sales journal to the related accounts receivable master file and compare the customer name, date, and amount for each one.
5. Examine sales returns for approval by an authorized official.
6. Review the prelisting of cash receipts to determine whether cash is prelisted daily.
7. Reconcile the recorded cash receipts on the prelisting with the cash receipts journal and the bank statement for a 1-month period.

Required a. Identify whether each audit procedure is a test of control or a substantive test of transactions.

b. State which of the six transaction-related audit objectives each of the audit procedures fulfills.

c. Identify the type of evidence used for each audit procedure, such as inspection and observation.

14-27 (Objectives 14-2, 14-3) The following sales procedures were encountered during the annual audit of Marvel Wholesale Distributing Company:

Customer orders are received by the sales order department. A clerk computes the approximate dollar amount of the order and sends it to the credit department for approval. Credit approval is stamped on the order and sent to the accounting department. A computer is then used to generate two copies of a sales invoice. The order is filed in the customer order file.

The customer copy of the sales invoice is held in a pending file awaiting notification that the order was shipped. The shipping copy of the sales invoice is routed through the warehouse, and the shipping department has authority for the respective departments to release and ship the merchandise. Shipping department personnel pack the order and manually prepare a three-copy bill of lading: The original copy is mailed to the customer, the second copy is sent with the shipment, and the other is filed in sequence in the bill of lading file. The sales invoice shipping copy is sent to the accounting department with any changes resulting from lack of available merchandise.

A clerk in accounting matches the received sales invoice shipping copy with the sales invoice customer copy from the pending file. Quantities on the two invoices are compared and prices are compared to an approved price list. The customer copy is then mailed to the customer, and the shipping copy is sent to the data processing department.

The data processing clerk in accounting enters the sales invoice data into the computer, which is used to prepare the sales journal and update the accounts receivable master file. She files the shipping copy in the sales invoice file in numerical sequence.

Required

a. To determine whether the internal controls operated effectively to minimize instances of failure to invoice a shipment, the auditor would select a sample of transactions from the population represented by the
   (1) customer order file.
   (2) bill of lading file.
   (3) customers' accounts receivable master file.
   (4) sales invoice file.

b. To gather audit evidence that uncollected items in customers' accounts represented existing trade receivables, the auditor would select a sample of items from the population represented by the
   (1) customer order file.
   (2) bill of lading file.
   (3) customers' accounts receivable master file.
   (4) sales invoice file.

c. To determine whether the internal controls operated effectively to minimize instances of failure to post invoices to customers' accounts receivable master file, the auditor would select a sample of transactions from the population represented by the
   (1) customer order file.
   (2) bill of lading file.
   (3) customers' accounts receivable master file.
   (4) sales invoice file.*

14-28 (Objectives 14-3, 14-5) The following are common audit procedures for tests of sales and cash receipts:

1. Compare the quantity and description of items on duplicate sales invoices with related shipping documents.
2. Trace recorded cash receipts in the accounts receivable master file to the cash receipts journal and compare the customer name, date, and amount of each one.
3. Examine duplicate sales invoices for an indication that unit selling prices were compared to the approved price list.
4. Examine duplicate sales invoices to determine whether the account classification for sales has been included on the document.
5. Examine the sales journal for related-party transactions, notes receivable, and other unusual items.

6. Select a sample of customer orders and trace the document to related shipping documents, sales invoices, and the accounts receivable master file for comparison of name, date, and amount.
7. Perform a proof of cash receipts.
8. Examine a sample of remittance advices for approval of cash discounts.
9. Account for a numerical sequence of remittance advices and determine whether there is a cross-reference mark for each one, indicating that it has been recorded in the cash receipts journal.

Required

a. Identify whether each audit procedure is a test of control or substantive test of transactions.

b. State which transaction-related audit objective(s) each of the audit procedures fulfills.

c. For each test of control in part a., state a substantive test that could be used to determine whether there was a monetary misstatement.

14-29 (Objective 14-3) The following are a list of possible errors or fraud (1 through 5) involving cash receipts and controls (a. through g.) that may prevent or detect the errors or fraud:

Possible Errors or Fraud

1. Customer checks are properly credited to customer accounts and are properly deposited, but errors are made in recording receipts in the cash receipts journal.
2. Customer checks are misappropriated before being forwarded to the cashier for deposit.
3. Customer checks are received for less than the customers' full account balances, but the customers' full account balances are credited.
4. Customer checks are credited to incorrect customer accounts.
5. Different customer accounts are each credited for the same cash receipt.

Internal Controls

a. Customer orders are compared with an approved customer list.

b. Prenumbered credit memos are used for granting credit for returned goods.

c. Remittance advices are separated from the checks in the mailroom and forwarded to the accounting department.

d. The cashier examines each check for proper endorsement.

e. Total amounts posted to the accounts receivable subsidiary records from remittance advices are compared with the validated bank deposit slip.

f. Monthly statements are mailed to customers with outstanding balances.

g. An employee, other than the bookkeeper, periodically prepares a bank reconciliation.

Required

For each error or fraud, select one internal control that if properly designed and implemented, most likely would be effective in preventing or detecting the errors and fraud. Each response in the list of controls may be used once, more than once, or not at all.*

14-30 (Objective 14-5) You have been asked by the board of trustees of a local church to review its accounting procedures. As part of this review you have prepared the following comments about the collections made at weekly services and record keeping for members' pledges and contributions:

1. The church's board of trustees has delegated responsibility for financial management and audit of the financial records to the finance committee. This group prepares the annual budget and approves major cash disbursements, but is not involved in collections or record keeping. No audit has been considered necessary in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years.

2. The collection at the weekly service is taken by a team of ushers. The head usher counts the collection in the church office after each service. She then places the collection and a notation of the amount in the church safe. The next morning, the financial secretary opens

the safe and recounts the collection. He withholds about $100 to meet cash expenditures during the coming week and deposits the remainder intact. To facilitate the deposit, members who contribute by check are asked to enter "Cash" on the payee line.

3. At their request, a few members are furnished prenumbered predated envelopes in which to insert their weekly contributions. The head usher removes the cash from the envelopes to be counted with the loose cash included in the collection and discards the envelopes. No record is maintained of issuance or return of the envelopes, and the envelope system is not encouraged.

4. Each member is asked to prepare a contribution pledge card annually. The pledge is regarded as a moral commitment by the member to contribute a stated weekly amount. Some members have inquired about having weekly contributions automatically withdrawn from their bank account or charged to their credit card, but the church has not established procedures that would allow payments other than by cash or check at weekly services. Based on the amounts shown on the pledge cards, the financial secretary furnishes a letter to members, upon request, to support the tax deductibility of their contributions.

Required

Identify the deficiencies and recommend improvements in procedures for collection made at weekly services and record keeping for members' pledges and contributions. Use the methodology for identifying deficiencies discussed in Chapter 10. Organize your answer sheets as follows:*

Deficiency	Recommended Improvement

14-31 (Objectives 14-3, 14-5) Items 1 through 10 present various internal control strengths or internal control deficiencies.

1. Credit is granted by a credit department.
2. Once shipment occurs and is recorded in the sales journal, all shipping documents are marked "recorded" by the accounting staff.
3. Sales returns are presented to a sales department clerk who prepares a written, prenumbered receiving report.
4. Cash receipts received in the mail are received by a secretary with no recordkeeping responsibility.
5. Cash receipts received in the mail are forwarded unopened with remittance advices to accounting.
6. The cash receipts journal is prepared by the treasurer's department.
7. Cash is deposited weekly.
8. Statements are sent monthly to customers.
9. Write-offs of accounts receivable are approved by the controller.
10. The bank reconciliation is prepared by individuals independent of cash receipts recordkeeping.

Required

a. For each of the preceding 1–10 items, indicate whether the item represents an:
   A. Internal control strength for the sales and collection cycle.
   B. Internal control deficiency for the sales and collection cycle.

b. For each item that you answered (A), indicate the transaction-related audit objective(s) to which the control relates.

c. For each item that you answered (B), indicate the nature of the deficiency.*

14-32 (Objective 14-3) YourTeam.com is an online retailer of college and professional sports team memorabilia, such as hats, shirts, pennants, and other sports logo products. Consumers select the college or professional team from a pull-down menu on the company's Web site. For each listed team, the Web site provides a product description, picture, and price for all products sold online. Customers click on the product number of the items they wish to purchase. The following are internal controls YourTeam.com has established for its online sales:

1. Only products shown on the Web site can be purchased online. Other company products not shown on the Web site listing are unavailable for online sale.

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2. The online sales system is linked to the perpetual inventory system that verifies quantities on hand before processing the sale.
3. Before the sale is authorized, YourTeam.com obtains credit card authorization codes electronically from the credit card agency.
4. Online sales are rejected if the customer's shipping address does not match the credit card's billing address.
5. Before the sale is finalized, the online screen shows the product name, description, unit price, and total sales price for the online transaction. Customers must click on the Accept or Reject sales buttons to indicate approval or rejection of the online sale.
6. Once customers approve the online sale, the online sales system generates a Pending Sales file, which is an online data file that is used by warehouse personnel to process shipments. Online sales are not recorded in the sales journal until warehouse personnel enter the bill of lading number and date of shipment into the Pending Sales data file.

Required

a. For each control, identify the transaction-related audit objective(s) being fulfilled if each control is in effect.

b. For each control, describe potential financial misstatements that could occur if the control was not present.

CASE

14-33 (Objective 14-4) The Kwan Pharmaceutical Company, a drug manufacturer, occasionally receives requests from customers for credit memos. The company has the following internal controls for recording sales returns and evaluating the adequacy of the accounts receivable allowance (A/R allowance).

1. All customer requests for credits are documented in a log and are forwarded to the controller.
2. The controller reviews each credit request for reasonableness and discusses it with the appropriate personnel related to the initial sale.
3. The controller documents the credit memo on a form explaining the reason for the credit and the amount of the credit.
4. The controller and the CFO both physically sign the credit memo paperwork.
5. The credit is issued by a separate department prior to the reduction of the A/R allowance for the customer, or is refunded by check.
6. The controller updates the accounting software for the credit memo.
7. On a quarterly basis, the controller evaluates the adequacy of the A/R allowance.

Sample of the Balance Sheet (in 000's):

	12/31/14	12/31/13
A/R	1,500	1,000
A/R allowance	(100)	(100)
Net A/R	1,400	900

As the Senior auditor, it is your responsibility to design the audit plan to test sales returns and allowances.

Required

a. In the form of a chart (see Table 14-2) for Kwan Pharmaceutical Company design an audit program for sales returns (credit memos):
   1. List the audit objectives to be achieved.
   2. List the key controls from the summary above.
   3. Suggest tests of controls for each objective.
   4. Suggest substantive tests of transactions for each objective.

b. Suggest testing to evaluate the adequacy of the sales return allowance.

c. What does the trend of the A/R allowance figures suggest to you? How would you modify your testing scope to address what you see?

INTEGRATED CASE APPLICATION—PINNACLE MANUFACTURING: PART V

14-34 (Objectives 14-3, 14-5) In Part III of this case study, you obtained an understanding of internal control and made an initial assessment of control risk for each transaction-related audit objective for acquisition and cash disbursement transactions. The purpose of Part V is to continue the assessment of control risk by determining the appropriate tests of controls and substantive tests of transactions. In order to do this, you must complete the steps needed to prepare a high-quality performance format audit program for tests of controls and substantive tests of transactions for acquisitions and cash disbursements.

Assume in Part III that you identified the following as the key controls you want to rely on (even though your answers were likely different from these):

1. Segregation of the purchasing, receiving, and cash disbursements functions
2. Use of prenumbered voucher packages, properly accounted for
3. Use of prenumbered checks, properly accounted for
4. Use of prenumbered receiving reports, properly accounted for
5. Internal verification of document package before check preparation
6. Review of supporting documents and signing of checks by an independent, authorized person
7. Cancellation of documents prior to signing of the check
8. Monthly reconciliation of the accounts payable master file with the general ledger
9. Independent reconciliation of the monthly bank statements

Required

a. Prepare an audit file listing the nine controls or download them from the textbook Web site.

b. After each control, identify the transaction-related audit objective(s) that it partially or fully satisfies.

c. Immediately below the control, list one audit procedure to test the control. Use the most reliable test of control evidence that you can think of. Write the audit procedure in good form.

d. Immediately below the test of control, list one substantive test of transactions audit procedure to test whether the control failed to be effective. Use the most reliable substantive tests of transactions evidence that you can think of.

e. Create a separate audit schedule labeled "Acquisitions Substantive Tests of Transactions." Decide and write one substantive test of transactions audit procedure for each transaction-related audit objective for acquisitions. The audit procedures must be different than the ones in requirement d. The schedule should be designed as follows:

Acquisitions Substantive Tests of Transactions

Occurrence	Write the substantive audit procedure
Completeness	Write the substantive audit procedure
Etc.	

f. Using a separate heading labeled "Cash Disbursements Substantive Tests of Transactions," decide and write one substantive test of transactions audit procedure for each transaction-related audit objective for cash disbursements. The audit procedures must be different than the ones in requirements d. and e. The audit schedule should be designed the same as the one in requirement e.

g. Prepare a performance audit program for acquisitions and cash disbursements using all audit procedures in requirements c. through f. See Figure 14-6 (p. 480) for a format. To the extent possible, follow the approach in procedure 13 a. through e. in Figure 14-6 of having "one starting point" procedure followed by other related procedures. Do this for both acquisitions and cash disbursements. Be sure to eliminate any duplicate audit procedures.

ACL PROBLEM

14-35 (Objectives 14-4 and 14-5) This problem requires the use of ACL software, which is included in the CD attached to the text. Information about installing and using ACL and solving this problem can be found in Appendix, pages 850–854. You should read all of the reference material preceding the instructions for "Quick Sort" before locating the appropriate command to answer questions a. through e. For this problem use the Metaphor_AR_2002 file in ACL_Demo. The suggested command or other source of information needed to solve the problem requirement is included at the end of each question.

Required

a. Determine the total number and amount of September 2002 transactions in the file. (Filter, Count, and Total Field)

b. Determine and print the total amount for each of the five types of 2002 transactions for comparison to the general ledger. (Summarize) Which transaction type has the highest count?

c. For sales invoices (IN), determine the number of transactions, total amount, largest amount, and average size. (Filter and Statistics)

d. Determine the number of days difference between the invoice date (DATE1) and the due date (DUE) for sales invoices (IN) and evaluate the internal controls over these two dates. (Computed Field)

e. To better decide the sales invoices to select for testing, you decide to stratify 2002 sales invoices (IN) after excluding all invoices less than $300. Print the output. (Filter and Stratify)

RESEARCH PROBLEM 14-1: REVENUE RECOGNITION FRAUD

The Securities and Exchange Commission (SEC) found that Bally Total Fitness Holding Corporation, a nationwide commercial operator of fitness centers, fraudulently accounted for three types of revenues it received from members. The SEC also charged the audit firm and six partners for their roles in the accounting violations. Visit the SEC Web site (www.sec.gov) and search the link to "Litigation Releases" to locate Litigation Release 20470 issued on February 28, 2008, against Bally Total Fitness Holding Corporation to learn more about this revenue fraud.

Required

a. Read the release and the accompanying complaint in this matter and briefly summarize the three types of alleged revenue frauds.

b. Return to the opening page on the SEC Web site and search the link for "Press Releases" to locate the December 17, 2009, announcement of the SEC charges against the audit firm and the six partners.

c. Read the press release and briefly summarize the SEC description of the nature of audit risk associated with the Bally's audit engagement.

d. Read the complaint against the audit engagement partner, who served as the 2001 and 2002 engagement partner. What factors caused the audit firm to recognize Bally as a high risk audit client for 1996–2003?