AUDITING
A RISK-BASED APPROACH TO CONDUCTING A QUALITY AUDIT

9th Edition

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CHAPTER 9
AUDITING THE REVENUE CYCLE

LEARNING OBJECTIVES

1. Identify the significant accounts, disclosures, and relevant assertions in the revenue cycle
2. Identify and assess inherent risks of material misstatement in the revenue cycle
3. Identify and assess fraud risks of material misstatement in the revenue cycle
4. Identify and assess control risks of material misstatement in the revenue cycle

LEARNING OBJECTIVES

5. Describe how to use preliminary analytical procedures to identify possible material misstatements for revenue cycle accounts, disclosures, and assertions
6. Determine appropriate responses to identified risks of material misstatement for revenue cycle accounts, disclosures, and assertions
7. Determine appropriate tests of controls and consider the results of tests of controls for revenue cycle accounts, disclosures, and assertions

LEARNING OBJECTIVES

8. Determine and apply sufficient appropriate substantive audit procedures for testing revenue cycle accounts, disclosures, and assertions
9. Apply the frameworks for professional decision making and ethical decision making to issues involving the audit of revenue cycle accounts, disclosures, and assertions

THE AUDIT OPINION FORMULATION PROCESS

I. Making Client Acceptance and Continuance Decisions
Chapter 14

II. Performing Risk Assessment
Chapters 3, 7 and 9–13

III. Obtaining Evidence about Internal Control Operating Effectiveness
Chapters 8–13 and 16

IV. Obtaining Substantive Evidence about Accounts, Disclosures and Assertions
Chapters 8–13 and 16

V. Completing the Audit and Making Reporting Decisions
Chapters 14 and 15

The Auditing Profession, the Risk of Fraud and Mechanisms to Address Fraud: Regulation, Corporate Governance, and Audit Quality
Chapters 1 and 2

Professional Liability and the Need for Quality Auditor Judgments and Ethical Decisions
Chapter 4

The Audit Opinion Formulation Process and A Framework for Obtaining Audit Evidence
Chapters 5 and 6

PROFESSIONAL JUDGMENT IN CONTEXT - HOW TO ACCOUNT FOR VIRTUAL SALES AT ZYNGA

- Revenue recognition approaches of Ernst & Young
  - Game-based - Revenue is recognized very slowly
  - User-based - Faster approach that lasts till user sticks with the game
  - Speedy item-based - Based on properties of individual virtual goods
  - Changing player life allowed Zynga to change a net loss for the six month period into net profit of $18.1 million

PROFESSIONAL JUDGMENT IN CONTEXT - HOW TO ACCOUNT FOR VIRTUAL SALES AT ZYNGA

- What are the inherent risks associated with revenue transactions? (LO 2)
- What are management's incentives to misstate revenue transactions? (LO 3)
- What controls should management have in place to mitigate the risks associated with revenue transactions? (LO 4)

PROFESSIONAL JUDGMENT IN CONTEXT - HOW TO ACCOUNT FOR VIRTUAL SALES AT ZYNGA

- How might auditors use preliminary analytical procedures to identify any potential concerns related to revenue? (LO 5)
- What is sufficient appropriate evidence when auditing revenue transactions and related accounts? (LO 6, 7, 8)

LEARNING OBJECTIVE 1

IDENTIFY THE SIGNIFICANT ACCOUNTS, DISCLOSURES, AND RELEVANT ASSERTIONS IN THE REVENUE CYCLE

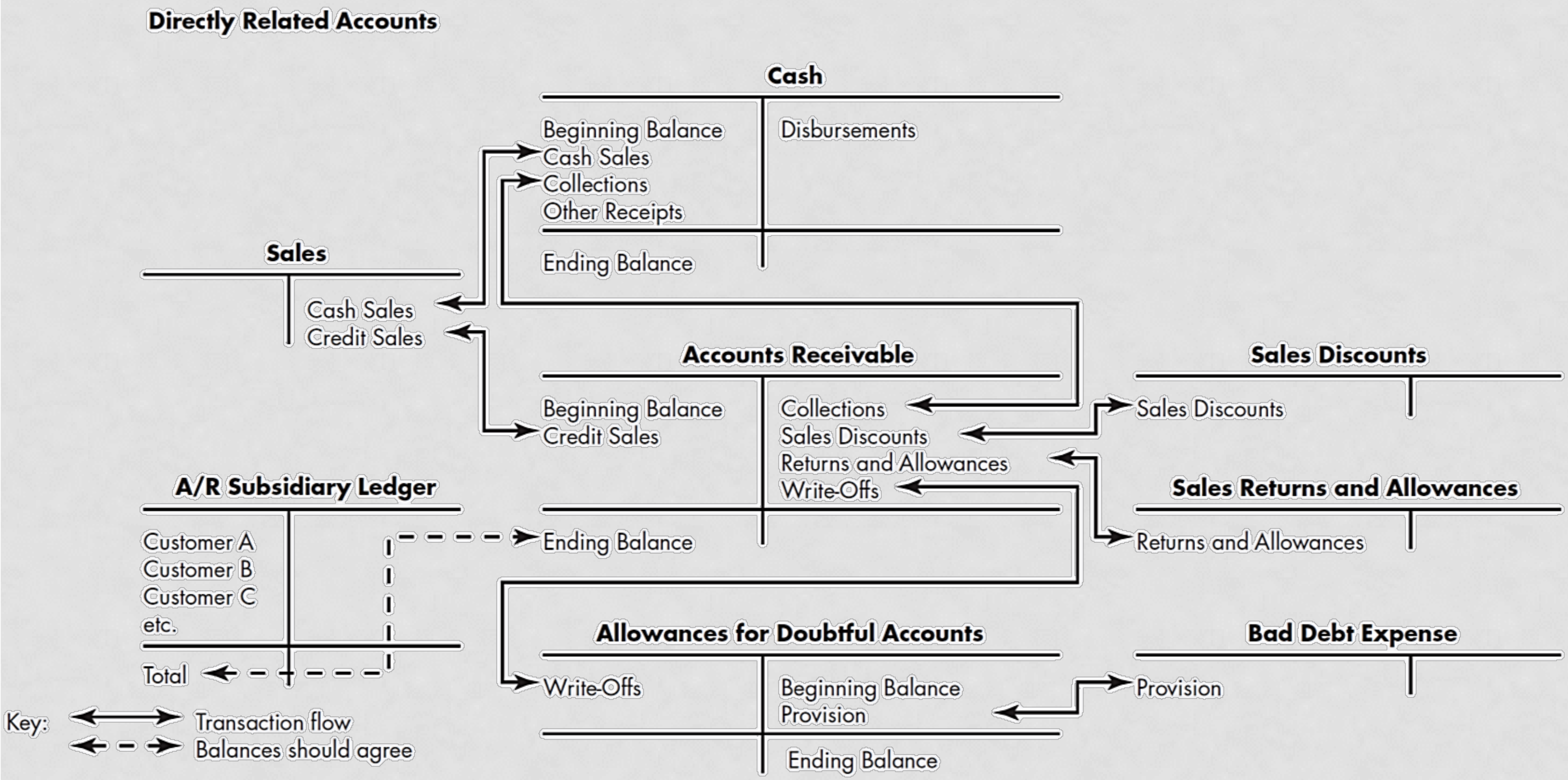
REVENUE CYCLE

- Process of:
  - Receiving a customer's order
  - Approving credit for a sale
  - Determining whether goods are available for shipment
  - Shipping the goods
  - Billing the customers
  - Collecting cash
  - Recognizing effect of this process on other related accounts

REVENUE CYCLE

- Significant accounts include revenue and accounts receivable
  - Evidence is obtained for each financial statement assertions
  - Relevance of assertions varies with accounts and clients
    - More relevant assertions:
      - Have risk of material misstatement
      - Require higher-quality audit evidence

EXHIBIT 9.1 - REVENUE CYCLE ACCOUNTS: AFFECTED BY SALES TRANSACTIONS



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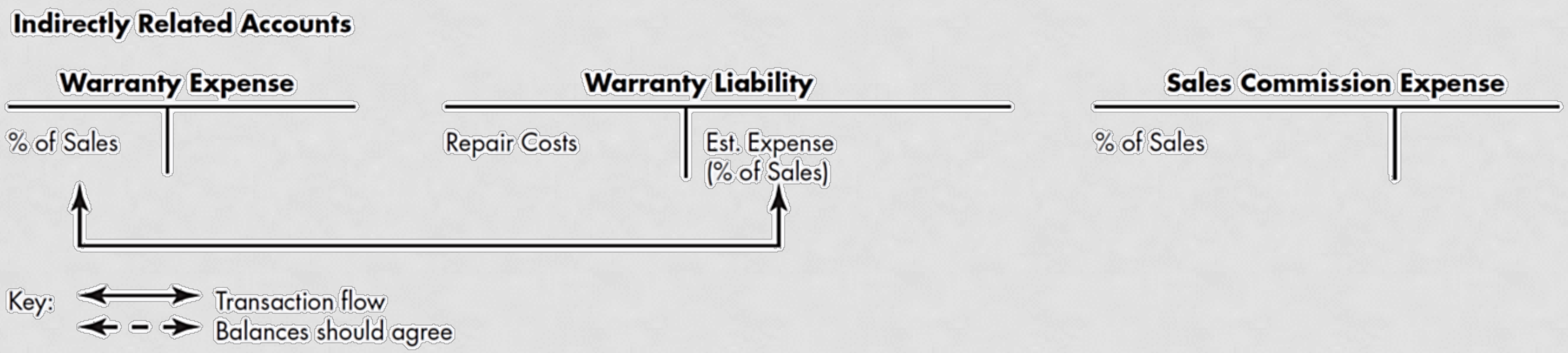


LEARNING OBJECTIVE 2

IDENTIFY AND ASSESS INHERENT RISKS OF MATERIAL MISSTATEMENT IN THE REVENUE CYCLE

PERFORMING RISK ASSESSMENT PROCEDURES IN THE REVENUE CYCLE

- Requires information about:
  - Inherent risks at the:
    - Financial statement level
    - Account and assertion levels
  - Fraud risks
  - Feedback from audit team's brainstorming session
  - Strengths and weaknesses in internal control
  - Results from preliminary analytical procedures

REVENUES: IDENTIFYING INHERENT RISKS

- Timing of revenue recognition - Important inherent risk related to revenue transactions
- Following information is required to audit revenue cycle
  - Organization’s principal business
  - Earnings process and nature of obligations that extend beyond normal shipment of goods
  - Impact of unusual terms, and when title passes to customer

REVENUES: IDENTIFYING INHERENT RISKS

- Right of customer to return a product, as well as returns history
- Contracts that are combinations of leases and sales
- Proper treatment of sales transactions made with recourse or that have an abnormal or unpredictable amount of returns

CRITERIA FOR REVENUE RECOGNITION

- Refer to guidance provided by:
  - International Accounting Standards Board (IASB)
  - Securities and Exchange Commission (SEC)
  - Financial Accounting Standards Board (FASB)
  - American Institute of Certified Public Accountants (AICPA)

CRITERIA DETERMINED BY SEC FOR REVENUE RECOGNITION

- Persuasive evidence of an arrangement should exist
- Delivery should have occurred, or services should have been rendered
- The seller's price to the buyer should be fixed or determinable
- Collectibility should be reasonably assured

CRITERIA DETERMINED BY SEC FOR REVENUE RECOGNITION

- It does not consider delivery to have occurred until customer:
  - Takes title of ownership
  - Assumes risks and rewards of ownership
- Auditors need to determine:
  - When a client should recognize revenue
  - How to audit revenue

AUDITING IN PRACTICE - CHANNEL STUFFING AT ARTHROCARE

- Highlights material misstatements that can occur if:
  - Client record revenue improperly
  - Auditor fails to detect misstatement
- Channel stuffing improperly inflated company revenue and earnings
- Sales personnel shipped products to distributors even though the distributers did not:
  - Need them
  - Have the ability to pay them

ACCOUNTS RECEIVABLE: IDENTIFYING INHERENT RISKS

- Receivables pledged as collateral against specific loans with restricted use
- Receivables incorrectly classified as current when likelihood of collection during next year is low
- Collection of a receivable contingent on specific events that cannot currently be estimated
- Payment not required until purchaser sells product to its end customers
- Accounts receivable aged incorrectly, and potentially uncollectible amounts not recognized
- Orders accepted from customers with poor credit, but allowance for doubtful accounts not increased accordingly

LEARNING OBJECTIVE 3

IDENTIFY AND ASSESS FRAUD RISKS OF MATERIAL MISSTATEMENT IN THE REVENUE CYCLE

FRAUD SCHEMES UNCOVERED BY THE SEC AND PCAOB

- Recognition of revenue on shipments that never occurred
- Hidden side letters giving customers an irrevocable right to return the product
- Recording consignment sales as final sales
- Creation of fictitious invoices
- Shipment of more product than customer ordered
- Early recognition of sales that occurred after end of fiscal period

FRAUD SCHEMES UNCOVERED BY THE SEC AND PCAOB

- Shipment of unfinished product
- Shipment of product before customers wanted or agreed to delivery
- Recording shipments to company's own warehouse as sales
- Recording reshipment as a sale of new goods before issuing credit for the returned sale
- Incorrect aging of accounts receivable
- Recording purchase orders as completed sales

LAPPING

- Technique used to cover up embezzlement of cash
  - Stealing cash collection from a customer and crediting him from another customer's payment
  - This process continues and at least one customer’s account is always overstated
- Occurs when duties are inadequately segregated

AUDITING IN PRACTICE - IMPORTANCE OF PROFESSIONAL SKEPTICISM IN AUDITING REVENUE AT TVIA

- It is important to be alert when client personnel have significant financial motives to fraudulently overstate revenue
- To prevent such behavior it is important to understand and test controls designed and implemented
- If controls are ineffective:
  - Exercise appropriate professional skepticism
  - Extend substantive testing

AUDITOR'S ROLE IN IDENTIFYING FRAUD RISK FACTORS

- Assessing motivation to enhance revenue because of either internal or external pressures
- Reviewing financial statements through preliminary analytical procedures
- Recognizing that not all of the fraud will be instigated by management
- Becoming aware of representations made by management to analysts
  - Potential effect of those expectations on stock prices

AUDITOR'S ROLE IN IDENTIFYING FRAUD RISK FACTORS

- Determining whether company's performance is significantly different from rest of the industry or economy
- Determining whether company's accounting is being investigated by organizations such as the SEC
- Considering management compensation schemes
- Determining whether accounting functions are centralized
  - If not, assessing if decentralization is appropriate

AUDITOR' S ROLE IN IDENTIFYING FRAUD RISK FACTORS

- Assessing whether company engages in complex sales arrangements
- Assessing whether company has a history of aggressive accounting interpretations
- Determining that an uninterrupted history of growth in earnings per share or revenue might provide incentives to continue to show that growth
- Determining if client has numerous manual journal entries affecting revenue process

AUDITING IN PRACTICE - RISKS RELATED TO DECENTRALIZED ACCOUNTING FUNCTIONS AT WORLDCOM

- Prime example of taking several actions that negatively affect quality of its financial statements
- Complex transactions were made difficult to understand and audit because:
  - Accounting personnel were not sufficiently qualified
  - Accounting function was spread over three locations without a good rationale for decentralization
  - Decentralization was by function

LEARNING OBJECTIVE 4

IDENTIFY AND ASSESS CONTROL RISKS OF MATERIAL MISSTATEMENT IN THE REVENUE CYCLE

IDENTIFYING CONTROL RISKS

- Requires understanding of internal controls for integrated audits and financial statement only audits
- Such understanding is gained by means of:
  - Walkthrough of the process
  - Inquiry
  - Observation
  - Review of client's documentation

IDENTIFYING CONTROL RISKS

- At account and assertion levels auditor considers:
  - Entity-wide controls
    - Commitment to financial accounting competencies
    - Independence of the board of directors
  - Transaction controls

CONTROLS RELATED TO EXISTENCE/OCCURRENCE

- Providing reasonable assurance that sale and accounts receivable are recorded only when:
  - Shipment has occurred
  - Primary revenue producing activity has been performed
- Mitigating risk that unearned revenues are recorded
  - Distributing monthly statements to customers
- Unusual transactions require a high level of management review

CONTROLS RELATED TO COMPLETENESS

- Using prenumbered shipping documents and sales invoices and its subsequent accounting
- Immediate online entry into computer system and assignment of unique identification number
- Reconciliation of shipping records with billing records
- Supervisory review
- Reconciliation of inventory with sales

CONTROLS RELATED TO VALUATION

- Sales made from authorized price lists
- Valuation issues arise with:
  - Unusual or uncertain sales terms
  - Returns and allowances
- Policies and procedures for identifying and recording returned goods
  - Spelling out contractual return provisions in sales contract
  - Approving acceptance of returns

CONTROLS RELATED TO VALUATION

- Recording goods returned on prenumbered documents accounted
- Identifying whether to:
  - Give credit
  - Rework the goods according to warranty provisions
- Determining potential obsolescence or defects in goods
- Assuring proper classification of goods
- Developing and implementing a sales returns reserve methodology

AUDITING IN PRACTICE - RISKS ASSOCIATED WITH SALES RETURNS

- Medicis fraud
  - Management knowingly underestimated the sales returns reserve
- E&Y auditors failed to properly evaluate the sales returns reserve
  - In 2012, PCAOB settled a disciplinary order censuring Ernst & Young (E&Y) and a $2 million fine
  - Medicis had to restate its financials

PROCEDURES USED IN CONTROLLING A COMPANY'S CREDIT RISK

- Formal credit policy
  - Automated for most transactions
  - Requires special approval for large and/or unusual transactions
- Continuous monitoring of receivables for evidence of increased risk
- Adequate segregation of duties in credit department

DOCUMENTING CONTROLS

- Required for:
  - Integrated audits
  - Financial statement only audits

EXHIBIT 9.5 – partial Control Risk Assessment Questionnaire: Sales and Receivables

SALES ORDERS

Sales authorized by: (Describe the source and scope of authority, and the documentation or other means of indicating authorizations. Include explicitly the authorization of prices for customers.)

Sales orders prepared by, or entered into the system by:

Individuals authorized to change price tables: (Indicate specific individuals and their authority to change prices on the system and the methods used to verify the correctness of changes.)

Existence of major contracts with customers that might merit special attention during the course of the audit: (Describe any major contracts and their terms.)

Restrictions on access to computer files for entering or changing orders: (Describe access control systems and indicate whether we have tested them in conjunction with our review of data processing general controls.)

EXHIBIT 9.6 - PARTIALLY COMPLETED CONTROLS MATRIX FOR CONTRACT REVENUE

Control Description	Risk of Misstatement—Relevant Assertion(s)	Testing Approach (Nature of Testing)	Timing of Testing	Extent of Testing	Testing Results (Including Deficiencies)
A revenue recognition review is performed by the revenue accountant before revenue is recorded.	The risks are that revenue will be recorded before the criteria for recognizing revenue have been met or that revenue will be recorded at the incorrect amount. • Valuation • Existence	Reperformance of analyses performed by the revenue accountant.	Year end		

LEARNING OBJECTIVE 5

DESCRIBE HOW TO USE PRELIMINARY ANALYTICAL PROCEDURES TO IDENTIFY POSSIBLE MATERIAL MISSTATEMENTS FOR REVENUE CYCLE ACCOUNTS, DISCLOSURES, AND ASSERTIONS

PERFORMING PRELIMINARY ANALYTICAL PROCEDURES

- Help identify areas of potential misstatements
- Require developing expectations for account balances, ratios, and trends
- Possible expected relationships in revenue cycle include the following
  - Absence of unusual year-end sales activity
  - Accounts receivable growth is consistent with revenue growth

PERFORMING PRELIMINARY ANALYTICAL PROCEDURES

- Revenue growth, receivables growth, and gross margin are consistent with activity in industry
- No unusual concentration of sales made to customers
- Accounts receivable turnover is not significantly different from prior year
- Ratio of allowance for doubtful accounts to total receivables or to credit sales is similar to the prior year

PERFORMING PRELIMINARY ANALYTICAL PROCEDURES

- Auditor compares unaudited financial statements with both past results and industry trends
- Following relationships might suggest a heightened risk of fraud
  - Revenue increases even though there is strong competition
  - Revenue increases are not consistent with industry or economy
  - Gross margins are higher than average, or there is an unexpected change in gross margins

PERFORMING PRELIMINARY ANALYTICAL PROCEDURES

- Large increases in revenue occur near end of the quarter or year
- Revenue has grown and net income has increased, but there is negative cash flow from operations

TREND ANALYSIS

- Considering ratios or accounts over time
- Include the following
  - Monthly sales analysis compared with past years and budgets
  - Identification of spikes in sales at end of quarters or end of the year
  - Trends in discounts allowed to customers that exceed both past experience and industry average

EXHIBIT 9.7 - USING RATIOS IN PRELIMINARY ANALYTICAL PROCEDURES IN THE REVENUE CYCLE

- Gross margin analysis
- Turnover of receivables (ratio of credit sales to average net receivables) or the number of days' sales in accounts receivable
- Average receivables balance per customer
- Receivables as a percentage of current assets
- Aging of receivables
- Allowance for uncollectible accounts as a percentage of accounts receivable
- Bad debt expense as a percentage of net credit sales
- Sales in the last month (or quarter) to total sales
- Sales discounts to credit sales
- Returns and allowances as a percentage of sales

COMPARING CLIENT' S RATIOS WITH AUDITOR' S EXPECTATIONS

- Consider business reasons for changes
  - Explore possible reasons for changes in ratios
  - Check for potential explanation for the changes
  - Look for corroborating evidence for potential explanation

LEARNING OBJECTIVE 6

DETERMINE APPROPRIATE RESPONSES TO IDENTIFIED RISKS OF MATERIAL MISSTATEMENT FOR REVENUE CYCLE ACCOUNTS, DISCLOSURES, AND ASSERTIONS

RESPONDING TO IDENTIFIED RISKS OF MATERIAL MISSTATEMENT

- Develop an audit approach that contains substantive procedures and tests of controls
  - Sufficiency and appropriateness of selected procedures will vary for each relevant assertion
  - Customize audit program based on assessment of risk of material misstatement

EXHIBIT 9.8 - PANEL A: SUFFICIENCY OF EVIDENCE FOR COMPLETENESS OF REVENUE

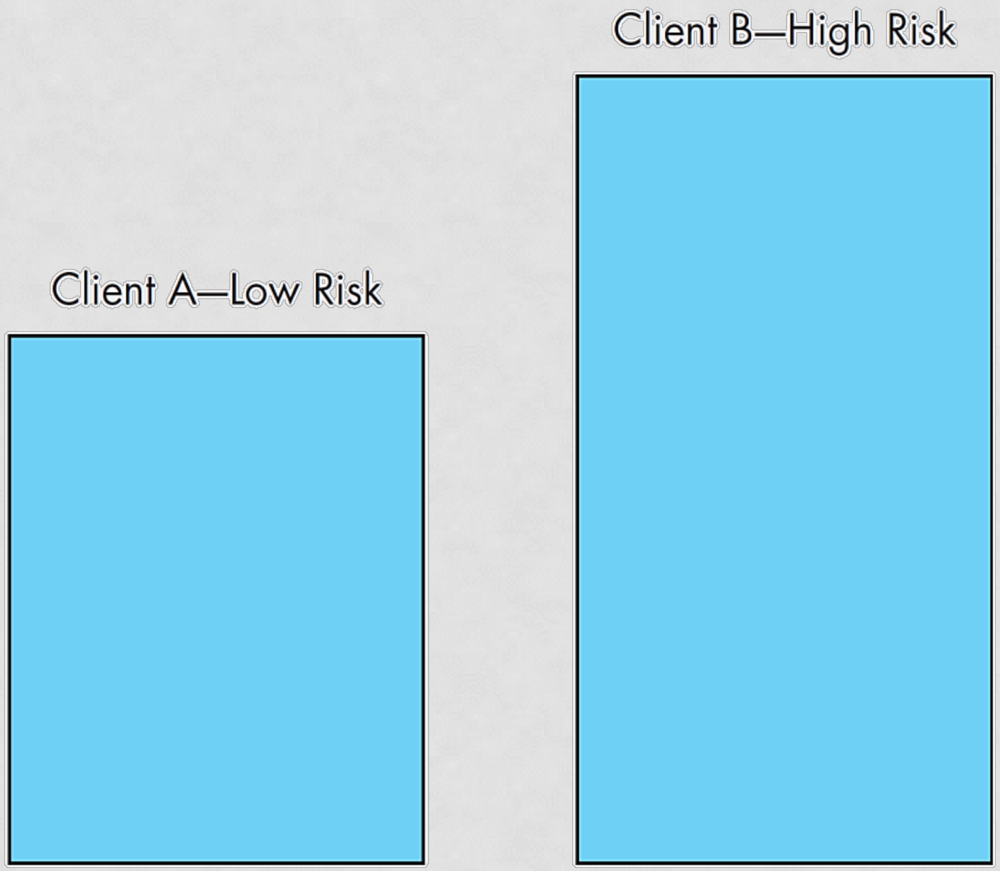
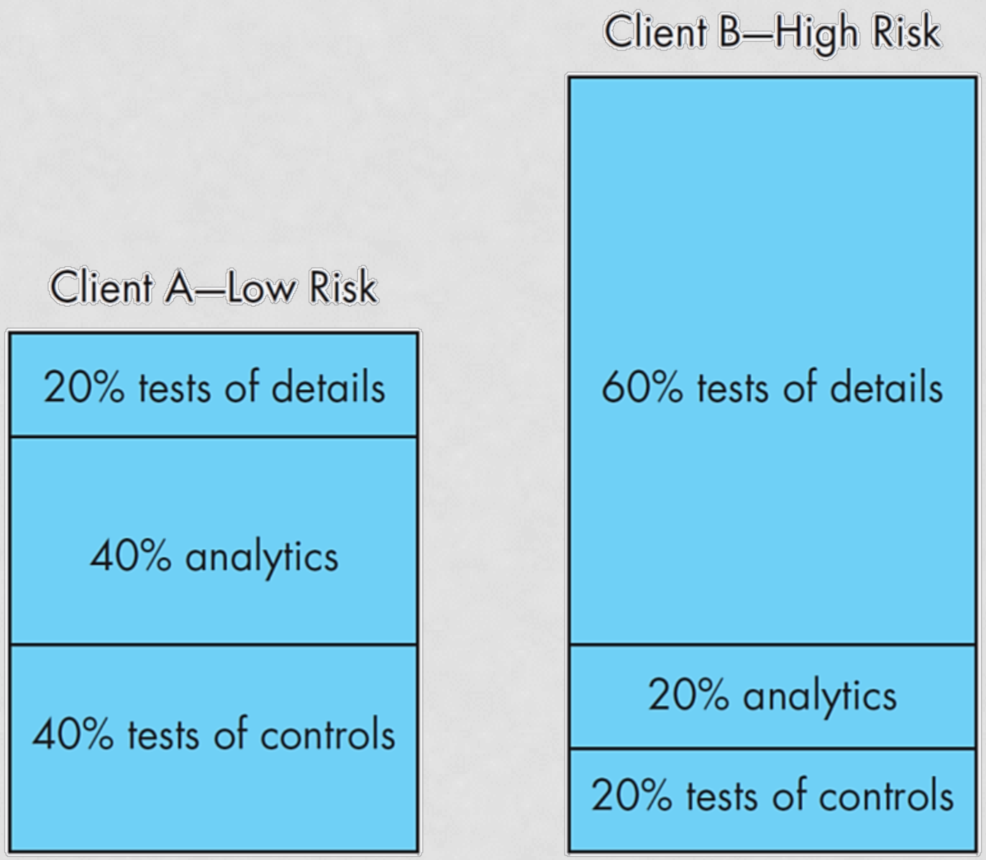


EXHIBIT 9.8 - PANEL B: APPROACHES TO OBTAINING AUDIT EVIDENCE FOR COMPLETENESS OF REVENUE



LEARNING OBJECTIVE 7

DETERMINE APPROPRIATE TESTS OF CONTROLS AND CONSIDER THE RESULTS OF TESTS OF CONTROLS FOR REVENUE CYCLE ACCOUNTS, DISCLOSURES, AND ASSERTIONS

TESTS OF TRANSACTION CONTROLS

- Inquiry of personnel performing the control
- Observation of control being performed
- Inspection of documentation confirming that control has been performed
- Reperformance of control by the individual testing the control

APPROACHES TO TESTING RECONCILIATION CONTROL

- Involve one or more of the following
  - Inquiry
  - Observation
  - Inspection
  - Reperformance

TESTS OF CONTROLS

- **Selecting samples of transactions and obtaining supporting documents**
- **Reviewing monitoring controls**
- **Testing computer access controls**
- **Using generalized audit software (GAS) to match documents and look for gaps**
- **Reviewing customer complaints**

TESTS OF CONTROLS

- Reviewing documents such as reconciliations and management reports noting timely action taken
- Reviewing sales contracts

ANALYZING THE RESULTS OF TESTS OF CONTROLS

- Helps determine additional appropriate procedures
- If control deficiencies are identified:
  - Assess to determine their severity
  - Modify the preliminary control risk assessment
  - Document the implications of control deficiencies

ANALYZING THE RESULTS OF TESTS OF CONTROLS

- If no control deficiencies are identified:
  - Determine that preliminary assessment of control risk as low is still appropriate
  - Determine the extent that controls can provide evidence on correctness of account balances
  - Determine planned substantive audit procedures

LEARNING OBJECTIVE 8

DETERMINE AND APPLY SUFFICIENT APPROPRIATE SUBSTANTIVE AUDIT PROCEDURES FOR TESTING REVENUE CYCLE ACCOUNTS, DISCLOSURES, AND ASSERTIONS

OBTAINING SUBSTANTIVE EVIDENCE IN THE REVENUE CYCLE

- Substantive tests are performed to provide evidence that:
  - Sales transactions do exist and are properly valued
  - Accounts receivable exist
  - Balance in allowance account is reasonable
  - Fraudulent transactions are not included in financial statements

EXHIBIT 9.10 - MANAGEMENT ASSERTIONS AND SUBSTANTIVE PROCEDURES IN REVENUE CYCLE

Management Assertion	Substantive Procedure
Existence or occurrence—Recorded sales and accounts receivable are valid.	1. Perform substantive analytical procedures. 2. Trace sales invoices to customer orders and bills of lading. 3. Confirm balances or unpaid invoices with customers. 4. Examine subsequent collections as evidence that the sale existed. 5. Scan sales journal for duplicate entries.
Completeness—All sales are recorded.	1. Perform substantive analytical procedures. 2. Trace bills of lading to sales invoice and sales journal. 3. Account for sequence of sales invoices in sales journal.
Rights and obligations—Pledged, discounted, assigned, and related-party accounts receivable are properly accounted for in accordance with GAAP.	1. Inquire of management. 2. Review trial balance of accounts receivable for related parties. 3. Review loan agreements and minutes of board meetings.
Valuation or allocation—Sales and accounts receivable are properly valued and recorded in the correct period. Revenue has been recognized in accordance with GAAP.	1. Verify clerical accuracy of sales invoices and agreement of sales invoices with supporting documents. 2. Trace sales invoices to sales journal and customer's ledger. 3. Confirm balances or unpaid invoices with customers. 4. Foot sales journal and accounts receivable trial balance and reconcile accounts receivable trial balance with control account. 5. Review adequacy of the allowance for doubtful accounts. 6. Perform sales cutoff test.
Presentation and disclosure—Pledged, discounted, assigned, and related-party accounts receivable are properly disclosed. Revenue recognition policies have been properly disclosed.	1. Obtain confirmations from banks and other financial institutions. 2. Inquire of management. 3. Review work performed in other audit areas. 4. Review revenue recognition policies for appropriateness and consistency.

AUDITING IN PRACTICE - PERFORMING APPROPRIATE SUBSTANTIVE AUDIT PROCEDURES IN REVENUE CYCLE

- PCAOB reviewed Kyoto's audits for two companies and found deficiencies
  - It released its first inspection report citing failure to:
    - Obtain sufficient competent evidential matter to support its opinion on issuer's financial statements
    - Perform sufficient procedures to test the allowance for doubtful accounts
    - Perform adequate substantive analytical audit procedures to test revenue

REVENUE - SUBSTANTIVE ANALYTICAL PROCEDURES

- Perform reasonableness test or regression analysis
- If expectations
  - Differ significantly - Follow up with sufficient appropriate tests of details
  - Do not differ significantly - Reduce tests of details

REGRESSION ANALYSIS

- Performed as a time-series analysis
- Cross-sectional analysis - Designed to compare results across a number of locations
  - Allows auditor to identify any unusual store performance

REVENUE - SUBSTANTIVE TESTS OF DETAILS

- Primarily involve inspection of relevant client documentation
- Focused on existence and valuation assertions

REVENUE - EXISTENCE AND VALUATION ASSERTIONS

- Most relevant for revenue accounts
- Compare quantities billed and shipped with customer orders
- Verify clerical accuracy of sales invoices to provide assurance on valuation
- Useful technique - Computerized audit process

REVENUE - COMPLETENESS ASSERTION

- Assures completeness in:
  - Prenumbered shipping
  - Billing documents
- Audit software can be used to:
  - Look for gaps in recorded sales invoice numbers
  - Verify that missing numbers are appropriate and do not represent unrecorded sales

REVENUE - CUTOFF ISSUES

- Additional audit attention given to sales transactions recorded before and after year end
  - Whether a recorded revenue transaction actually occurred before end of accounting period
  - Whether transactions recorded in subsequent year actually relate to year being audited

REVENUE - CUTOFF ISSUES

- Following items examined to determine whether proper cutoff of sales and sales returns has been achieved

Cutoff Test	Items to Examine
Sales	Shipping documents and related recorded sales
Sales returns	Receiving reports and related credits to customer accounts

ACCOUNTS RECEIVABLE - SUBSTANTIVE PROCEDURES BASED ON AGED TRIAL BALANCE

- Starting point for accounts receivable substantive procedures is either of the following:
  - Obtaining a detailed aged accounts receivable trial balance from client
  - Manually preparing a trial balance
  - Using GAS to develop aging information

ACCOUNTS RECEIVABLE - SUBSTANTIVE PROCEDURES BASED ON AGED TRIAL BALANCE

- Aged trial balance used by auditor to:
  - Agree the detail to balance in control account
  - Select customer balances for confirmation
  - Identify amounts due from:
    - Officers, employees, or other related parties
    - Nontrade receivables that need to be separately disclosed
  - Help determine reasonableness of allowance for doubtful accounts by identifying past-due balances

ACCOUNTS RECEIVABLE - SUBSTANTIVE TESTS OF DETAILS - CONFIRMATIONS

- Used to ask client's customers to confirm existence and amount they owe to client
- Not necessarily assuring correct valuation
- Auditing standards require use of confirmations unless one of the following conditions exists:
  - Accounts receivable are not material
  - Use of confirmations would be ineffective
- Auditor' s assessment of risk of material misstatement is low and with sufficient assessment

AUDITING IN PRACTICE - A PCAOB PROPOSED AUDITING STANDARD ON CONFIRMATIONS

- Based on Exposure Draft, issued by PCAOB
  - Limits internal auditors' involvement in confirmation process
  - Clarifies that receipt of an oral response to a confirmation request does not meet definition of an external confirmation
  - Does not include exceptions for not confirming receivables

AUDITING IN PRACTICE - A PCAOB PROPOSED AUDITING STANDARD ON CONFIRMATIONS

- Communicates with those charged with governance if auditor concludes that management's refusal to allow confirmations is unreasonable
- Limits instances in which negative confirmation requests are the only form of confirmation request
  - To address assessed risk of material misstatement at assertion level
- Allows auditors to use electronic media to send confirmation requests and receive responses

POSITIVE CONFIRMATIONS

- Requesting customers to respond directly to auditor if they agree or disagree with indicated balance
- Auditors should inquire about:
  - Possibility of bill-and-hold transactions
  - Extended payment terms or nonstandard installment receivables
  - Unusual volume of sales to distributors/retailers

POSITIVE CONFIRMATIONS

- **Side letter**
  - Agreement containing contract terms not part of formal contract
  - Increase in audit risk because they enable key contract terms to be hidden from auditor

NEGATIVE CONFIRMATIONS

- Requesting customers to respond directly to auditor only if they disagree with indicated balance
- Less expensive to administer
- Used if following conditions exist:
  - Large number of relatively small customer balances
  - Assessed level of risk of material misstatement for receivables and related revenue transactions is low
  - Auditor believes that customers are likely to give proper attention to requests

AUDITING IN PRACTICE - PCAOB ENFORCEMENT ACTIONS RELATED TO CONFIRMING ACCOUNTS RECEIVABLE

- There exist examples in which auditors inexplicably do not adhere to U.S. professional auditing standards
- Most audits are performed in a quality manner
- Certain examples illustrate that problems occur and that you should be aware of such a possibility as you enter the profession

THE CONFIRMATION PROCESS

- Prepared using GAS
- Customers requested to return confirmations directly to auditor's office
- Undeliverable confirmations raise auditor's suspicion regarding existence of recorded receivable

SAMPLE SELECTION AND SAMPLING UNIT

- Sample selection - Confirm the large balances and randomly select some of the smaller balances
  - Include in the sample accounts that:
    - Have credit balances
    - Are significant and past due
    - Have unusual customer names that are unfamiliar to the auditor
- Sampling unit - Customer's entire account balance or one or more of the unpaid invoices that make up that balance

UNDELIVERABLE CONFIRMATIONS

- Determine customer's existence if:
  - Confirmations are returned as undeliverable - Determine the reason
  - Wrong address used - Obtain correct address and send another request

FOLLOW-UP TO NONRESPONSES FOR POSITIVE CONFIRMATIONS

- Required for confirmations that are not returned within a reasonable time after being mailed
- **Alternative procedures**:
  - Procedures used to obtain evidence about existence and valuation of accounts receivable when a positive confirmation is not returned
  - Such procedures include:
    - Subsequent collection of the balance after year end
    - Examination of supporting documents

FOLLOW-UP PROCEDURES FOR EXCEPTIONS NOTED ON POSITIVE CONFIRMATIONS

- **Exceptions**: Differences between a customer's records and client's records reported on positive or negative confirmations
  - Investigated to determine difference being:
    - Customer error
    - Item in dispute
    - Client misstatement
    - **Timing differences**: Confirmation exceptions caused by transactions that are in process at confirmation date
      - These are not misstatements

FOLLOW-UP FOR NEGATIVE CONFIRMATIONS

- Customer may not respond even though balance is wrong because:
  - Letter was lost, misplaced, or sent to wrong address
  - Customer did not understand the request
  - Request was simply ignored and thrown away
- Reasons for negative confirmations being returned
  - Customer did not understand the request

FOLLOW-UP FOR NEGATIVE CONFIRMATIONS

  - Customer confirms an incorrect amount because payments or shipments are in transit
  - Amount recorded by the client is in error
- Follow-up work performed to determine whether confirmed amount represents a misstatement
- If errors are detected, use expanded procedures to:
  - Find underlying cause of errors
  - Estimate amount of misstatement in account balance

ADDITIONAL PROCEDURES WHEN ACCOUNTS ARE CONFIRMED AT AN INTERIM DATE

- Gathering additional evidence during roll-forward period if receivables confirmed at an interim date
- Roll-forward procedures include:
  - Comparing customer balances at interim confirmation date with year-end balances and confirming their increase
  - Checking whether monthly sales, collections, sales discounts, and sales returns and allowances during the roll-forward period appear out of line compared with those of prior periods

ADDITIONAL PROCEDURES WHEN ACCOUNTS ARE CONFIRMED AT AN INTERIM DATE

- Reconciling receivable subsidiary records to general ledger at confirmation date and year end
- For returns and allowances at year end, testing the cutoff of:
  - Sales
  - Cash collections
  - Credit memos
- Scanning journals to identify receivables postings from unusual sources and investigate unusual items

ADDITIONAL PROCEDURES WHEN ACCOUNTS ARE CONFIRMED AT AN INTERIM DATE

- Computing number of days' sales in receivables at confirmation date and year end, compared to prior periods
- Computing gross profit percentage during roll-forward period

ACCOUNTS RECEIVABLE - SUBSTANTIVE PROCEDURES FOR ALLOWANCE ACCOUNT

- Determining reasonableness of client's estimate of allowance for doubtful accounts is a difficult task
- Client's estimate must reflect:
  - Economic status of client's customers
  - Current economic conditions
  - An informed expectation about potential default on payment

APPROACHES USED TO OBTAIN EVIDENCE ABOUT REASONABLENESS OF CLIENT' S ESTIMATE

- Inquire of management about collectibility of large and long overdue customer balances
- Develop an independent model
- Review credit reports from outside credit bureaus
- Review customer correspondence files
- Review customer's latest financial statements
  - For unusually large or past due accounts
- Inquire about client's procedures for deciding when to write off an account

ACCOUNTS RECEIVABLE - OTHER SUBSTANTIVE PROCEDURES ACCOUNTS RECEIVABLE: RIGHTS AND OBLIGATIONS

- Some companies sell receivables to financial institutions but may retain responsibility for collecting them
- Receivables sold with recourse, discounted, or pledged as collateral on loans should be disclosed in notes to financial statements

SUBSTANTIVE AUDIT PROCEDURES REVEALING RECEIVABLES OWNERSHIP AND RELATED DISCLOSURE ISSUES

- Reviewing all arrangements and obtaining confirmations from banks about contingent liabilities
- Inquiring about activities related to receivables
- Scanning cash receipts journal for relatively large inflows of cash posted from unusual sources
- Obtaining bank confirmations, including information on obligations to bank and loan collateral
- Reviewing board of directors' minutes, generally containing approval for these items

ACCOUNTS RECEIVABLE - PRESENTATION AND DISCLOSURE

- Trade accounts receivable should be presented separately from other receivables
- Audit procedures directed toward identifying related-party transactions include the following
  - Reviewing SEC filings
  - Reviewing accounts receivable trial balance
  - Inquiring of management and audit committee about receivables from related parties

ACCOUNTS RECEIVABLE - PRESENTATION AND DISCLOSURE

- Material debit balances in accounts payable for amounts due from vendors should be reclassified as accounts receivable
- Material credit balances in accounts receivable should be reclassified as accounts payable
- Receivables not due within normal operating cycle or one year should be listed as noncurrent assets

AUDIT PROCEDURES TO IDENTIFY MISCLASSIFIED RECEIVABLES

- Making inquiries of management
- Reviewing aged trial balance for large or old outstanding balances
- Reading board of directors' minutes
- Scanning subsidiary ledger to identify unusually large receivable balances

POTENTIAL FRAUD RISK FACTORS IN REVENUE CYCLE

- Excessive credit memos or other credit adjustments to accounts receivable after end of fiscal year
- Customer complaints and discrepancies in accounts receivable confirmations
- Unusual entries to accounts receivable subsidiary ledger or sales journal
- Missing or altered source documents or inability of client to produce original documents in a reasonable period of time

POTENTIAL FRAUD RISK FACTORS IN REVENUE CYCLE

- Lack of cash flow from operating activities when income from operating activities has been reported
- Unusual reconciling differences between accounts receivable subsidiary ledger and control account
- Sales to customers in last month of fiscal period at terms more favorable than previous months
- Predated or postdated transactions
- Large or unusual adjustments to sales accounts just prior to or just after fiscal year end

FRAUD-RELATED AUDIT PROCEDURES USED TO RESPOND TO FRAUD RISK FACTORS

- Performing a thorough review of original source documents
- Analyzing and reviewing accounts receivable adjustments for period subsequent to balance sheet date
- Analyzing all large or unusual sales made near year end and vouching to original source documents
- Confirming terms of transaction directly with customer
- Comparing number of weeks of inventory in distribution channels with prior periods for unusual changes

FRAUD-RELATED AUDIT PROCEDURES USED TO RESPOND TO FRAUD RISK FACTORS

- **Scanning general ledger, accounts receivable subsidiary ledger, and sales journal for unusual activity**
- **Performing analytical reviews of credit memo and writing-off activity by comparing to prior periods**
- **Analyzing recoveries of written-off accounts**
- **Inquiring of company's non-accounting personnel for any unusual terms or conditions in connection with sales**

DOCUMENTATION REQUIREMENTS FOR ACCOUNTS RECEIVABLE

- Tests of adequacy of allowance for doubtful accounts
- Details on inquires made regarding whether receivables are sold, pledged, or assigned
- Cutoff tests
- Evidence of roll-forward procedures if confirmations were sent at an interim date

DOCUMENTATION RELATED TO THE REVENUE SUBSTANTIVE PROCEDURES

- Substantive analytical procedures performed
- Unusual sales transactions
- Information indicating an understanding of client's revenue recognition policies
- Identification of specific items tests
- Relevant information on tests of details