CHAPTER 16

COMPLETING THE TESTS IN THE SALES AND COLLECTION CYCLE: ACCOUNTS RECEIVABLE

LEARNING OBJECTIVES

After studying this chapter, you should be able to

16-1 Describe the methodology for designing tests of details of balances using the audit risk model.

16-2 Design and perform analytical procedures for accounts in the sales and collection cycle.

16-3 Design and perform tests of details of balances for accounts receivable.

16-4 Obtain and evaluate accounts receivable confirmations.

16-5 Design audit procedures for the audit of accounts receivable, using an evidence planning worksheet as a guide.

Things Aren't Always As They Appear

The Wilsall Trading Company has been in operation for 10 years and has always presented solid financial statements. The same CPA firm has performed the audit since the inception of Wilsall and has become very familiar with the company, its operations, and its management. In 2013, the CPA firm decided (based on the risk assessment) to send a total of 30 positive confirmations to selected companies listed as accounts receivable on the balance sheet. The senior auditor was put in charge of mailing and following up on the confirmations. After three weeks, the busy season was now in full swing and only 5 of the confirmations had been received. The senior was very busy with other work and grumbled to herself, "what a pain, no one ever returns these things . . . and if they do, they are filled out incorrectly! I don't have time for all of this follow up."

The senior enlisted the help of the staff auditor on the engagement, who assisted with the follow up of confirmations. The staff auditor didn't really have a good understanding of the process and did not have much supervision because the senior was so busy. As the weeks rolled on, the staff auditor realized that there were a few confirmations that were just never going to come back and—figuring they were immaterial amounts—she made a note about the two missing confirmations and marked the workpaper as complete. The other testing areas proceeded normally, and none of the reviewers noticed the note about the missing A/R confirmations on the workpaper. Wilsall Trading Company showed positive results as usual and the CPA firm issued an unqualified opinion.

Three months later, Wilsall Trading Company found itself in dire financial straits and began looking frantically for outside financing. Owners of the company wondered how they had ended up in this situation, considering the results they had showed at year-end. The CEO personally looked into the financial results and through intense questioning found that the Controller and the CFO had conspired to artificially inflate the results of the company by creating fictitious accounts receivable from fictitious companies which were written off after year-end by credit memos. Both the Controller and CFO were fired immediately and the CEO went after the CPA firm next.

Was there something else the CPA firm could have done to detect this fraud during the audit? Granted, fraud committed with collusion between management can be hard to detect, but surely there must have been something else the CPA firm could have done, right?

In the preceding two chapters, we examined tests of controls and substantive tests of transactions for the sales and collection cycle. Both types of tests are part of phase II of the audit process. We now move to phase III and turn our attention to substantive analytical procedures and tests of details of balances for the sales and collection cycle.

This chapter shows that it is essential for auditors to select the appropriate evidence to verify the account balances in the sales and collection cycle, after considering performance materiality, performing risk assessment procedures to assess inherent and control risks, and performing tests of controls and substantive tests of transactions. This chapter examines designing substantive analytical procedures and tests of details of balances for the two key balance sheet accounts in the cycle: accounts receivable and the allowance for uncollectible accounts.

METHODOLOGY FOR DESIGNING TESTS OF DETAILS OF BALANCES

OBJECTIVE 16-1

Describe the methodology for designing tests of details of balances using the audit risk model.

Figure 16-1 shows the methodology auditors follow in designing the appropriate tests of details of balances for accounts receivable. This methodology was introduced in Chapter 13 and is now applied to the audit of accounts receivable.

The methodology shown in Figure 16-1 relates directly to the evidence planning worksheet first introduced in Chapter 9. The worksheet was partially completed on page 290 for materiality and risk considerations (part of phase I) and was further completed as a part of the study of tests of controls and substantive tests of transactions on page 516 in Chapter 15 (phase II). We will continue to complete the worksheet as we proceed through phase III in this chapter. For now, you might want to look at the example of a completed worksheet in Figure 16-7 on page 557 to see what the completed worksheet looks like, to provide you an overview of the focus of this chapter.

The appropriate evidence to be obtained from tests of details of balances must be decided on an objective-by-objective basis. Because several interactions affect the need for evidence from test of details of balances, this audit decision can be complex. For example, the auditor must evaluate the potential for fraud and also consider inherent risk, which may vary by objective, as well as the results of tests of controls and the related control risk assessment, which also may vary by objective. The auditor must also consider the results of substantive tests of sales and cash receipts.

In designing tests of details of balances for accounts receivable, auditors must satisfy each of the eight balance-related audit objectives first discussed on pages 179–181 in Chapter 6. These eight general objectives are the same for all accounts. Specifically applied to accounts receivable, they are called **accounts receivable balance-related audit objectives** and are as follows:[1]

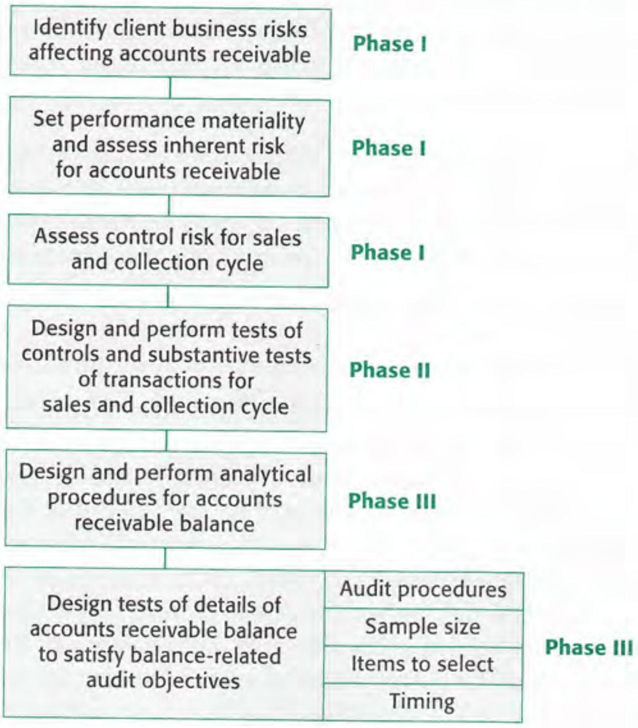
1. Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger. (Detail tie-in)
2. Recorded accounts receivable exist. (Existence)
3. Existing accounts receivable are included. (Completeness)
4. Accounts receivable are accurate. (Accuracy)
5. Accounts receivable are correctly classified. (Classification)
6. Cutoff for accounts receivable is correct. (Cutoff)
7. Accounts receivable is stated at realizable value. (Realizable value)
8. The client has rights to accounts receivable. (Rights)

The columns in the evidence planning worksheet in Figure 16-7 include the balance-related audit objectives. The auditor uses the factors in the rows to aid in assessing planned detection risk for accounts receivable, by objective.

Students of auditing need to understand the entire methodology for designing tests of details of balances for accounts receivable and all other accounts. The following

[1]Detail tie-in is included as the first objective here, compared with being objective 6 in Chapter 6, because tests for detail tie-in are normally done first.

FIGURE 16-1 Methodology for Designing Tests of Details of Balances for Accounts Receivable



overview explains the methodology. Portions of the discussion are a review of information studied in earlier chapters, but they are intended to aid in understanding the relationship of each part of Figure 16-1 to designing tests of details of balances.

Identify Client Business Risks Affecting Accounts Receivable (Phase I)

Tests of accounts receivable are based on the auditor's risk assessment procedures that provide an understanding of the client's business and industry, discussed in Chapter 8. As part of this understanding, the auditor studies the client's industry and external environment and evaluates management objectives and business processes to identify significant client business risks that could affect the financial statements, including accounts receivable. As part of gaining this understanding, the auditor also performs preliminary analytical procedures that may indicate increased risk of misstatements in accounts receivable.

Client business risks affecting accounts receivable are considered in the auditor's evaluation of inherent risk and planned evidence for accounts receivable. For example, as a result of adverse changes in the industry's economic environment, the auditor may increase inherent risk for net realizable value of accounts receivable.

Set Performance Materiality and Assess Inherent Risk (Phase I)

As studied in Chapter 9, the auditor first decides the preliminary judgment about materiality for the entire financial statements, and then allocates the preliminary judgment amount to each significant balance sheet account, including accounts receivable. This allocation is called *setting performance materiality*. Accounts receivable is typically one of the most material accounts in the financial statements for companies that sell on credit. For even small accounts receivable balances, the transactions in the sales and collection cycle that affect the balance in accounts receivable are almost certain to be highly significant.

Auditors assess inherent risk for each objective for an account such as accounts receivable, considering client business risk and the nature of the client and industry.

Auditing standards indicate that auditors must normally identify a specific fraud risk for revenue recognition. This likely affects the auditor's assessment of inherent risk for the following objectives: existence, sales cutoff, and sales returns and allowances cutoff. It is common for clients to misstate cutoff either by error or through fraud. It is also common for clients to unintentionally or fraudulently misstate the allowance for uncollectible accounts (realizable value) because of the difficulty of the judgments to determine the correct balance.

Assess Control Risk for the Sales and Collection Cycle (Phase I)

Internal controls over sales and cash receipts and the related accounts receivable are at least reasonably effective for most companies because management is concerned with keeping accurate records to maintain good relations with customers. Auditors are especially concerned with three aspects of internal controls:

1. Controls that prevent or detect embezzlements
2. Controls over cutoff
3. Controls related to the allowance for uncollectible accounts

Earlier, we studied transaction-related audit objectives in the sales and collection cycle (see Chapter 14). The auditor must relate control risk for transaction-related audit objectives to balance-related audit objectives in deciding planned detection risk and planned evidence for tests of details of balances. For the most part, this relationship is straightforward. Figure 16-2 shows the relationship for the two primary classes of transactions in the sales and collection cycle. For example, assume the auditor concluded that control risk for both sales and cash receipts transactions is low for the accuracy transaction-related audit objective. The auditor can therefore conclude that controls for the accuracy balance-related audit objective for accounts receivable are effective because the only transactions that affect accounts receivable are sales and cash receipts. Of course, if sales returns and allowances and write-off of uncollectible accounts receivable are significant, assessed control risk must also be considered for these two classes of transactions.

Two aspects of the relationships in Figure 16-2 deserve special mention:

1. For sales, the occurrence transaction-related audit objective affects the existence balance-related audit objective. For cash receipts, however, the occurrence transaction-related audit objective affects the completeness balance-related audit objective. A similar relationship exists for the completeness transaction-related audit objective. The reason for this somewhat surprising conclusion is that an increase in sales increases accounts receivable, but an increase in cash receipts decreases accounts receivable. For example, recording a sale that did not occur violates the occurrence transaction-related audit objective and existence balance-related audit objective (both overstatements). Recording a cash receipt that did not occur violates the occurrence transaction-related audit objective, but it also violates the completeness balance-related audit objective for accounts receivable because a receivable that is still outstanding is no longer included in the records.
2. The realizable value and rights accounts receivable balance-related audit objectives, as well as the presentation and disclosure-related objectives, are not affected by assessed control risk for classes of transactions. To assess control risk below the maximum for these objectives, the auditor must identify and test separate controls that support those objectives.

Figure 16-7 (p. 557) includes three rows for assessed control risk: one for sales, one for cash receipts, and one for additional controls related to the accounts receivable balance. The source of each control risk for sales and cash receipts is the control risk matrix assuming that the tests of controls results supported the original assessment. The auditor makes a separate assessment of control risk for objectives that are related only to the accounts receivable balance or to presentation and disclosure audit objectives.

FIGURE 16-2 **Relationship Between Transaction-Related Audit Objectives for the Sales and Collection Cycle and Balance-Related Audit Objectives for Accounts Receivable**

CLASS OF TRANSACTIONS	TRANSACTION-RELATED AUDIT OBJECTIVES	ACCOUNTS RECEIVABLE BALANCE-RELATED AUDIT OBJECTIVES: Detail tie-in	Existence	Completeness	Accuracy	Classification	Cutoff	Realizable value	Rights
Sales	Occurrence		X						
	Completeness			X					
	Accuracy				X				
	Posting and summarization	X							
	Classification					X			
	Timing						X		
Cash receipts	Occurrence			X					
	Completeness		X						
	Accuracy				X				
	Posting and summarization	X							
	Classification					X			
	Timing						X		

Design and Perform Tests of Controls and Substantive Tests of Transactions (Phase II)

Chapters 14 and 15 covered designing audit procedures for tests of controls and substantive tests of transactions, deciding sample size, and evaluating the results of those tests. The results of the tests of controls determine whether assessed control risk for sales and cash receipts needs to be revised. Auditors use the results of the substantive tests of transactions to determine the extent to which planned detection risk is satisfied for each accounts receivable balance-related audit objective. The evidence planning worksheet in Figure 16-7 shows three rows for control risk and two for substantive tests of transactions, one for sales, and the other for cash receipts.

Design and Perform Analytical Procedures (Phase III)

OBJECTIVE 16-2

Design and perform analytical procedures for accounts in the sales and collection cycle.

As discussed in Chapter 8, analytical procedures are often done during three phases of the audit: during planning, when performing detailed tests, and as a part of completing the audit. This chapter covers planning analytical procedures and substantive analytical procedures done when performing detailed tests for accounts in the sales and collection cycle.

Most analytical procedures performed during the detailed testing phase are done after the balance sheet date but before tests of details of balances. It makes little sense to perform extensive analytical procedures before the client has recorded all transactions for the year and finalized the financial statements.

Auditors perform analytical procedures for the entire sales and collection cycle, not just accounts receivable. This is necessary because of the close relationship between income statement and balance sheet accounts. If the auditor identifies a possible misstatement in sales or sales returns and allowances using analytical procedures, accounts receivable will likely be the offsetting misstatement.

Table 16-1 presents examples of ratios and comparisons for the sales and collection cycle and potential misstatements that analytical procedures may uncover. Although Table 16-1 focuses on the comparison of current year results with previous years, auditors also consider current year results compared to budgets and industry trends. Observe in the "possible misstatement" column how both balance sheet and income statement accounts are affected. For example, when the auditor performs analytical procedures for sales, evidence is being obtained about both sales and accounts receivable.

In addition to the analytical procedures in Table 16-1, auditors should also review accounts receivable for large and unusual amounts, such as large balances, accounts that have been outstanding for a long time, receivables from affiliated companies, officers, directors, and other related parties, and credit balances. To identify these amounts, the auditor should review the listing of accounts (aged trial balance) at the balance sheet date to determine which accounts should be investigated further.

To illustrate the use of analytical procedures during the detailed testing phase, Table 16-2 presents comparative trial balance information for the sales and collection cycle information for Hillsburg Hardware Co. Building on that information, Table 16-3 demonstrates several substantive analytical procedures. The only potential misstatement indicated in these two tables is in the allowance for uncollectible accounts. This is indicated by the ratio of the allowance to accounts receivable, as explained at the bottom of Table 16-3.

TABLE 16-1 Analytical Procedures for the Sales and Collection Cycle

Analytical Procedure	Possible Misstatement
Compare gross margin percentage with previous years (by product line).	Overstatement or understatement of sales and accounts receivable.
Compare sales by month (by product line) over time.	Overstatement or understatement of sales and accounts receivable.
Compare sales returns and allowances as a percentage of gross sales with previous years (by product line).	Overstatement or understatement of sales returns and allowances and accounts receivable.
Compare individual customer balances over a stated amount with previous years.	Misstatements in accounts receivable and related income statement accounts.
Compare bad debt expense as a percentage of gross sales with previous years.	Uncollectible accounts receivable that have not been provided for.
Compare number of days that accounts receivable are outstanding with previous years and related turnover of accounts receivable.	Overstatement or understatement of allowance for uncollectible accounts and bad debt expense; also may indicate fictitious accounts receivable.
Compare aging categories as a percentage of accounts receivable with previous years.	Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.
Compare allowance for uncollectible accounts as a percentage of accounts receivable with previous years.	Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.
Compare write-off of uncollectible accounts as a percentage of total accounts receivable with previous years.	Overstatement or understatement of allowance for uncollectible accounts and bad debt expense.

TABLE 16-2	**Comparative Information for Hillsburg Hardware Co.—Sales and Collection Cycle**				
	Amount				
	12-31-13 (in Thousands)	**Percent Change 2012–2013**	**12-31-12 (in Thousands)**	**Percent Change 2011–2012**	**12-31-11 (in Thousands)**
Sales	$144,328	9.0%	$132,421	7.0%	$123,737
Sales returns and allowances	1,242	3.9	1,195	13.6	1,052
Gross margin	39,845	9.6	36,350	7.0	33,961
Accounts receivable	20,197	15.3	17,521	3.3	16,961
Allowance for uncollectible accounts	1,240	(5.4)	1,311	21.5	1,079
Bad debt expense	3,323	(2.1)	3,394	7.3	3,162
Total current assets	51,027	2.3	49,895	1.5	49,157
Total assets	61,367	0.9	60,791	1.8	59,696
Net earnings before taxes	5,681	21.9	4,659	39.0	3,351
Number of accounts receivable	258	16.7	221	5.7	209
Number of accounts receivable with balances over $100,000	37	15.6	32	6.7	30

The auditor's conclusions about substantive analytical procedures for the sales and collection cycle are incorporated in the evidence planning worksheet in Figure 16-7 (p. 557) in the third row from the bottom. Because analytical procedures are substantive tests, they reduce the extent to which the auditor needs to perform detailed tests of balances, if the analytical procedure results are favorable.

When analytical procedures in the sales and collection cycle uncover unusual fluctuations, however, the auditor should make additional inquiries of management. Management's responses should be critically evaluated to determine whether they adequately explain the unusual fluctuations and whether they are supported by corroborating evidence.

TABLE 16-3	**Analytical Procedures for Hillsburg Hardware Co.—Sales and Collection Cycle**		
	12-31-13	**12-31-12**	**12-31-11**
Gross margin/net sales	27.85%	27.70%	27.68%
Sales returns and allowances/gross sales	0.9%	0.9%	0.9%
Bad debt expense/net sales	2.3%	2.6%	2.6%
Allowance for uncollectible accounts/accounts receivable	6.1%	7.5%	6.4%
Number of days receivables outstanding*	48.09	47.96	49.32
Net accounts receivable/total current assets	37.2%	32.5%	32.3%

*Based on year-end accounts receivable only.

Comment: Allowance as a percentage of accounts receivable has declined from 6.4% to 6.1%. Number of days receivables outstanding and economic conditions do not justify this change. Potential misstatement is approximately $60,000 ($20,197,000 x [.064 – .061]).

Design and Perform Tests of Details of Accounts Receivable Balance (Phase III)

The appropriate tests of details of balances depend on the factors listed in the evidence planning worksheet in Figure 16-7 (p. 557). Planned detection risk for each accounts receivable balance-related audit objective is shown in the second row from the bottom. It is a subjective decision made by auditors after they have combined the conclusions reached about each of the factors listed above that row.

The task of combining the factors that determine planned detection risk is complex because the measurement for each factor is imprecise and the appropriate weight given to each factor is highly subjective. Conversely, the relationship between each factor and planned detection risk is well established. For example, auditors know that a high inherent risk or control risk decreases planned detection risk and increases planned substantive tests, whereas good results of substantive tests of transactions increase planned detection risk and decrease other planned substantive tests.

The bottom row in Figure 16-7 shows the planned audit evidence for tests of details of balances for accounts receivable by objective. As we've discussed, planned audit evidence is the inverse of planned detection risk. After deciding whether planned audit evidence for a given objective is high, medium, or low, the auditor must then decide on the appropriate audit procedures, sample size, items to select, and timing.

For the remainder of this chapter, we will discuss how auditors decide on the specific audit procedures and their timing for auditing accounts receivable. In Chapter 17, we'll address sample size and selecting items from the population for testing.

DESIGNING TESTS OF DETAILS OF BALANCES

OBJECTIVE 16-3

Design and perform tests of details of balances for accounts receivable.

Even though auditors emphasize balance sheet accounts in tests of details of balances, they are not ignoring income statement accounts because the income statement accounts are tested as a by-product of the balance sheet tests. For example, if the auditor confirms accounts receivable balances and finds overstatements caused by mistakes in billing customers, then both accounts receivable and sales are overstated.

Confirmation of accounts receivable is the most important test of details of accounts receivable. We will discuss confirmation briefly as we study the appropriate tests for each of the balance-related audit objectives. We'll examine it in more detail later in this chapter.

For our discussion of tests of details of balances for accounts receivable, we will focus on balance-related audit objectives. We will also assume two things:

1. Auditors have completed an evidence planning worksheet similar to the one in Figure 16-7.
2. They have decided planned detection risk for tests of details for each balance-related audit objective.

The audit procedures selected and their sample size will depend heavily on whether planned evidence for a given objective is low, medium, or high.

Accounts Receivable Are Correctly Added and Agree with the Master File and the General Ledger

Most tests of accounts receivable and the allowance for uncollectible accounts are based on the aged trial balance. An **aged trial balance** lists the balances in the accounts receivable master file at the balance sheet date, including individual customer balances outstanding and a breakdown of each balance by the time passed between the date of sale and the balance sheet date. Figure 16-3 illustrates a typical aged trial balance, based on the Hillsburg Hardware example. Notice that the total is the same as accounts receivable on the general ledger trial balance on page 170.

Ordinarily, auditors test the information on the aged trial balance for detail tie-in before any other tests to verify that the population being tested agrees with the general ledger and accounts receivable master file. The total column and the columns depicting the aging must be test footed and the total on the trial balance compared with the general ledger. In addition, auditors should trace a sample of individual balances to supporting documents such as duplicate sales invoices to verify the customer's name,

FIGURE 16-3 **Aged Trial Balance for Hillsburg Hardware Co.**

PBC

Hillsburg Hardware Co.
Accounts Receivable
Aged Trial Balance
12/31/13

Schedule
Prepared by Client
Approved by

Date
1/5/14

			Aging, Based on Invoice Date				
Account Number	**Customer**	**Balance 12/31/13**	**0–30 days**	**31–60 days**	**61–90 days**	**91–120 days**	**over 120 days**
01011	Adams Supply	146,589	90,220	56,369			
01044	Argonaut, Inc.	30,842	30,842				
01100	Atwater Brothers	210,389	210,389				
01191	Beekman Bearings	83,526	73,526		10,000		
01270	Brown and Phillips	60,000				60,000	
01301	Christopher Plumbing	15,789					15,789
09733	Travelers Equipment	59,576	59,576				
09742	Underhill Parts and Maintenance	179,263	179,263				
09810	UJW Co.	102,211	34,911	34,700	32,600		
09907	Zephyr Plastics	286,300	186,000	100,300			
		$20,196,800	$14,217,156	$2,869,366	$1,408,642	$1,038,926	$662,710

balance, and proper aging. The extent of the testing for detail tie-in depends on the number of accounts involved, the degree to which the master file has been tested as a part of tests of controls and substantive tests of transactions, and the extent to which the schedule has been verified by an internal auditor or other independent person before it is given to the auditor. Auditors often use audit software to foot and cross-foot the aged trial balance and to recalculate the aging.

Recorded Accounts Receivable Exist

Confirmation of customers' balances is the most important test of details of balances for determining the existence of recorded accounts receivable. When customers do not respond to confirmations, auditors also examine supporting documents to verify the shipment of goods and evidence of subsequent cash receipts to determine whether the accounts were collected. Normally, auditors do not examine shipping documents or evidence of subsequent cash receipts for any account in the sample that is confirmed, but they may use these documents extensively as alternative evidence for nonresponses.

Existing Accounts Receivable Are Included

It is difficult for auditors to test for account balances omitted from the aged trial balance except by relying on the self-balancing nature of the accounts receivable master file. For example, if the client accidentally excluded an account receivable from the trial balance, the only likely way it will be discovered is for the auditor to foot the accounts receivable trial balance and reconcile the balance with the control account in the general ledger.

If all sales to a customer are omitted from the sales journal, the understatement of accounts receivable is almost impossible to uncover by tests of details of balances. For example, auditors rarely send accounts receivable confirmations to customers with zero balances, in part because research shows that customers are unlikely to respond to requests that indicate their balances are understated. In addition, unrecorded sales to a new customer are difficult to identify for confirmation because that customer is not included in the accounts receivable master file. The understatement of sales and accounts receivable is best uncovered by substantive tests of transactions for shipments made but not recorded (completeness objective for tests of sales transactions) and by analytical procedures.

Accounts Receivable Are Accurate

Confirmation of accounts selected from the trial balance is the most common test of details of balances for the accuracy of accounts receivable. When customers do not respond to confirmation requests, auditors examine supporting documents in the same way as described for the existence objective. Auditors perform tests of the debits and credits to individual customers' balances by examining supporting documentation for shipments and cash receipts.

Accounts Receivable Are Properly Classified

Normally, auditors can evaluate the classification of accounts receivable relatively easily, by reviewing the aged trial balance for material receivables from affiliates, officers, directors, or other related parties. Auditors should verify that notes receivable or accounts that should be classified as noncurrent assets are separated from regular accounts, and significant credit balances in accounts receivable are reclassified as accounts payable.

There is a close relationship between the classification balance-related objective and the related classification and understandability presentation and disclosure objective. To satisfy the classification balance-related audit objective, the auditor must determine whether the client has correctly separated different classifications of accounts receivable. For example, the auditor will determine whether receivables from related parties have been separated on the aged trial balance. To satisfy the objective for presentation and disclosure, the auditor must make sure that the classifications are properly presented by determining whether related party transactions are correctly shown in the financial statements during the completion phase of the audit.

Cutoff for Accounts Receivable Is Correct

Cutoff misstatements exist when current period transactions are recorded in the subsequent period or vice versa. The objective of cutoff tests, regardless of the type of transaction, is to verify whether transactions near the end of the accounting period are recorded in the proper period. The cutoff objective is one of the most important in the cycle because misstatements in cutoff can significantly affect current period income. For example, the intentional or unintentional inclusion of several large, subsequent period sales in the current period—or the exclusion of several current period sales returns and allowances—can materially overstate net earnings.

Cutoff misstatements can occur for *sales, sales returns and allowances*, and *cash receipts*. For each one, auditors require a threefold approach to determine the reasonableness of cutoff:

1. Decide on the appropriate *criteria for cutoff*.
2. Evaluate whether the client has established *adequate procedures* to ensure a reasonable cutoff.
3. *Test* whether the cutoff was correct.

Sales Cutoff Most merchandising and manufacturing clients record a sale based on *shipment of goods* criterion. However, some companies record invoices at the time title passes, which can occur before shipment (as in the case of custom-manufactured goods), at the time of shipment, or subsequent to shipment. For the correct measurement of current period income, the method must be in accordance with accounting standards and consistently applied.

The most important part of evaluating the client's method of obtaining a reliable cutoff is to determine the procedures in use. When a client issues prenumbered shipping documents sequentially, it is usually a simple matter to evaluate and test cutoff. Moreover, the segregation of duties between the shipping and the billing function also enhances the likelihood of recording transactions in the proper period. However, if shipments are made by company truck, if the shipping records are unnumbered, and if shipping and billing department personnel are not independent of each other, it may be difficult, if not impossible, to be assured of an accurate cutoff.

EARLY REVENUE RECOGNITION BOOSTS PROFITS

Faced with declining sales for its traditional product lines, Xerox prematurely recognized revenues to meet market expectations, according to charges filed by the SEC. The SEC stated that Xerox accelerated the recognition of equipment revenue to increase revenues by over $3 billion and pre-tax earnings by approximately $1.5 billion over the period 1997 through 2000. The early revenue recognition and other actions to increase earnings were significant, representing 37 percent of reported pre-tax earnings for the fourth quarters of 1997 and 1998. Without these actions to increase earnings, the SEC charged that Xerox would have fallen short of market earnings expectations for almost every reporting period from 1997 through 1999.

A primary issue was how Xerox accounted for lease revenue. The revenue in Xerox's leasing arrangements represented three components: the value of the equipment, servicing over the life of the lease, and financing. The revenue from the equipment was recorded at the beginning of the lease, but revenues from servicing and financing were recognized over the life of the lease contract. According to the SEC complaint, Xerox took a number of actions to shift servicing and financing revenue to the value of the equipment, so that more of the revenue could be recognized immediately.

The SEC alleged that these actions were set by the "tone at the top" and ordered six senior executives to pay over $22 million in penalties and disgorgement of profits from their actions. Without admitting or denying the allegations made in the SEC complaint, Xerox agreed to pay a $10 million fine, at that time the largest ever for a public company.

Sources: 1. Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 1542 (April 11, 2002); 2. Securities and Exchange Commission Press Release 2003-70 (June 5, 2003) (www.sec.gov).

When the client's internal controls are adequate, auditors can usually verify the cutoff by obtaining the shipping document number for the last shipment made at the end of the period and comparing this number with current and subsequent period recorded sales. As an illustration, assume the shipping document number for the last shipment in the current period is 1489. All recorded sales before the end of the period should bear a shipping document number preceding number 1490, and no sales recorded and shipped in the subsequent period should have a bill of lading numbered 1489 or lower. An auditor can easily test this by comparing recorded sales with the related shipping documents for the last few days of the current period and the first few days of the subsequent period.

Sales Returns and Allowances Cutoff Accounting standards require that sales returns and allowances be *matched with related sales* if the amounts are material. For example, if current period shipments are returned in the subsequent period, the sales return should appear in the current period. (The returned goods should be treated as current period inventory.) For most companies, however, sales returns and allowances are recorded in the *accounting period in which they occur*, under the assumption of approximately equal, offsetting amounts at the beginning and end of each accounting period. This approach is acceptable as long as the amounts are not material. Some companies establish a reserve, similar to the allowance for uncollectible accounts, for the expected amount of returns in the subsequent period.

When the auditor is confident that the client records all sales returns and allowances promptly, the cutoff tests are simple and straightforward. The auditor can examine supporting documentation for a sample of sales returns and allowances recorded during several weeks subsequent to the closing date to determine the date of the original sale. If auditors discover that the amounts recorded in the subsequent period are significantly different from unrecorded returns and allowances at the beginning of the period under audit, they must consider an adjustment. For example, a company may experience an increase in sales returns when it launches a new product. In addition, if the internal controls for recording sales returns and allowances are evaluated as ineffective, a larger sample is needed to verify cutoff.

Cash Receipts Cutoff For most audits, a proper cash receipts cutoff is *less important* than either the sales or the sales returns and allowances cutoff because the improper cutoff of cash affects only the cash and the accounts receivable balances, not earnings. Nevertheless, if the misstatement is material, it can affect the fair presentation of these accounts, especially when cash is a small or negative balance.

It is easy to test for a cash receipts cutoff misstatement (often called *holding the cash receipts book open*) by tracing recorded cash receipts to subsequent period bank deposits on the bank statement. If a delay of several days exists, that could indicate a cutoff misstatement.

To some degree, auditors may also rely on the confirmation of accounts receivable to uncover cutoff misstatements for sales, sales returns and allowances, and cash receipts. However, it is often difficult to distinguish a cutoff misstatement from a normal **timing difference** due to shipments and payments in transit at year end. For example, if a customer mails and records a check to a client for payment of an unpaid account on December 30 and the client receives and records the amount on January 2, the records of the two organizations will be different on December 31. This is not a cutoff misstatement, but a timing difference due to the delivery time. It may be difficult for the auditor to evaluate whether a cutoff misstatement or a timing difference occurred when a confirmation reply is the source of information. This type of situation requires additional investigation, such as inspection of supporting documents.

Accounts Receivable Is Stated at Realizable Value

Accounting standards require that companies state accounts receivable at the amount that will ultimately be collected. The **realizable value of accounts receivable** equals gross accounts receivable less the *allowance for uncollectible accounts*. To calculate the allowance, the client estimates the total amount of accounts receivable that it expects to be uncollectible. Obviously, clients cannot predict the future precisely, but it is necessary for the auditor to evaluate whether the client's allowance is reasonable, considering all available facts. To assist with this evaluation, the auditor often prepares an audit schedule that analyzes the allowance for uncollectible accounts, as illustrated in Figure 16-4. In this example, the analysis indicates that the allowance is understated. This can be the result of the client failing to adjust the allowance or economic factors. Note that the potential understatement of the reserve was signaled by the analytical procedures in Table 16-3 (p. 543) for Hillsburg Hardware.

To begin the evaluation of the allowance for uncollectible accounts, the auditor reviews the results of the tests of controls that are concerned with the client's credit policy. If the client's credit policy has remained unchanged and the results of the tests of credit policy and credit approval are consistent with those of the preceding year, the change in the balance in the allowance for uncollectible accounts should reflect only changes in economic conditions and sales volume. However, if the client's credit policy or the degree to which it correctly functions has significantly changed, auditors must take great care to consider the effects of these changes as well.

Auditors often evaluate the adequacy of the allowance by carefully examining the noncurrent accounts on the aged trial balance to determine which ones have not been paid subsequent to the balance sheet date. The size and age of unpaid balances can then be compared with similar information from previous years to evaluate whether the amount of noncurrent receivables is increasing or decreasing over time. Auditors also gain insights into the collectibility of the accounts by examining credit files, discussions with the credit manager, and review of the client's correspondence file. These procedures are especially important if a few large balances are noncurrent and are not being paid on a regular basis.

Auditors face two shortcomings in evaluating the allowance by reviewing individual noncurrent balances on the aged trial balance. First, the current accounts are ignored in establishing the adequacy of the allowance, even though some of these amounts will undoubtedly become uncollectible. Second, it is difficult to compare the results of the current year with those of previous years on such an unstructured basis.

FIGURE 16-4 **Analysis of Allowance for Uncollectible Accounts for Hillsburg Hardware Co.**

Hillsburg Hardware Co.
Analysis of Allowance for Uncollectible Accounts
12/31/13

Schedule	**B-4**	**Date**	
Prepared by	**TW**	**1/8/14**	
Approved by	**SB**	**1/10/14**	

A/R Category	A/R Balance 12/31/13	Estimated Allowance Percentage	Estimated Required Allowance	
0–30 days	$ 14,217,156 ✓	3% ×	$ 426,515	
31–60 days	2,869,366 ✓	6% ×	172,162	
61–90 days	1,408,642 ✓	15% ×	211,296	
91–120 days	1,038,926 ✓	25% ×	259,732	
Over 120	662,710 ✓	40% ×	265,084	
Total	$20,196,800		$1,334,789	
Recorded Allowance			$1,240,000	TB
Difference			$ 94,789	

✓ – Traced to aged accounts receivable trial balance.
× – Allowance percentages are consistent with prior year and appear reasonable based on historical loss percentages documented in permanent file.
TB – Agreed to trial balance.

Conclusion: Recorded allowance appears understated based on aging analysis. Approximate amount of $95,000 not considered material. Include on Summary of Possible Misstatements schedule on A-3. (See Figure 24-6 on page 788.)

If the accounts are becoming progressively uncollectible over several years, this fact can be overlooked. To avoid these two shortcomings, clients can establish a history of bad debt write-offs over a period of time as a frame of reference for evaluating the current year's allowance. For example, a client might calculate that 2 percent of current accounts, 10 percent of 30- to 90-day accounts, and 35 percent of all balances over 90 days ultimately become uncollectible. Auditors can apply these percentages to the current year's aged trial balance totals and compare the result with the balance in the allowance account. Of course, the auditor has to verify the appropriateness of the percentages used and be careful to modify the calculations for changed conditions.

Bad Debt Expense After the auditor is satisfied with the allowance for uncollectible accounts, it is easy to verify bad debt expense. Assume that:

- The beginning balance in the allowance account was verified as a part of the previous audit.
- The uncollectible accounts written off were verified as a part of the substantive tests of transactions.
- The ending balance in the allowance account has been verified by various means.

Bad debt expense is then simply a residual balance that can be verified by recalculation.

The Client Has Rights to Accounts Receivable

The client's rights to accounts receivable ordinarily cause no audit problems because the receivables usually belong to the client. In some cases, however, a portion of the receivables may have been pledged as collateral, assigned to someone else, factored, or sold at discount. Normally, the client's customers are not aware of the existence of such matters, so the confirmation of receivables will not bring them to light. To uncover instances in which the client has limited rights to receivables, the auditor may review the minutes, discuss with the client, confirm with banks, examine debt contracts for evidence of accounts receivable pledged as collateral, and examine correspondence files.

Accounts Receivable Presentation and Disclosure

Tests of the four presentation and disclosure-related audit objectives are generally done as part of the completion phase of the audit. However, some tests of presentation and disclosure are often done with tests to meet the balance-related audit objectives. For example, when testing sales and accounts receivable, the auditor must understand and evaluate the appropriateness of the client's revenue recognition policy to determine whether it is properly disclosed in the financial statements. The auditor must also decide whether the client has properly combined amounts and disclosed related party information in the statements. To evaluate the adequacy of the presentation and disclosure, the auditor must have a thorough understanding of accounting standards and presentation and disclosure requirements.

An important part of the evaluation involves deciding whether the client has separated material amounts requiring separate disclosure in the statements. For example, receivables from officers and affiliated companies must be segregated from accounts receivable from customers if the amounts are material. Similarly, under SEC requirements, companies must disclose sales and assets for different business segments separately. The proper aggregation of general ledger balances in the financial statements also requires combining account balances that are not relevant for external users of the statements. If all accounts included in the general ledger were disclosed separately on the statements, most statement users would be more confused than enlightened.

CONFIRMATION OF ACCOUNTS RECEIVABLE

OBJECTIVE 16-4

Obtain and evaluate accounts receivable confirmations.

Confirmation of accounts receivable was a recurring concept in our discussion about designing tests of details of balances for accounts receivable. The primary purpose of accounts receivable confirmation is to satisfy the *existence*, *accuracy*, and *cutoff* objectives.

Confirmations are one of the eight types of audit evidence introduced in Chapter 7. A confirmation is a direct written response from a third party in paper or electronic form, and they are considered to be highly reliable evidence because they are received directly from third parties. Although an oral response provides audit evidence, it is not considered a confirmation.

Auditing Standards Requirements

U.S. auditing standards indicate that auditors should use external confirmations for material accounts receivable. Confirmation may not be appropriate in the following circumstances:

1. *The auditor considers confirmations ineffective evidence because response rates will likely be inadequate or unreliable.* In certain industries, such as hospitals, response rates to confirmations are very low.
2. *The combined level of inherent risk and control risk is low and other substantive evidence can be accumulated to provide sufficient evidence.* If a client has effective internal controls and low inherent risk for the sales and collection cycle, the auditor should often be able to satisfy the evidence requirements by tests of controls, substantive tests of transactions, and analytical procedures.

If the auditor decides not to confirm accounts receivable, the justification for doing so must be documented in the audit files. While U.S. auditing standards require the use of confirmations for accounts receivable in most circumstances, international auditing standards suggest but do not require their use. This is one of the few notable differences between requirements of U.S. and international audit standards. The PCAOB is also considering changes to its Auditing Standards that might expand the use of confirmations by potentially eliminating the exceptions noted above and by expanding the types of receivables that should be confirmed.

Types of Confirmation

In performing confirmation procedures, the auditor must first decide the type of confirmation to use.

Positive Confirmation A **positive confirmation** is a communication addressed to the debtor requesting the recipient to confirm directly whether the balance as stated on the confirmation request is correct or incorrect. Figure 16-5 (p. 552) illustrates a positive confirmation in the audit of Hillsburg Hardware Co. Notice that this confirmation is for one of the largest accounts on the aged trial balance in Figure 16-3 (p. 545).

A **blank confirmation form** is a type of positive confirmation that does not state the amount on the confirmation but requests the recipient to fill in the balance or furnish other information. Because blank forms require the recipient to determine the information requested, they are considered more reliable than confirmations that include balance information. Blank forms are rarely used in practice because they often result in lower response rates.

An **invoice confirmation** is another type of positive confirmation in which an individual invoice is confirmed, rather than the customer's entire accounts receivable balance. Many customers use voucher systems that allow them to confirm individual invoices but not balance information. As a result, the use of invoice confirmations may improve confirmation response rates. Invoice confirmations also result in fewer timing differences and other reconciling items than balance confirmations. However, invoice confirmations have the disadvantage of not directly confirming ending balances.

Sales to major customers often involve special terms or side-agreements for the return of goods that may affect the amount and timing of revenue to be recognized from the sale. When this has been identified as a significant risk, positive confirmations often request the customer to confirm the existence of any special terms or side-agreements between the client and customer. The vignette at the bottom of this page illustrates the importance of confirming transaction terms.

Negative Confirmation A **negative confirmation** is also addressed to the debtor but requests a response only when the debtor disagrees with the stated amount. Figure 16-6 (p. 553) illustrates a negative confirmation in the audit of Hillsburg Hardware Co. that has been attached to a customer's monthly statement.

REVENUES AND MARGINS TOO GOOD TO BE TRUE

Channel-stuffing is a form of aggressive revenue recognition that can sometimes cross the line to fraudulent reporting and which is often carried out by enticing or pressuring customers to accept additional products through pricing or other incentives. That was the case with Bristol-Myers Squibb and their largest pharmaceutical wholesalers such as D&K Healthcare Resources, Inc. Top executives at Bristol-Myers Squibb were found guilty of fraudulent channel-stuffing practices in which they encouraged wholesalers to accept inventory products above and beyond what they would normally purchase, by offering pricing discounts and by helping to cover inventory carrying costs, effectively making the sale a consignment arrangement. This practice overstated revenue by $2.5 billion over a three-year period.

The channel-stuffing and side agreements had a ripple effect on wholesalers by inflating their gross margins as a result of the "purchasing incentives." When Bristol-Myers was investigated by the SEC and forced to stop their channel-stuffing practices, both Bristol Myers and D&K restated previously-reported results and were named as defendants in class action lawsuits. Incidences of channel-stuffing like this illustrate why an auditor should consider confirming sales transaction terms, such as right of return or side agreements, in addition to the balance owed by the customer.

Sources: 1. SEC 2004-105. Bristol-Myers Squibb Company Agrees to Pay $150 Million to Settle Fraud Charges, August 4, 2004 (www.sec.gov); 2. Gary Dutton vs. D&K Healthcare Resources, Class Action Litigation Complaint (www.securities.stanford.edu).

FIGURE 16-5 **Positive Confirmation**

HILLSBURG HARDWARE CO.
Gary, Indiana

January 5, 2014

Atwater Brothers
19 South Main Street
Middleton, Ohio 36947

To Whom It May Concern:

In connection with an audit of our financial statements, please confirm directly to our auditors

BERGER & ANTHONY, CPAs
Gary, Indiana

the correctness of the balance of your account with us as of December 31, 2013, as shown below.

This is not a request for payment; please do not send your remittance to our auditors. Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

Erma Swanson

Erma Swanson, Controller

BERGER & ANTHONY, CPAs
Gary, Indiana

The balance receivable from us of $210,389 as of December 31, 2013, is correct except as noted below:

____
____
____
____

Date ____________ By ________________

A positive confirmation is *more reliable* evidence because the auditor can perform follow-up procedures if a response is not received from the debtor. With a negative confirmation, failure to reply must be regarded as a correct response, even though the debtor may have ignored the confirmation request.

Offsetting the reliability disadvantage, negative confirmations are less expensive to send than positive confirmations, and thus more can be distributed for the same total cost. Negative confirmations cost less because there are no second requests and no follow-up of nonresponses.

The determination of which type of confirmation to use is an auditor's decision, and it should be based on the facts in the audit. Auditing standards state that it is acceptable to use negative confirmations only when *all* of the following circumstances are present:

1. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate evidence regarding the design and operating effectiveness of controls relevant to the assertion being tested by the confirmation procedure.
2. The population of items subject to negative confirmation procedures is made up of a large number of small, homogenous account balances, transactions, or other items.
3. The auditor expects a low exception rate.

FIGURE 16-6 **Negative Confirmation**

AUDITOR'S ACCOUNT CONFIRMATION

Please examine this statement carefully. If it does NOT agree with your records, please report any exceptions directly to our auditors

BERGER & ANTHONY, CPAs
Gary, Indiana

who are conducting an audit of our financial statements as of December 31, 2013. An addressed envelope is enclosed for your convenience in replying.

Do not send your remittance to our auditors.

4. The auditor reasonably believes that recipients of negative confirmation requests will give the requests adequate consideration. For example, if the response rate to positive confirmations in prior years was extremely high or if there are high response rates on audits of similar clients, it is likely that recipients will give negative confirmations reasonable consideration as well.

Typically, when negative confirmations are used, the auditor puts considerable emphasis on the effectiveness of internal controls, substantive tests of transactions, and analytical procedures as evidence of the fairness of accounts receivable, and assumes that the large majority of the recipients will provide a conscientious reading and response to the confirmation request.

Negative confirmations are often used for audits of hospitals, retail stores, banks, and other industries in which the receivables are due from the general public. Auditors may use a combination of negative and positive confirmations by sending the latter to accounts with large balances and the former to those with small balances.

The auditor's choice of confirmation falls along a continuum, starting with the use of no confirmations in some circumstances, to using only negatives, to using both negatives and positives, to using only positives. The primary factors affecting the auditor's decision are the materiality of total accounts receivable, the number and size of individual accounts, control risk, inherent risk, the effectiveness of confirmations as audit evidence, and the availability of other audit evidence.

Timing

The most reliable evidence from confirmations is obtained when they are sent as close to the balance sheet date as possible. This permits the auditor to directly test the accounts receivable balance on the financial statements without making any inferences about the transactions taking place between the confirmation date and the balance sheet date. However, as a means of completing the audit on a timely basis, it is often necessary to confirm the accounts at an interim date. This is permissible if internal controls are adequate and can provide reasonable assurance that sales, cash receipts, and other credits are properly recorded between the date of the confirmation and the end of the accounting period. The auditor is likely to consider other factors in making the decision, including the materiality of accounts receivable and the auditor's exposure to lawsuits because of the possibility of client bankruptcy and similar risks.

If the decision is made to confirm accounts receivable before year-end, the auditor typically prepares a roll-forward schedule that reconciles the accounts receivable balance at the confirmation date to accounts receivable at the balance sheet date. In addition to performing analytical procedures on the activity during the intervening period, it may be necessary to test the transactions occurring between the confirmation date and the balance sheet date. The auditor can accomplish this by examining internal documents such as duplicate sales invoices, shipping documents, and evidence of cash receipts.

Sampling Decisions

Sample Size The major factors affecting sample size for confirming accounts receivable fall into several categories and include the following:

- Performance materiality
- Inherent risk (relative size of total accounts receivable, number of accounts, prior-year results, and expected misstatements)
- Control risk
- Achieved detection risk from other substantive tests (extent and results of substantive tests of transactions, analytical procedures, and other tests of details)
- Type of confirmation (negatives normally require a larger sample size)

Selection of the Items for Testing Some type of *stratification* is desirable with most confirmations. In a typical approach to stratification for selecting the balances for confirmation, an auditor considers both the dollar size of individual accounts and the length of time an account has been outstanding. In most audits, the emphasis should be on confirming larger and older balances because these are most likely to include a significant misstatement. But it is also important to sample some items from every material segment of the population. In many cases, the auditor selects all accounts above a certain dollar amount and selects a random sample from the remainder.

Management may refuse to allow the auditor to send confirmation requests to certain customers. The auditor must inquire about the reason for the client's request, which is often due to litigation or negotiations between the client and customer. The auditor should obtain evidence to evaluate the reasonableness of the client's request, and evaluate whether the request indicates a potential fraud risk or increased risk of material misstatement.

Verification of Addresses and Maintaining Control

The auditor should perform procedures to verify the addresses or email addresses used for confirmation. For example, auditors should consider performing additional procedures when the address is a post office box or when an email address is inconsistent with the customer's Web site address.

For confirmations sent by mail, the auditor must maintain control of the confirmations until they are returned from the customer. The client may assist with preparing the confirmations, but the auditor must be responsible for mailing the confirmation *outside* the client's office. A return address must be included on all envelopes to make sure that undelivered mail is received by the CPA firm. Similarly, self-addressed return envelopes accompanying the confirmations must be addressed for delivery to the CPA firm's office. These procedures are designed to ensure that responses will be received directly by the auditor.

Follow-Up on Nonresponses

It is inappropriate to regard confirmations mailed but not returned by customers as significant audit evidence. For example, nonresponses to positive confirmations do not provide audit evidence. Similarly, for negative confirmations, the auditor should not conclude that the recipient received the confirmation request and verified the information requested. Negative confirmations do, however, provide some evidence of the existence assertion.

When positive confirmations are used, auditing standards require follow-up procedures for confirmations not returned by the customer. It is common to send second and sometimes even third requests for confirmations. Even with these efforts, some customers do not return the confirmation, so it is necessary to follow up with **alternative procedures**. The objective of alternative procedures is to determine by a means other than confirmation whether the nonconfirmed account existed and was properly stated at the confirmation date. For any positive confirmation not returned, auditors can examine the following documentation to verify the existence and accuracy of individual sales transactions making up the ending balance in accounts receivable:

FALSE AUDIT CONFIRMATIONS HIDE FRAUD AT U.S. SUBSIDIARY

Confirmations are normally considered highly reliable evidence because they come from independent third parties. However, in some cases customers have colluded with audit clients and returned false audit confirmations. Such was the case at U.S. Foodservice, Inc., a U.S. subsidiary of Royal Ahold, a company headquartered in The Netherlands. The SEC complaints charged that U.S. Foodservice inflated promotional allowances from vendors by at least $700 million for fiscal years 2001 and 2002 in order to meet earnings targets. U.S. Foodservice personnel contacted vendors and pressured them to return false confirmation letters to the auditors. In two separate complaints, the SEC charged 16 individuals who were employees of or agents for vendors that supplied U.S. Foodservice.

Sources: 1. Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 2341, November 2, 2005 (www.sec.gov/litigation); 2. Securities and Exchange Commission Accounting and Auditing Enforcement Release No. 2167, January 13, 2005 (www.sec.gov/litigation).

Subsequent Cash Receipts Evidence of the receipt of cash subsequent to the confirmation date includes examining remittance advices, entries in the cash receipts records, or perhaps even subsequent credits in the accounts receivable master file. On the one hand, the examination of evidence of subsequent cash receipts is a highly useful alternative procedure because it is reasonable to assume that a customer would not have made a payment unless it was an existing receivable. On the other hand, payment does not establish whether an obligation existed on the date of the confirmation. In addition, auditors should take care to match each unpaid sales transaction with evidence of its subsequent payment as a test for disputes or disagreements over individual outstanding invoices.

Duplicate Sales Invoices These are useful in verifying the actual issuance of a sales invoice and the actual date of the billing.

Shipping Documents These are important in establishing whether the shipment was actually made and as a test of cutoff.

Correspondence with the Client Usually, the auditor does not need to review correspondence as a part of alternative procedures, but correspondence can be used to disclose disputed and questionable receivables not uncovered by other means.

The extent and nature of the alternative procedures depend primarily on the materiality of the nonresponses, the types of misstatements discovered in the confirmed responses, the subsequent cash receipts from the nonresponses, and the auditor's conclusions about internal control.

It is normally desirable to account for all unconfirmed balances with alternative procedures even if the amounts are small, as a means of properly generalizing from the sample to the population. Another acceptable approach is to assume that nonresponses are 100 percent overstatement amounts.

Analysis of Differences

When the confirmation requests are returned by the customer, the auditor must determine the reason for any reported differences. In many cases, they are caused by timing differences between the client's and the customer's records. It is important to distinguish between timing differences and *exceptions*, which represent misstatements of the accounts receivable balance. The most commonly reported types of differences in confirmations include:

Payment Has Already Been Made Reported differences typically arise when the customer has made a payment before the confirmation date, but the client has not received the payment in time for recording before the confirmation date. Such instances should be carefully investigated to determine the possibility of a cash receipts cutoff misstatement, lapping, or a theft of cash.

Goods Have Not Been Received These differences typically result because the client records the sale at the date of shipment and the customer records the acquisition when the goods are received. The time that the goods are in transit is often the cause of differences reported on confirmations. These should be investigated to determine the possibility of the customer not receiving the goods at all or the existence of a cutoff misstatement on the client's records.

The Goods Have Been Returned The client's failure to record a credit memo could have resulted from timing differences or the improper recording of sales returns and allowances. Like other differences, these must be investigated.

Clerical Errors and Disputed Amounts The most likely types of reported differences in a client's records are when the customer states that there is an error in the price charged for the goods, the goods are damaged, the proper quantity of goods was not received, and so forth. These differences must be investigated to determine whether the client is in error and the amount of the error.

In most instances, the auditor will ask the client to reconcile the difference and, if necessary, will communicate with the customer to resolve any disagreements. Naturally, the auditor must carefully verify the client's conclusions on each significant difference.

Drawing Conclusions

When all differences have been resolved, including those discovered in performing alternative procedures, the auditor must *reevaluate internal control*. Each client misstatement must be analyzed to determine whether it was consistent or inconsistent with the original assessed level of control risk. If a significant number of misstatements occurred that are inconsistent with the assessment of control risk, it is necessary to revise the assessment and consider the effect of the revision on the audit. Auditors of public companies must also consider implications for the audit of internal control over financial reporting.

It is also necessary to generalize from the sample to the entire population of accounts receivable. Even though the sum of the misstatements in the sample may not significantly affect the financial statements, the auditor must consider whether the population is likely to be materially misstated. Generalizing from the sample to the population can be done using nonstatistical or statistical sampling techniques and is discussed in Chapter 17.

The auditor should always evaluate the qualitative nature of the misstatements found in the sample, regardless of the dollar amount of the estimated population misstatement. Even if the estimated misstatement is less than performance materiality for accounts receivable, the misstatements found in a sample can be symptomatic of a more serious problem.

The final decision about accounts receivable and sales is whether sufficient appropriate evidence has been obtained through tests of controls and substantive tests of transactions, analytical procedures, cutoff procedures, confirmation, and other substantive tests to justify drawing conclusions about the correctness of the stated balance.

DEVELOPING TESTS OF DETAILS AUDIT PROGRAM

OBJECTIVE 16-5

Design audit procedures for the audit of accounts receivable, using an evidence planning worksheet as a guide.

We use Hillsburg Hardware Co. to illustrate the development of audit program procedures for tests of details in the sales and collection cycle, which serves as the summary of this chapter. The determination of these procedures is based on the tests of controls and substantive tests of transactions, as illustrated in Chapters 14 and 15, and the analytical procedures described earlier in this chapter.

Fran Moore, the audit senior, prepared the evidence-planning worksheet in Figure 16-7 as an aid to help her decide the extent of planned tests of details of balances. The source of each of the rows is as follows:

- *Performance materiality.* The preliminary judgment of materiality for the financial statements as a whole was set at $442,000 (approximately 6 percent of

FIGURE 16-7 **Evidence-Planning Worksheet to Decide Tests of Details of Balances for Hillsburg Hardware Co.—Accounts Receivable**

	Detail tie-in	Existence	Completeness	Accuracy	Classification	Cutoff	Realizable value	Rights
Acceptable audit risk	Medium	Medium	Medium	Medium	Medium	Medium	Medium	Medium
Inherent risk	Low	Medium	Low	Low	Low	Medium	Medium	Low
Control risk—Sales	Low	Medium	Low	High	Low	Medium	High	Not applicable
Control risk—Cash receipts	Low	Medium	Low	Low	Low	Low	Not applicable	Not applicable
Control risk—Additional controls	None	None	None	None	None	None	None	Low
Substantive tests of transactions—Sales	Good results	Good results	Good results	Fair results	Good results	Unacceptable results	Not applicable	Not applicable
Substantive tests of transactions—Cash receipts	Good results	Good results	Good results	Good results	Good results	Good results	Not applicable	Not applicable
Analytical procedures	Good results	Good results	Good results	Good results	Good results	Good results	Unacceptable results	Not applicable
Planned detection risk for tests of details of balances	High	Medium	High	Medium	High	Low	Low	High
Planned audit evidence for tests of details of balances	Low	Medium	Low	Medium	Low	High	High	Low

Performance materiality $265,000

earnings from operations of $7,370,000). She allocated $265,000 as performance materiality to the audit of accounts receivable (see page 273).

- *Acceptable audit risk.* Fran assessed acceptable audit risk as medium because the company is publicly traded, but is in good financial condition, and has high management integrity. Although Hillsburg is a publicly traded company, its stock is not widely held or extensively followed by financial analysts.
- *Inherent risk.* Fran assessed inherent risk as medium for existence and cutoff because of concerns over revenue recognition identified in auditing standards. Fran also assessed inherent risk as medium for realizable value. In past years, the client made audit adjustments to the allowance for uncollectible accounts

TABLE 16-4 **Balance-Related Audit Objectives and Audit Program for Hillsburg Hardware Co.—Sales and Collection Cycle (Design Format)**

Balance-Related Audit Objective	Audit Procedures
Accounts receivable in the aged trial balance agree with related master file amounts, and the total is correctly added and agrees with the general ledger (detail tie-in).	Obtain the accounts receivable aged trial balance and trace the balance to the general ledger (1). Use audit software to foot and cross-foot the aged trial balance (2). Trace 10 accounts from the trial balance to accounts on master file (8).
The accounts receivable on the aged trial balance exist (existence).	Confirm accounts receivable, using positive confirmations. Confirm all amounts over $100,000 and a statistical sample of the remainder (10). Perform alternative procedures for all confirmations not returned on the first or second request (11). Review accounts receivable trial balance for large and unusual receivables (3).
Existing accounts receivable are included in the aged trial balance (completeness).	Trace five accounts from the accounts receivable master file to the aged trial balance (9).
Accounts receivable in the trial balance are accurate (accuracy).	Confirm accounts receivable, using positive confirmations. Confirm all amounts over $100,000 and a statistical sample of the remainder (10). Perform alternative procedures for all confirmations not returned on the first or second request (11). Review accounts receivable trial balance for large and unusual receivables (3).
Accounts receivable on the aged trial balance are correctly classified (classification).	Review the receivables listed on the aged trial balance for notes and related party receivables (5). Inquire of management whether there are any related party notes or long-term receivables included in the trial balance (6).
Transactions in the sales and collection cycle are recorded in the proper period (cutoff).	Select the last 20 sales transactions from the current year's sales journal and the first 20 from the subsequent year's and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording (14). Review large sales returns and allowances before and after the balance sheet date to determine whether they are recorded in the correct period (15).
Accounts receivable is stated at realizable value (realizable value).	Trace 10 accounts from the aged trial balance to the accounts receivable master file to test for correctness of aging and the balance (8). Use audit software to foot and cross-foot the aged trial balance (2). Discuss with the credit manager the likelihood of collecting older accounts. Examine subsequent cash receipts and the credit file on all accounts over 90 days and evaluate whether the receivables are collectible (12). Evaluate whether the allowance is adequate after performing other audit procedures for collectibility of receivables (13).
The client has rights to accounts receivable on the trial balance (rights).	Review the minutes of the board of directors meetings for any indication of pledged or factored accounts receivable (7). Inquire of management whether any receivables are pledged or factored (7).

Note: The procedures are summarized into a performance format in Table 16-5 on page 559. The numbers in parentheses after the procedures refer to Table 16-5.

because it was found to be understated. Inherent risk was assessed as low for all other objectives.

- *Control risk.* Control risk assessments for each audit objective are the same as those in Figure 15-6 on page 516. (Recall that results of tests of controls and substantive tests of transactions in Chapter 15 were consistent with the

TABLE 16-5	Test of Details of Balances Audit Program for Hillsburg Hardware Co.—Sales and Collection Cycle (Performance Format)
1.	Obtain the accounts receivable aged trial balance and trace the balance to the general ledger.
2.	Use audit software to foot and cross-foot the aged trial balance.
3.	Review aged trial balance for large and unusual receivables.
4.	Calculate analytical procedures indicated in carry-forward audit schedules (not included) and follow up on any significant changes from prior years.
5.	Review the receivables listed on the aged trial balance for notes and related party receivables.
6.	Inquire of management whether there are any related party, notes, or long-term receivables included in the trial balance.
7.	Review the minutes of the board of directors meetings and inquire of management to determine whether any receivables are pledged or factored.
8.	Trace 10 accounts from the aged trial balance to the accounts receivable master file to test for correctness of aging and the balance.
9.	Trace five accounts from the accounts receivable master file to the aged trial balance.
10.	Confirm accounts receivable, using positive confirmations. Confirm all amounts over $100,000 and select a statistical sample using audit software for the remaining accounts.
11.	Perform alternative procedures for all confirmations not returned on the first or second request.
12.	Discuss with the credit manager the likelihood of collecting older accounts. Examine subsequent cash receipts and the credit file on all larger accounts over 90 days and evaluate whether the receivables are collected.
13.	Evaluate whether the allowance is adequate after performing other audit procedures for collectability of receivables.
14.	Select the last 20 sales transactions from the current year's sales journal and the first 20 from the subsequent year's and trace each to the related shipping documents, checking for the date of actual shipment and the correct recording.
15.	Review large sales returns and allowances before and after the balance sheet date to determine whether they are recorded in the correct period.

auditor's initial control risk assessments, except for the accuracy and realizable value objectives for sales.)

- *Substantive tests of transactions results.* These results were also taken from Figure 15-6. (Recall from Chapter 15 that all results were acceptable except for the accuracy and cutoff objectives for sales.)
- *Analytical procedures.* See Tables 16-2 and 16-3 (both on page 543).
- *Planned detection risk and planned audit evidence.* These two rows are decided for each objective based on the conclusions in the other rows.

Table 16-4 shows the tests of details audit program for accounts receivable, by objective, and for the allowance for uncollectible accounts. The audit program reflects the conclusions for planned audit evidence on the evidence-planning worksheet in Figure 16-7 (p. 557).

Table 16-5 shows the audit program in a performance format. The audit procedures are identical to those in Table 16-4 except for procedure 4, which is an analytical procedure. The numbers in parentheses are a cross reference between the two tables.

ESSENTIAL TERMS

Accounts receivable balance-related audit objectives—the eight specific audit objectives used by the auditor to decide the appropriate audit evidence for accounts receivable

Aged trial balance—a listing of the balances in the accounts receivable master file at the balance sheet date broken down according to the amount of time passed between the date of sale and the balance sheet date

Alternative procedures—the follow-up of a positive confirmation not returned by the debtor with the use of documentation evidence to determine whether the recorded receivable exists

Blank confirmation form—a letter, addressed to the debtor, requesting the recipient to fill in the amount of the accounts receivable balance; it is considered a positive confirmation

Cutoff misstatements—misstatements that take place as a result of current period transactions being recorded in a subsequent period, or subsequent period transactions being recorded in the current period

Invoice confirmation—a type of positive confirmation in which an individual invoice is confirmed, rather than the customer's entire accounts receivable balance

Negative confirmation—a letter, addressed to the debtor, requesting a response only if the recipient disagrees with the amount of the stated account balance

Positive confirmation—a letter, addressed to the debtor, requesting that the recipient indicate directly on the letter whether the stated account balance is correct or incorrect and, if incorrect, by what amount

Realizable value of accounts receivable—the amount of the outstanding balances in accounts receivable that will ultimately be collected

Timing difference—a reported difference in a confirmation from a debtor that is determined to be a timing difference between the client's and debtor's records and therefore not a misstatement

REVIEW QUESTIONS

16-1 (Objective 16-1) Distinguish among tests of details of balances, tests of controls, and substantive tests of transactions for the sales and collection cycle. Explain how the tests of controls and substantive tests of transactions affect the tests of details of balances.

16-2 (Objective 16-1) Sharizat is a new audit trainee at Khairy Chartered Accountants. She was asked to perform the following tests by her supervisor. The accounts supervisor at the company's client, Lau Ah Pek Berhad, uses Microsoft Excel worksheets to prepare the accounts. Lau Ah Pek Berhad is not willing to invest in accounting software. You are the audit supervisor. Explain to Sharizat why she is doing the following tasks:

a. Cast the balances to the Accounts Receivables subledger and compare the total with the general ledger.
b. Randomly select any invoice and trace it to the Accounts Receivable ledger.
c. Trace transactions in the Accounts Receivable subledger to stock records.
d. Check the casting in the Accounts Receivable Control account.
e. Check to see whether invoices issued after the cut-off date are in the customer's accounts at the year-end date.

16-3 (Objective 16-2) List five analytical procedures for the sales and collection cycle. For each test, describe a misstatement that could be identified.

16-4 (Objective 16-3) Your client, Amah.com, organizes a special year end sale, from Boxing Day to New Year's Day every year. Explain why is it important to separate the proceeds of the sales on New Year's Eve prior from the sales on New Year's Day.

16-5 (Objective 16-3) Identify the eight accounts receivable balance-related audit objectives. For each objective, list one audit procedure.

16-6 (Objective 16-3) Which of the eight accounts receivable balance-related audit objectives can be partially satisfied by confirmations with customers?

16-7 (Objective 16-3) State the purpose of footing the total column in the client's accounts receivable trial balance, tracing individual customer names and amounts to the accounts receivable master file, and tracing the total to the general ledger. Is it necessary to trace each amount to the master file? Why?

16-8 (Objective 16-3) Distinguish between accuracy tests of gross accounts receivable and tests of the realizable value of receivables.

16-9 (Objective 16-4) The customer of your client Nikesh Pte. Ltd. was very unhappy with the balance stated in the letter of confirmation of accounts receivable. The customer was unhappy because the balances in your letter were much higher than in the customer's records. Explain possible reasons for this.

16-10 (Objective 16-4) Distinguish between a positive and a negative confirmation and state the circumstances in which each should be used. Why do CPA firms sometimes use a combination of positive and negative confirmations on the same audit?

16-11 (Objective 16-4) Under what circumstances is it acceptable to confirm accounts receivable before the balance sheet date?

16-12 (Objective 16-4) State the most important factors affecting the sample size in confirmations of accounts receivable.

16-13 (Objective 16-4) Discuss whether email responses and oral responses are acceptable confirmation responses. How can an auditor verify the addresses for confirmations sent by mail and confirmations sent electronically?

16-14 (Objective 16-4) Under what circumstances would an auditor choose to confirm information such as the right of return or special sales terms in addition to the customer balance?

16-15 (Objective 16-4) Define what is meant by alternative procedures in the confirmation of accounts receivable and explain their purpose. Which alternative procedures are the most reliable? Why?

16-16 (Objective 16-4) Explain why the analysis of differences is important in the confirmation of accounts receivable, even if the misstatements in the sample are not material.

16-17 (Objective 16-4) State three types of differences that might be observed in the confirmation of accounts receivable that do not constitute misstatements. For each, state an audit procedure that will verify the difference.

16-18 (Objective 16-1) What is the relationship of each of the following to the sales and collection cycle: flowcharts, assessing control risk, tests of controls, and tests of details of balances?

16-19 (Objective 16-3) Why does an auditor review sales returns subsequent to year-end? What audit objective does this procedure satisfy?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

16-20 (Objective 16-2) The following questions concern analytical procedures in the sales and collection cycle. Choose the best response.

a. As a result of analytical procedures, the auditor determines that the gross profit percentage has declined from 30% in the preceding year to 20% in the current year. The auditor should
   (1) express a qualified opinion due to inability of the client company to continue as a going concern.
   (2) evaluate management's performance in causing this decline.
   (3) require footnote disclosure.
   (4) consider the possibility of a misstatement in the financial statements.

b. An auditor's preliminary analysis of accounts receivable turnover revealed the following rates over these accounting periods

2013	2012	2011
4.3	6.2	7.3

Which of the following is the most likely cause of the decrease in accounts receivable turnover?
(1) Increase in the cash discount offered
(2) Liberalization of credit policy
(3) Shortening of due date terms
(4) Increased cash sales

c. After a CPA has determined that accounts receivable have increased as a result of slow collections in a "tight money" environment, the CPA will be likely to
(1) increase the balance in the allowance for bad debt account.
(2) review the going concern ramifications.
(3) review the credit and collection policy.
(4) expand tests of collectibility.

16-21 (Objective 16-4) The following questions deal with confirmation of accounts receivable. Choose the best response.

a. Which of the following procedures will an auditor most likely perform for year-end accounts receivable confirmations when the auditor did not receive replies to second requests?
(1) Review the cash receipts journal for the month prior to year end.
(2) Intensify the study of internal control concerning the revenue cycle.
(3) Inspect the shipping records documenting the merchandise sold to the debtors.
(4) Increase the assessed level of detection risk for the existence assertion.

b. The negative form of accounts receivable confirmation request is useful *except* when
(1) internal control surrounding accounts receivable is considered to be effective.
(2) a large number of small balances are involved.
(3) the auditor has reason to believe the persons receiving the requests are likely to give them consideration.
(4) individual account balances are relatively large.

c. The return of a positive confirmation of accounts receivable without an exception attests to the
(1) collectibility of the receivable balance.
(2) accuracy of the allowance for uncollectible accounts.
(3) accuracy of the aging of accounts receivable.
(4) accuracy of the receivable balance.

16-22 (Objective 16-3) The following questions concern audit objectives and management assertions for accounts receivable. Choose the best response.

a. Which of the following will most likely provide the most assurance concerning the accuracy balance-related objective for accounts receivable?
(1) Vouch amounts in the subsidiary ledger to details on shipping documents.
(2) Compare receivable turnover ratios with industry statistics for reasonableness.
(3) Inquire about receivables pledged under loan agreements.
(4) Assess the allowance for uncollectible accounts for reasonableness.

b. Which of the following audit procedures will best uncover an understatement of sales and accounts receivable?
(1) Test a sample of sales transactions, selecting the sample from prenumbered shipping documents.
(2) Test a sample of sales transactions, selecting the sample from sales invoices recorded in the sales journal.
(3) Confirm accounts receivable.
(4) Review the aged accounts receivable trial balance.

c. The confirmation of customers' accounts receivable rarely provides reliable evidence about the completeness assertion because
   (1) customers may not be inclined to report understatement errors in their accounts.
   (2) recipients usually respond only if they disagree with the information on the request.
   (3) many customers merely sign and return the confirmation without verifying details.
   (4) there is likely to be reliable third party evidence available.

DISCUSSION QUESTIONS AND PROBLEMS

16-23 (Objective 16-3) You have asked your audit trainee Sharizat to perform the following tasks. She wanted to know why you are asking her to perform such mundane tasks. As mentioned earlier, your client Lau Ah Pek Berhad has not purchased any accounting software and their financial records are all performed in Excel worksheets. Your client's year end is 31 December. Explain to her the objectives of the tasks.

Required

a. Pick any 10 cash till roll receipts from 30 December, 10 receipts from 31 December, 10 receipts from 1 January, and 10 receipts from 7 January, and trace the items on the receipts to the stock cards.
b. Extract the 20 highest balances from the accounts receivable trial balance, prepare the confirmation letters to the selected company, have the client sign the letters, and have them sent out.
c. Peruse the accounts receivable ledger for any unpaid invoices above 90 days.
d. Cast the balances of the accounts receivable trial balance and trace this to the General Ledger.

16-24 (Objective 16-3) The following misstatements are sometimes found in the sales and collection cycle's account balances:

1. Several cash receipts were posted to the incorrect customer accounts.
2. Several accounts receivable in the accounts receivable master file are not included in the aged trial balance.
3. One account receivable in the accounts receivable master file is included on the aged trial balance twice.
4. A shipment made in the subsequent period is recorded as a current period sale.
5. The allowance for uncollectible accounts is inadequate because of the client's failure to reflect depressed economic conditions in the allowance.
6. Several accounts receivable are in dispute as a result of claims of defective merchandise.
7. The pledging of accounts receivable to the bank for a loan is not disclosed in the financial statements.
8. Goods were returned for credit on the last day of the fiscal year but the sales return was not recorded until the following fiscal year.
9. Long-term interest-bearing notes receivable from affiliated companies are included in accounts receivable.

Required

a. For each misstatement, identify the balance-related audit objective to which it pertains.
b. For each misstatement, list an internal control that should prevent it.
c. For each misstatement, list one test of details of balances audit procedure that the auditor can use to detect it.

16-25 (Objective 16-3) The following are the eight balance-related audit objectives, six tests of details of balances for accounts receivable, and seven tests of controls or substantive tests of transactions for the sales and collection cycle:

Balance-Related Audit Objective

Detail tie-in	Classification
Existence	Cutoff
Completeness	Realizable value
Accuracy	Rights

Test of Details of Balances, Test of Control, or Substantive Test of Transactions Audit Procedure

1. Confirm accounts receivable ending balances and sales terms, such as right of return and consignment arrangements.
2. Review sales returns after the balance sheet date to determine whether any are applicable to the current year.
3. Compare dates on shipping documents with the sales journal throughout the year.
4. Perform alternative procedures for nonresponses to confirmations.
5. Examine sales transactions for related-party or employee sales recorded as regular sales.
6. Examine duplicate sales invoices for consignment sales and other shipments for which title has not passed.
7. Trace a sample of accounts from the accounts receivable master file to the aged trial balance.
8. Trace recorded sales transactions to shipping documents to determine whether a document exists.
9. Examine duplicate sales invoices for initials that indicate internal verification of extensions and footings.
10. Trace a sample of shipping documents to related sales invoice entries in the sales journal.
11. Compare amounts and dates on the aged trial balance with the accounts receivable master file.
12. Trace from the sales journal to the accounts receivable master file to make sure the information is the same.
13. Inquire of management whether there are notes from related parties included with trade receivables.

Required

a. Identify which procedures are tests of details of balances, which are tests of controls, and which are substantive tests of transactions.

b. For each balance-related audit objective, identify which test of details of balances and test of controls or substantive test of transactions partially satisfy the balance-related objective.

16-26 (Objective 16-3) Jarmell Foodstuffs sells produce to small grocery stores.

Prenumbered shipping documents are required by the company to be issued for each sale. The shipping clerk writes the date on the shipping document whenever there is a shipment or pickup. The final shipment made in the fiscal year ending June 30, 2013, was recorded on document 5427. Shipments are billed in the order the billing clerk receives the shipping documents. For late June and early July, shipping documents are billed on sales invoices as follows:

Shipping Document No.	Sales Invoice No.
5423	6237
5424	6223
5425	6226
5426	6235
5427	6236
5428	6216
5429	6238
5430	6242
5431	6231
5432	6229

The June and July sales journals have the following information included:

SALES JOURNAL—JUNE 2013

Day of Month	Sales Invoice No.	Amount of Sale ($)
23	6223	699.32
27	6226	2,978.61
28	6235	827.23
31	6242	504.96
31	6236	35.42

SALES JOURNAL—JULY 2013

Day of Month	Sales Invoice No.	Amount of Sale ($)
3	6237	7,236.49
3	6229	99.87
4	6238	423.32
5	6216	511.12
6	6231	1,306.75

Required

a. What are the GAAP requirements for a correct sales cutoff?

b. Which sales invoices, if any, are recorded in the wrong accounting period? Prepare an adjusting entry to correct the financial statements for the year ending June 30, 2013. Assume that the company uses a periodic inventory system (i.e., inventory and cost of sales do not need to be adjusted).

c. Assume that the shipping clerk accidentally wrote June 30 on shipping documents 5428 through 5430. Explain how that will affect the correctness of the financial statements. How will you, as an auditor, discover that error?

d. Describe, in general terms, the audit procedures you would follow in making sure that cutoff for sales is accurate at the balance sheet date.

e. Identify internal controls that will reduce the likelihood of cutoff misstatements. How would you test each control?

16-27 (Objective 16-3) The following are audit procedures in the sales and collection cycle:

1. Add the columns on the aged trial balance and compare the total with the general ledger.
2. Examine a sample of shipping documents to determine whether each has a sales invoice number included on it.
3. Examine a sample of customer orders and see if each has a credit authorization.
4. Compare the date on a sample of shipping documents a few days before and after the balance sheet date with related sales journal transactions.
5. Discuss with the sales manager whether any sales allowances have been granted after the balance sheet date that may apply to the current period.
6. Observe whether the controller makes an independent comparison of the total in the general ledger with the trial balance of accounts receivable.
7. Compare the date on a sample of shipping documents throughout the year with related duplicate sales invoices and the accounts receivable master file.
8. Compute the ratio of allowance for uncollectible accounts divided by accounts receivable and compare with previous years.

Required

a. For each procedure, identify the applicable type of audit evidence.

b. For each procedure, identify which of the following it is:
   (1) Test of control
   (2) Substantive test of transactions
   (3) Analytical procedure
   (4) Test of details of balances

c. For those procedures you identified as a test of control or substantive test of transactions, what transaction-related audit objective or objectives are being satisfied?

d. For those procedures you identified as a test of details of balances, what balance-related audit objective or objectives are being satisfied?

16-28 (Objective 16-4) Dodge, CPA, is auditing the financial statements of a manufacturing company with a significant amount of trade accounts receivable. Dodge is satisfied that the accounts are correctly summarized and classified and that allocations, reclassifications, and valuations are made in accordance with GAAP. Dodge is planning to use accounts receivable confirmation requests to obtain sufficient appropriate evidence as to trade accounts receivable.

Required

a. Identify and describe the two forms of accounts receivable confirmation requests and indicate what factors Dodge will consider in determining when to use each.

b. Assume that Dodge has received a satisfactory response to the confirmation requests. Describe how Dodge can evaluate collectibility of the trade accounts receivable.

c. What are the implications to a CPA if during an audit of accounts receivable some of a client's trade customers do not respond to a request for positive confirmation of their accounts?

d. What auditing steps should a CPA perform if there is no response to a second request for a positive confirmation?*

16-29 (Objectives 16-3, 16-4) Tim Flynn is the engagement manager for the audit of O'Donnell Enterprises. Tim is currently planning tests of details of balances for acc ounts receivable and is considering the use of electronic confirmation requests to improve response rates. The historical response rate to written confirmation requests sent to O'Donnell's customers has been below 50% and Tim believes they can increase that to over 80% using electronic requests. Tim is considering two different options. The first option is to use email confirmation requests with requests emailed directly to customers and the customers emailing responses directly to the audit firm. The second option is to use direct access to customer's electronic records through website links for O'Donnell's largest customers, and then written requests to the remaining customers.

Required

a. What factors does Tim need to consider in deciding whether to use written confirmation requests, email requests, or direct access to electronic records?

b. How will the audit firm ensure the reliability of the responses? For example, how might they verify the email addresses or the reliability of the electronic records? Who should provide the email addresses for the email confirmations, or the website links for direct access to electronic records?

16-30 (Objectives 16-2, 16-3) The Albring Company sells electronics equipment and has grown rapidly in the last year by adding new customers. The audit partner has asked you to evaluate the allowance for doubtful accounts at December 31, 2013. Comparative information on sales and accounts receivable is included below:

	Year Ended 12/31/13	Year Ended 12/31/12
Sales	$12,169,876	$10,452,513
Accounts Receivable	1,440,381	1,030,933
Allowance for doubtful accounts	90,000	75,000
Bad debt charge-offs	114,849	103,471
Accounts Receivable:		
0–30 days	$ 897,035	$ 695,041
30–60 days	254,269	160,989
60–90 days	171,846	105,997
Over 90 days	117,231	68,906
TOTAL	$ 1,440,381	$ 1,030,933

Required

a. Identify what tests of controls and substantive tests of transactions you recommend be performed before conducting your analysis of the allowance for doubtful accounts.

b. Perform analytical procedures to evaluate whether the allowance is fairly stated at December 31, 2013. Assume performance materiality for the allowance account is $15,000.

16-31 (Objective 16-4) As part of the accounts receivable confirmation process, you have asked your client to sign and send the following confirmation to a number of customers.

Carmen Chin's Fashion House (Singapore) Pte. Ltd.
8-8-8 Plaza Temasek
Orchid Road
Singapore

14 February 2014

Name and Address of Client

To Whom it may Concern,

In connection with an audit of our financial statements, please confirm directly to our auditors the correctness of the balance of your account as of December 31, 2013, as shown below. Our auditor's contact details are as follows: **Pinto and Patel, Public Accountants**, 8th Floor Plaza Geylang, Geylang, Singapore, Tel: (65) 5844 8556.

This is not a request for payment; please do not send your remittance to our auditors. Your prompt attention to this request will be appreciated. An envelope is enclosed for your reply.

Tan KhiaSzeKesha (Ms)
Finance Director

The balance receivable of $XXXX as of 31 December, 2013, is correct except as noted below. Your receptionist received the following replies:

1. Lim See Kooi of Lim Brothers Pte. Ltd.: *My father's company Lim Tee Pu Pte. Ltd. wound up after my father died 3 years ago. We don't owe you $5,000. Ask my brother Lim See Pek. He is in charge of Lim Tee Pu Pte. Ltd.*
2. Jennifer Low: *I did not receive the clothes I ordered on 30 December 2013 costing $3,000 on time. So I am not paying this. I received the shipment on 17 January 2014. This invoice is not due.*
3. Mat Isa NasiKandar: *Sorry, I forgot to pay for the table cloth I ordered for Valentine's Day last year. Here is a check for $2,000.*
4. Mary Hathaway-Berkshaw (telephone call): *I have transferred $500 to your account at Maybank online on 3 January 2014. Today is Valentine's Day. You should have updated my account.*

Required

Describe the implications of the above confirmation responses and the follow-up actions you will take as auditor.

16-32 (Objectives 16-3, 16-5) The following are various changes in audit circumstances.

Audit Circumstance

1. Analytical procedures indicated a significant slowing in accounts receivable turnover.
2. The client entered into sales contracts with new customers that differ from the client's standard sales contracts.
3. The client had a significant increase in sales near year-end.
4. Accounts receivable confirmations were ineffective due to a very low response rate in the prior year audit.
5. The client began experiencing an increase in returns due to product changes that resulted in increased defects.
6. You found several pricing errors in your substantive tests of transactions for sales.
7. In performing substantive test of transactions for cash receipts, you found that receipts were promptly recorded in customer accounts, but there were delays in depositing the receipts at the bank.
8. The client entered into a new loan agreement with the bank. Accounts receivable are pledged as collateral for the loan.
9. The client did not reconcile the accounts receivable subsidiary records with the accounts receivable balance in the general ledger on a regular basis.

Required

Match each change in audit circumstance with the most likely test of details of balances response. Each response is used once.

a. Expand testing of sales returns after year-end and compare the level of returns with the prior year.
b. Send positive confirmations that include requests for information on side agreements and special terms.
c. Increase the number of accounts traced from the accounts receivable trial balance to the accounts receivable subsidiary records.
d. Expand the review of cash receipts after year-end to evaluate the collectibility of accounts receivable.
e. Increase the sample size for sales cutoff testing for sales recorded before year-end.
f. Send a confirmation to the bank confirming amounts pledged as collateral under loan agreements.
g. Increase the sample size for positive confirmations of accounts receivable.
h. While at the client's premises at year-end, obtain information on the last few cash receipts at year-end for cash receipts cutoff testing.
i. Perform alternative procedures to test the existence and accuracy of accounts receivable instead of sending positive confirmations.

16-33 (Objective 16-4) In the confirmation of accounts receivable for the Reliable Service Company, 85 positive and no negative confirmations were mailed to customers. This represents 35% of the dollar balance of the total accounts receivable. Second requests were sent for all nonresponses, but there were still 10 customers who did not respond. The decision was made to perform alternative procedures on the 10 unanswered confirmation requests. An assistant is requested to conduct the alternative procedures and report to the senior auditor after he has completed his tests on two accounts. He prepared the following information for the audit files:

1. Confirmation request no. 9
   Customer name—Jolene Milling Co.
   Balance—$3,621 at December 31, 2013
   Subsequent cash receipts per the accounts receivable master file: January 15, 2014—$1,837; January 29, 2014—$1,263; February 6, 2014—$1,429
2. Confirmation request no. 26
   Customer name—Rosenthal Repair Service
   Balance—$2,500 at December 31, 2013
   Subsequent cash receipts per the accounts receivable master file: February 9, 2014—$500
   Sales invoices per the accounts receivable master file (I examined the duplicate invoice): September 1, 2013—$4,200

Required

a. If you are called on to evaluate the adequacy of the sample size, the type of confirmation used, and the percent of accounts confirmed, what additional information will you need?
b. Discuss the need to send second requests and perform alternative procedures for nonresponses.
c. Evaluate the adequacy of the alternative procedures used for verifying the two nonresponses.

CASE

16-34 (Objectives 16-1, 16-3, 16-4, 16-5) You are auditing the sales and collection cycle for Synensys, a small electronics manufacturer, who deals with a variety of computer makers. The company is respected in its industry for its creativity and rapid growth, but their accounting office is perpetually neglected, and the sales department frequently makes errors in billing clients. In previous years, your CPA firm has found quite a few misstatements in billings, cash receipts, and accounts receivable. Like many companies, the largest assets are accounts receivable, inventory, and fixed assets.

Synensys has several large loans payable to local banks, and the two banks have told management that they are reluctant to extend more credit, especially considering that a bigger and well known electronics manufacturer is moving into the area. In previous slow years Synensys covered deficits with capital it had saved, but its recent expansion has diminished its capital reserves substantially.

In previous years, your response from clients of Synensys to confirmation requests has been frustrating at best. The response rate has been extremely low, and those who did respond did not know the purpose of the confirmations or their correct outstanding balance. You have had the same experience in confirming receivables with other, similar organizations. You conclude that control over cash is excellent and the likelihood of fraud is extremely small. You are less confident about unintentional errors in billing, recording sales, cash receipts, accounts receivable, and bad debts.

Required

a. Identify the major factors affecting client business risk and acceptable audit risk for this audit.

b. What inherent risks are you concerned about?

c. In this audit of the sales and collection cycle, which types of tests are you likely to emphasize?

d. For each of the following, explain whether you plan to emphasize the tests and give reasons:

(1) Tests of controls
(2) Confirmations
(3) Substantive tests of transactions
(4) Analytical procedures
(5) Tests of details of balances

INTEGRATED CASE APPLICATION—PINNACLE MANUFACTURING: PART VII

16-35 (Objectives 16-2, 16-3, 16-4) Parts III, V, and VI of this case study dealt with obtaining an understanding of internal control and assessing control risk for transactions affecting accounts payable of Pinnacle Manufacturing. In Part VII, you will design analytical procedures and design and perform tests of details of balances for accounts payable.

Assume that your understanding of internal controls over acquisitions and cash disbursements and the related tests of controls and substantive tests of transactions support an assessment of a low control risk. The listing of the 519 accounts making up the accounts payable balance of $12,969,686 at December 31, 2013, is included under the Pinnacle link on the textbook Web site.

Required

a. List those relationships, ratios, and trends that you believe will provide useful information about the overall reasonableness of accounts payable. You should consider income statement accounts that affect accounts payable in selecting the analytical procedures.

b. Study Table 19-5 (p. 659) containing balance-related audit objectives and tests of details of balances for accounts payable to be sure you understand each procedure and its purpose. Prepare an audit program for accounts payable in a performance format, using the audit procedures in Table 19-5. The format of the audit program should be similar to Table 16-5 (p. 559). Be sure to include a sample size for each procedure.

c. Assume for requirement b. that (1) assessed control risk had been high rather than low for each transaction-related audit objective, (2) inherent risk was high for each balance-related audit objective, and (3) analytical procedures indicated a high potential for misstatement. What would the effect have been on the audit procedures and sample sizes for requirement b.?

d. Confirmation requests were sent to a stratified sample of 51 vendors listed in Figure 16-8 (p. 570). Confirmation responses from 45 vendors were returned indicating no difference between the vendor's and the company's records. Figure 16-9 (pp. 571–572) presents the six replies that indicate a difference between the vendor's balance and the company's records. The auditor's follow-up findings are indicated on each reply. Prepare an audit schedule similar to the one illustrated in Figure 16-10 (p. 573) to determine the misstatements, if any, for each difference. The audit schedule format

FIGURE 16-8 **Pinnacle Manufacturing Sample of Accounts Payable Selected for Confirmation—December 31, 2013**

High-Volume Items (>$250,000)		
1. American Press	$ 340,767.94	
2. Clean-O-Rama Co.	317,668.63	
3. Fiberchem	793,049.89	
4. Rufus Austin Antiques	400,046.08	
5. Todd Machinery	531,073.93	
6. Welburn Manufacturing	388,836.07	$2,771,442.54
Large Balance Items ($50,001–$250,000)		
1. A & M Sandler, Inc.	$ 81,348.54	
2. American Baby/USTC	75,432.73	
3. Beach & Hoover Refining	76,408.79	
4. Bearing Drives Co.	73,017.24	
5. Burton Martin	78,682.54	
6. Cable Sys./Ind. Traf. Cons.	71,288.95	
7. Eddie Ventura, Inc.	60,255.55	
8. Fiberoptics	60,102.78	
9. Finish Metals, Inc.	60,769.71	
10. Freeman Furniture–Attn A/P	130,493.51	
11. GP Chambers Co.	64,125.44	
12. Godwin Drug Co.	84,331.05	
13. Holy Family Hospital	117,916.83	
14. Las Flores Designs, Inc.	88,644.92	
15. Lean Corp.	67,985.23	
16. MacDonald Svc. Corporation	147,943.95	
17. McCoys, Inc.	67,936.32	
18. Metadyne Corp.	85,432.51	
19. Micron Power Systems	136,071.37	
20. Mobil Oil	93,210.48	
21. National Elevator & Mach. Co.	76,921.40	
22. Norris Industries	88,314.64	
23. R & B Products	80,092.46	
24. Remington Supply	123,411.24	
25. Safety Envelope Co.	223,950.34	
26. Scandec USA, Inc.	65,942.94	
27. The Dutton Company	63,882.02	
28. The Haberdashery Co.	71,869.16	
29. University of California	80,624.95	
30. ZZZZ Bank Adjustments	64,471.21	$2,660,878.80
Items $50,000 and less		
1. Advent Sign Mfg. Co.	$ 51,750.00	
2. B&K Mfg. Co., Inc.	42,668.50	
3. Bellco	42,710.74	
4. Boston Shoecase Co.	52,174.50	
5. Dynamic Metal Products	36,546.05	
6. Everhart Co.	47,519.14	
7. Fuller Travel	32,470.11	
8. Good House Home Video, Inc.	46,472.67	
9. Harrah's Metals, Inc.	51,279.85	
10. J C Licht Co.—Glendale Hts.	53,228.47	
11. Liberty Lighting	46,802.78	
12. Long Beach Lawn Service	48,488.96	
13. Premier Whirlpool Bath	6,550.33	
14. Quaker Transanalysis	50,363.69	
15. Tower International	37,299.55	$ 646,325.34
TOTAL TESTED		$6,078,646.68

shown in Figure 16-10 can be downloaded using the Pinnacle link on the textbook Web site. The exception for Fiberchem is analyzed as an illustration. Assume that Pinnacle Manufacturing took a complete physical inventory at December 31, 2013, and the auditor concluded that recorded inventory reflects all inventory on hand at the balance sheet date. Include the balances confirmed without exception as one amount on the schedule for each stratum, and total the schedule columns.

e. Estimate the total misstatement in the income statement, not just the misstatements in the sample, based on the income statement misstatements you identified in requirement d. The total misstatement should include a projected misstatement and an estimate for sampling error. *Hint:* See pages 275–276 for guidance on calculating the point estimate. Note that the misstatements should be projected separately for each stratum. You will need to determine the size of each stratum using the accounts payable listing. Use your judgment to estimate sampling error, considering the size of the population and the amounts tested.

FIGURE 16-9 Replies to Requests for Information

STATEMENT FROM FIBERCHEM

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

Invoice No.	Date	Amount	Balance Due
8312	11-22-13	$300,000.00	$300,000.00
8469	12-02-13	178,000.00	478,000.00
8819	12-18-13	315,049.89	793,049.89(1)
9002	12-30-13	32,500.00(2)	825,549.89

Auditor's notes:
(1) Agrees with accounts payable listing.
(2) Goods shipped FOB Fiberchem's plant on December 31, 2013; arrived at Pinnacle Manufacturing on January 4, 2014.

STATEMENT FROM MOBIL OIL

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

Invoice No.	Date	Amount	Balance Due
DX14777	12-23-13	$93,210.48	$ 93,210.48(1)
DX16908	12-29-13	37,812.00(2)	131,022.48

Auditor's notes:
(1) Agrees with accounts payable listing.
(2) Goods shipped FOB Pinnacle Manufacturing on December 29, 2013; arrived at Pinnacle Manufacturing on January 3, 2014.

STATEMENT FROM NORRIS INDUSTRIES

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

Invoice No.	Date	Amount	Balance Due
14896	12-27-13	$ 88,314.64	$ 88,314.64(1)
15111	12-28-13	117,296.00(2)	205,610.64

Auditor's notes:
(1) Agrees with accounts payable listing.
(2) Goods received December 30, 2013; recorded on January 2, 2014.

(Figure 16-9 continued on next page)

FIGURE 16-9 Replies to Requests for Information *(Cont.)*

STATEMENT FROM REMINGTON SUPPLY

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

Invoice No.	Date	Amount	Balance Due
141702	11-11-13	$23,067.00	$ 23,067.00
142619	11-19-13	12,000.00	35,067.00
142811	12-04-13	7,100.00	42,167.00
143600	12-21-13	27,715.24	69,882.24
144927	12-29-13(2)	53,529.00	123,411.24(1)

Auditor's notes:
(1) Agrees with accounts payable listing.
(2) Goods shipped FOB Pinnacle Manufacturing on December 29, 2013; arrived at Pinnacle Manufacturing on January 4, 2014.

STATEMENT FROM ADVENT SIGN MFG. CO.

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

First progress billing per contract	$51,750.00(1)
Second progress billing per contract	7,500.00(2)
Total due	$59,250.00

Auditor's notes:
(1) Agrees with accounts payable listing.
(2) Progress payment due as of December 31, 2013, per contract for construction of new custom electric sign; sign installation completed on January 15, 2014.

STATEMENT FROM FULLER TRAVEL

Pinnacle Manufacturing
Detroit, MI

Amounts due as of December 31, 2013:

Invoice No.	Date	Amount	Balance Due
84360110	12-04-13	$9,411.63(2)	$ 9,411.63
84360181	12-12-13	9,411.63(2)	18,823.26
84360222	12-21-13	7,100.00(1)	25,923.26
84360291	12-26-13	13,646.85(2)	39,570.11

Auditor's notes:
(1) Paid by Pinnacle Manufacturing on December 28, 2013; payment in transit at year-end.
(2) The total of these items of $32,470.11 agrees with accounts payable listing.

f. Estimate the total misstatement in accounts payable in the same way you did for the income statement in requirement e. *Hint:* A misstatement caused by the failure to record an FOB origin purchase is an understatement of accounts payable and inventory and has no effect on income.

g. What is your conclusion about the fairness of the recorded balance in accounts payable for Pinnacle Manufacturing as it affects the income statement and balance

FIGURE 16-10 **Pinnacle Manufacturing Analysis of Trade Accounts Payable—December 31, 2013**

					Misstatement in Related Accounts			
Vendor	**Balance per Books**	**Amount Confirmed by Vendor**	**Books Over (Under) Amount Confirmed**	**Timing Difference: No Misstatement**	**Misstatement in Accounts Payable o/s (u/s)***	**Other Balance Sheet Misstatement o/s (u/s)***	**Income Statement Misstatement o/s (u/s)***	**Brief Explanation**
Key Accounts (>$250,000)								
Fiberchem	$793,049.89	$825,549.89	$(32,500.00)		$(32,500.00)	$(32,500.00)		F.O.B. Origin error: Dr. Inv. Cr. A/P
Accounts in stratum $50,001–$250,000								
Accounts in stratum less than or equal to $50,000								

* o/s = overstatement u/s = understatement

sheet? How does this affect your assessment of control risk as being low for all transaction-related audit objectives? Assume you decided that performance materiality for accounts payable as it affects the income statement is $250,000.

ACL PROBLEM

16-36 (Objective 16-3) 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 f. For this problem use the Metaphor_Trans_All file in ACL Demo, which is a file of outstanding sales invoices (each row represents an invoice transaction). 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 of invoices (read the bottom of the Metaphor_Trans_All file screen) and total unpaid invoices outstanding (NEWBAL) for comparison to the general ledger. (Total Field)

b. How many of the invoices included a finance charge (FINCHG) and what was the total amount of the finance charges? (Filter, Count Records, and Total Field)

c. Determine and print accounts receivable outstanding from each customer and total the amount for comparison to part a. (*Note:* remove the filter from step b. first). (Summarize and Total Field) Which customer number has the largest balance due?

d. What is the largest and smallest account balance outstanding? (Quick Sort)

e. For the account with the largest balance, prepare and print an aging of the account from the transaction file using the statement date labeled "STMTTDT." Use the aging date as of 4/30/2003 and "NEWBAL" as the subtotal field. (Filter and Age)

f. To better decide the customers to select for confirmation you decide to stratify customer balances into two intervals after excluding all balances less than $5,000. How many balances are greater than $5,000? Print the output. (Filter and Stratify)

RESEARCH PROBLEM 16-1: REVENUE RECOGNITION

In recent years, several high-profile incidents of improper revenue recognition attracted the attention of the business media. The SEC has also expressed concerns about the number of instances of improper revenue recognition identified by SEC staff. One revenue issue involves "bill and hold" sales. In a bill and hold transaction, a customer agrees to purchase the goods, but the seller retains physical possession until the customer requests shipment to designated locations. Normally, such an arrangement does not qualify as a sale because delivery has not occurred. Under certain conditions, however, when a buyer has made a firm purchase commitment and has assumed the risks and rewards of the purchased product, but is unable to accept delivery because of a compelling business reason, bill and hold sales may qualify for revenue recognition. Read the SEC guidance on revenue recognition (www.sec.gov/interps/account/sabcodet13.htm) to answer the following questions:

Required

a. What does the SEC indicate are the four basic criteria for determining whether revenue is realized or realizable?

b. A customer of your audit client, Henson, LLC, made a formal written request to establish a bill and hold arrangement in November 2013, an arrangement which is typical in the industry. The customer's written request outlines a delivery schedule that will begin in February 2014. As of November 2013, the product to be shipped in February is already complete and ready for shipment. Because the sale was completed in 2013, your audit client would like to record the bill and hold the transaction described as a sale in 2013. You do not recall noticing any inventory held in a separate area of the client's warehouse during the December 31, 2013, inventory observation. In making your determination regarding the timing of the revenue recognition, what criteria has the SEC determined to be important?