Chapter 14

Audit of the Sales and Collection Cycle: Tests of Controls and Substantive Tests of Transactions

■ **Concept Checks**

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1. a. The *customer order* is a request from the customer indicating the quantity and the description of the merchandise ordered.
   b. A *sales invoice* is a document indicating the description and quantity of goods sold, the price including freight, insurance, terms, and other relevant data. It is the method of indicating to the customer the amount owed for the sale and the due date of the payments. The original is sent to the customer and one or more copies are retained. The sales invoice is the document for recording sales in the accounting records.
   c. A *prelisting of cash receipts* is a list prepared when cash is received by someone who has no responsibility for recording sales, accounts receivable, or cash and who has no access to accounting records. It is used to verify whether cash received was recorded and deposited at the correct amounts and on a timely basis.
   d. The *monthly statement to customers* is the document prepared monthly and sent to each customer indicating the beginning balance of that customer's accounts receivable, the amount and date of each sale, cash payments received, credit memos issued, and the ending balance due. It is, in essence, a copy of the customer's portion of the accounts receivable master file.

2. A *shipping document* is prepared at the time of shipment indicating the quantity and description of goods ordered. It is used to generate an invoice to the customer. Assuring that all shipments are recorded and billed is important to addressing the completeness assertion, as well as the accuracy of the quantities billed.

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1. The following are the three main authorizations in the sales cycle:

   1. Credit is authorized before a sale takes place.

      Credit approval is critical to ensure that goods are only shipped to customers who have the ability to pay for the goods.

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2. Goods are shipped only after proper authorization.

   This authorization is to verify that goods are only shipped to valid customers who have the ability to pay.

3. Prices, including payment terms, freight, and discounts, are properly authorized.

   Prices are authorized to ensure that customers are charged the appropriate price consistent with company policy.

2. The following are the transaction-related audit objectives for sales and examples of internal controls that can reduce the likelihood of misstatements.

TRANSACTION-RELATED AUDIT OBJECTIVE	KEY INTERNAL CONTROLS
1. Recorded sales are for shipments actually made to existing customers (occurrence).	■ Recording of sales is supported by authorized shipping documents and approved customer orders. ■ Credit is authorized before shipment takes place. ■ Sales invoices are prenumbered and properly accounted for. ■ Only customer numbers existing in the computer data files are accepted when they are entered. ■ Monthly statements are sent to customers; complaints receive independent follow-up.
2. Existing sales transactions are recorded (completeness).	■ Shipping documents are prenumbered and accounted for. ■ Sales invoices are prenumbered and accounted for.
3. Recorded sales are for the amount of goods shipped and are correctly billed and recorded (accuracy).	■ Determination of prices, terms, freight, and discounts is properly authorized. ■ Internal verification of invoice preparation. ■ Approved unit selling prices are entered into the computer and used for sales. ■ Batch totals are compared with computer summary reports.

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TRANSACTION-RELATED AUDIT OBJECTIVE	KEY INTERNAL CONTROLS
4. Sales transactions are properly included in the accounts receivable master file and are correctly summarized (posting and summarization).	■ Regular monthly statements sent to customers. ■ Internal verification of accounts receivable master file contents. ■ Comparison of accounts receivable master file or trial balance with general ledger balance.
5. Sales transactions are properly classified (classification).	■ Use of adequate chart of accounts. ■ Internal review and verification of the account classifications.
6. Sales are recorded on the correct dates (timing).	■ Procedures requiring billing and recording of sales on a daily basis as close to the time of occurrence as possible. ■ Internal verification of timely recording of transactions.

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1. Auditors are generally more concerned with the completeness of cash receipts as cash is a target for theft or defalcation. The occurrence of cash can be readily verified using bank statements and other evidence.

2. The theft of cash receipts from customer payments on account is easily identified by sending customers monthly statements, unless the theft is covered by some other means. One way to hide the theft of cash receipts is to write-off the customer's receivable.

■ Review Questions

14-1 a. The *bill of lading* is a document prepared at the time of shipment of goods to a customer indicating the description of the merchandise, the quantity shipped, and other data. Formally, it is a written contract of the shipment and receipt of goods between the seller and carrier. It is also used as a signal to bill the client. The original is sent to the customer and one or more copies are retained.

b. The *credit memo* is a document indicating a reduction in the amount due from a customer because of returned goods or an allowance granted. It often takes the same general form as a sales invoice, but it reduces the customer's accounts receivable balance rather than increasing it.

14-1 (continued)

c. A *remittance advice* is a document mailed to the customer and typically returned to the seller with the customer's payment. It indicates the customer name, the sales invoice number, and the amount of the invoice. A remittance advice is used as a record of the payment received to permit the immediate deposit of checks received and to improve control over the custody of assets.

d. The *accounts receivable trial balance* is a report from the accounts receivable master file that shows the amount receivable from each customer at a point in time. An *aged trial balance* includes the total balance outstanding and the number of days the receivable has been outstanding, grouped by category of days (such as less than 30 days, 31 to 60 days, and so on).

14-2 Proper credit approval for sales helps minimize the amount of bad debts and the collection effort for accounts receivable by requiring that each sale be evaluated for collection potential.

Adequate controls in the credit function enable the auditor to place more reliance on the client's estimate of uncollectible accounts. Without these controls, the auditor would have to make his or her own credit checks on the customers in order to be convinced that the allowance for uncollectible accounts is reasonable.

14-3 The sales journal contains the record of each sales transaction that includes the customer name, date, amount, and the account classification for each transaction. The sales journal generally represents the record of each individual transaction. Typically, the sales journal accumulates transactions for a period of time, which is often monthly. Transactions recorded in the sales journal are then posted to the general ledger, and if the transaction is for sales on account, the accounts receivable master file is updated for each transaction.

The accounts receivable master file is used to record individual sales, cash receipts, and sales returns and allowances for each customer and to maintain customer account balances. The master file is updated using data from the sales journal, sales return journal, and cash receipts journal. The total in the accounts receivable master file equals the total in the accounts receivable general ledger account.

14-4 BestSellers.com could integrate its online ordering system with its inventory system so that a book shipment is made only after the customer's credit card company approves the customer's purchase. Because credit card issuers often transfer funds electronically almost immediately after a sale, BestSellers.com could also set up their system to ship books only after payment has been received by the credit card issuer. Finally, BestSellers.com could arrange with an online credit service bureau to run credit checks on customers purchasing over a preset minimum amount. Although BestSellers.com sells its goods through the Internet, the company should still record sales revenue when the books are shipped to customers.

14-5

Tests of controls:

1. On a sample of sales invoices, examine proper authorization and indication of internal verification of sales amounts.
2. Examine approved computer file that reflects the master file contents containing unit selling prices.
3. Examine file of batch control totals for initials of data control clerk who reconciled those totals; compare totals to summary reports.

Substantive tests of transactions:

1. Recompute information on sales invoices.
2. Trace entries in sales journal to related sales invoices.
3. Trace detail on sales invoices to shipping documents, approved price lists, and customers' orders.

14-6 The most important duties that should be segregated in the sales and collection cycle are:

1. Receiving and approving orders for credit sales
2. Shipping goods
3. Billing customers and recording sales
4. Maintaining inventory records
5. Maintaining general accounting records
6. Maintaining detailed accounts receivable records
7. Processing cash receipts
8. Granting credit and pursuing unpaid accounts

Segregation of duties should be used extensively in the sales and collection cycle for two reasons. First, cash receipts are subject to easy manipulation. Second, the large number and nature of transactions within the cycle make the procedure of cross-checking, where one employee's duties automatically serve to verify the accuracy of another's, highly desirable.

If the asset-handling activities (shipping goods and processing cash receipts) are combined with their respective accountability activities (maintaining inventory, accounts receivable, and general accounting records), a serious deficiency with respect to safeguarding those assets exists. It would be easy for an employee, by either omitting or adding an entry, to use the company's assets for his or her own purpose. If the credit granting function is combined with the sales function, there may be a tendency of sales staff to optimize volume even at the expense of high bad debt write-offs.

14-7 The use of prenumbered documents is meant to prevent the failure to bill or record sales as well as to prevent duplicate billings and recordings. An example of a useful control to provide reasonable assurance that all shipments are billed is for the billing clerk to file a copy of all shipping documents in sequential order after a shipment has been billed. Periodically, someone can account for all numbers in the sequence and investigate the reason for missing documents. Computer programs can be used to identify gaps and duplicates in the sequence. The same type of useful test in this area is to account for the sequence of duplicate sales invoices in the sales journal, examining for omitted numbers, duplicate numbers, or invoices outside the normal sequence. This test simultaneously provides evidence of both the occurrence and completeness objectives.

14-8 The purpose of footing and crossfooting the sales journal and tracing the totals to the general ledger is to determine that sales transactions are properly included in the accounts receivable master file and are correctly summarized. The auditor will make a sample selection from the sales journal to perform tests of controls and substantive tests of transactions, so he or she must determine that the general ledger agrees with the sales journal.

14-9 The verification of sales returns and allowances is quite different from the verification of sales for three primary reasons:

1. Sales returns and allowances are normally an insignificant portion of operations and therefore receive little attention from the auditor.
2. The primary emphasis the auditor places on sales returns and allowances is to determine that returns and allowances are properly authorized and that sales are not overstated at year-end and subsequently reversed by the issuance of returns.
3. The completeness objective cannot be ignored because unrecorded sales returns and allowances can materially overstate net income.

14-10 Cash is the most liquid asset that a company owns and thus it is the most likely target of misappropriation. The emphasis the auditor places on the possibility of misappropriation of cash is not inconsistent with his or her responsibility, which is to determine the fairness of the presentation of the financial statements. If material fraud has occurred, and it is not fully disclosed in the financial statements, those statements are not fairly presented.

14-11

TRANSACTION-RELATED AUDIT OBJECTIVE	KEY INTERNAL CONTROLS
1. Recorded cash receipts are for funds actually received by the company (occurrence).	■ Separation of duties between handling cash and record keeping. ■ Independent reconciliation of bank accounts.
2. Cash received is recorded in the cash receipts journal (completeness).	■ Separation of duties between handling cash and record keeping. ■ Use of remittance advices or a prelisting of cash. ■ Immediate endorsement of incoming checks. ■ Internal verification of the recording of cash receipts. ■ Regular monthly statements to customers.
3. Cash receipts are deposited and recorded at the amounts received (accuracy).	■ Same as 2 above. ■ Approval of cash discounts. ■ Regular reconciliation of bank accounts. ■ Batch totals are compared with computer summary reports.
4. Cash receipts are properly included in the accounts receivable master file and are correctly summarized (posting and summarization).	■ Regular monthly statements to customers. ■ Internal verification of accounts receivable master file contents. ■ Comparison of accounts receivable master file or trial balance totals with general ledger balance.
5. Cash receipts transactions are properly classified (classification).	■ Use of adequate chart of accounts. ■ Internal review and verification.
6. Cash receipts are recorded on the correct dates (timing).	■ Procedure requiring recording of cash receipts on a daily basis. ■ Internal verification.

14-12 Audit procedures that the auditor can use to determine whether all cash receipts were recorded are:

- Discussion with personnel and observation of the separation of duties between handling cash and record keeping.
- Account for numerical sequence of remittance advices or examine prelisting of cash receipts.
- Observe immediate endorsement of incoming checks.
- Examine indication of internal verification of the recording of cash receipts.
- Observe whether monthly statements are sent to customers.
- Trace from remittance advices or prelisting to cash receipts journal.

14-13 Proof of cash receipts is a procedure to test whether all recorded cash receipts have been deposited in the bank account. In this test, the total cash receipts recorded in the cash receipts journal for a period of time, such as a month, are reconciled to the actual deposits made to the bank during the same time period. The procedure is not useful to discover cash receipts that have not been recorded in the journals or time lags in making deposits, but it is useful to discover recorded cash receipts that have not been deposited, unrecorded deposits, unrecorded loans, bank loans deposited directly into the bank account, and similar misstatements.

14-14 Lapping is the postponement of entries for the collection of receivables to conceal an existing cash shortage. The fraud is perpetrated by someone who records cash in the cash receipts journal and then enters them into the computer system. The person defers recording the cash receipts from one customer and covers the shortage with receipts from another customer. These in turn are covered by the receipts from a third customer a few days later. The employee must either continue to cover the shortage through lapping, replace the stolen money, or find another way to conceal the shortage.

This fraud can be detected by comparing the name, amount, and dates shown on remittance advices to cash receipts journal entries and related duplicate deposit slips. Since the procedure is relatively time-consuming, auditors ordinarily perform the procedure only where there is a specific concern with fraud because of internal control deficiencies discovered.

14-15 The audit procedures most likely to be used to verify accounts receivable charged off as uncollectible and the purpose of each procedure are as follows:

- Examine approvals by the appropriate persons of individual accounts charged off. The purpose is to determine that charge-offs are approved.
- Examine correspondence in client’s files that indicates the uncollectibility of the accounts for a selected number of write-offs. The purpose is to determine that the account appears to be uncollectible.

14-15 (continued)

- Examine credit records as an indication of the uncollectibility of an account. The purpose is the same as the previous procedure.
- Consider the reason for the charge-off compared to the company policy for writing off uncollectible accounts. The purpose is to determine whether or not company policy is being followed.

14-16 It is often acceptable to perform tests of controls and substantive tests of transactions at an interim date. The auditor may decide it is necessary to test the untested period at year-end. It is acceptable to perform tests of controls and substantive tests of transactions for sales and cash receipts at an interim date and not perform additional tests of the system at year-end under the following circumstances:

- The auditor believes that internal controls are effective.
- The auditor does not anticipate significant changes in the internal controls during the remaining period.
- The transactions normally occurring between the completion of the tests of controls and substantive tests of transactions and the end of the year are similar to the transactions prior to the test date.
- The remaining period is not too long.

14-17 The primary objective of the tests of controls and substantive tests of transactions for sales and cash receipts is to determine whether or not the auditor may rely on internal controls to produce accurate information. If it is determined through tests of controls and substantive tests of transactions that the system provides reliable information as to accounts receivable balances, the auditor may reduce the sample size for the confirmation of accounts receivable and adjust the type of confirmation and timing of the tests. If the system is not considered effective because of deficiencies in internal control, the sample size must be increased, positive confirmations will probably be necessary, and the confirmations will most likely be as of the balance sheet date.

14-18 Generally, successful tests of controls and substantive tests of transactions allow for a reduction of tests of details of balance at year-end. However, Diane Smith chose the month of March, which only represents one-twelfth of the year, as her test period. With such a short test period, Diane cannot conclude that she has selected a representative sample from the total population; therefore, without testing additional months (most firms would require at least nine months coverage), Diane should not change the scope of her tests of details of balances at year-end.

■ Multiple Choice Questions From CPA Examinations

14-19 a. (2) b. (1) c. (3)

14-20 a. (2) b. (3) c. (2)

14-21 a. (4) b. (2) c. (3)

■ Multiple Choice Questions From Becker CPA Exam Review

14-22 a. (2) b. (1) c. (1)

■ Discussion Questions and Problems

14-23 1.
a. Recorded sales are to valid customers who are able to pay (Occurrence).
b. Select a sample of sales recorded in the sales journal and determine if the appropriate individuals approved the corresponding customer order.
c. Sales may be overstated if customer is unable to pay for the goods.
d. Examine sales returns and write-offs of accounts during the year to determine if returns and write-offs are the result of customers unable to pay. Review aging of accounts receivable to determine if accounts in older aging categories include sales transactions that are unlikely to be collected.

2.
a. Existing sales transactions are recorded (Completeness) and sales are recorded on the correct dates (Timing).
b. Inquire of shipping personnel about the process they use to forward shipping documents to accounting and observe the timeliness of when that occurs.
c. Goods shipped may not be recorded in the sales journal at all or in the wrong time period thereby understating sales.
d. Compare date per shipping order to date of posting in sales journal for a sample of shipments.

3.
a. Recorded sales are for shipments actually made (Occurrence) and all shipments are recorded as sales (Completeness).
b. Review the client's documentation for the sequence of bills of lading.
c. Shipments could be recorded twice (due to duplicate bills of lading), which would overstate sales, or shipments may not be recorded (due to missing bills of lading), which would understate sales.
d. Review the list of bills of lading to determine if there are duplicates or missing documents.

14-23 (continued)

4. a. Online sales are recorded in the sales system (Completeness).
   b. Review online sales system documentation and make inquiries of client personnel to determine that the automatic interface is a part of the system design. Enter a sample of test transactions of online sales to determine if test data are included in the sales journals. Reverse all test data items.
   c. Online sales may not be recorded in the sales account, which would understate sales.
   d. Trace a sample of online sales transactions to the sales journal.

5. a. Recorded sales are billed using approved prices (Accuracy).
   b. Obtain a list of pre-approved unit prices in the master file. Enter product numbers into the sales system to determine if the unit price presented is correct. Inquire about access privileges to the master file. Attempt to login to access the master file.
   c. Sales transactions could be recorded using incorrect amounts.
   d. Compare a sample of prices on a sample of sales invoices to the approved prices lists at the time the sale occurred.

6. a. Recorded sales are for the correct amounts (Accuracy).
   b. Review a sample of sales transactions to determine if there is documentation of the independent verification.
   c. Sales could be misstated because they are recorded at inaccurate amounts.
   d. For a sample of sales transactions, verify the accuracy of the sales amount.

7. a. Recorded sales are for shipments actually made (Occurrence).
   b. Review systems documentation and make inquiries of personnel to determine if the sales application is programmed to only allow recording of sales with a valid bill of lading number. Attempt to enter a sales transaction into the sales journal without a bill of lading number to determine if the transaction is rejected.
   c. Sales could be recorded even though goods have not been shipped to customers, which overstates sales.
   d. Review the sales journal to determine if there is a corresponding bill of lading for a sample of sales journal entries.

14-23 (continued)

8. a. Sales transactions are correctly included in the accounts receivable master file and are correctly summarized (Posting and Summarization).
   b. Examine evidence that the accounts receivable master file has been reconciled to the general ledger for accounts receivable.
   c. The accounts receivable master file does not reflect transactions that are included in the ending accounts receivable general ledger balance.
   d. Compare the dates of entry in the sales journal for a sample of sales transactions to the date the transactions are posted in the accounts receivable master file.

9. a. All cash sales are recorded (Completeness).
   b. Inquire about duties for individuals responsible for cash collections and observe whether they have access to accounting or shipping functions.
   c. The person handling cash collections may misappropriate cash and not record the cash sale in accounting records understating cash and sales.
   d. Trace a sample of shipments to determine if they have been recorded as sales in the accounting records.

14-24

a.

Business Function	Starbucks	Amazon	Physician Practice	University
Processing customer orders	Baristas receive orders from customers at the cash register or through on-line ordering application.	Customers shop and process orders online via the Amazon.com Web site.	Physicians provide medical treatments based on the physician's diagnosis while patient is at the office.	University registrars have records of enrolled students. Students are billed in advance of a semester based on whether they are full-time or part-time students.
Granting credit	No credit approval is required for cash sales. Debit or credit card sales are verified by swiping of card, which verifies transaction. Large debit or credit card sales require online credit approval from credit card company.	Customers make purchases via debit or credit cards. The Amazon system verifies credit worthiness with credit card company before completing sales order.	Before services are provided, patients must present documentation of health insurance coverage. Physician practices generally are aware of insurance coverage for specific health plans. For those patients without health insurance, some practices require prepayment of services and they often require patients to sign legal documents indicating their obligation to pay.	Many universities do not grant credit for tuition. Rather, students seek credit from outside sources (e.g., student loans) and remit the cash to the university. If tuition is not paid by a certain date in the early part of a semester, the student is no longer allowed to take classes.
Shipping goods	Goods are delivered to customer on site just after order is placed.	Goods are shipped after the online sale is processed. Shipment is made via third-party shippers (e.g., FedEx, UPS, etc.).	Medical services are provided to the patient at the physician's office. No shipment of goods is required.	There is no shipment of goods. Universities deliver classes onsite or online.

14-24 (continued)

Business Function	Starbucks	Amazon	Physician Practice	University
Billing customers and recording sales	All sales are entered in the cash register upon ordering.	The Amazon online sales system captures the sales order at the point of ordering and customer debit or credit card transactions are approved before order is complete; payment is processed by Amazon from credit card companies, generally daily. No separate billing by Amazon is required.	Co-payments are collected from patient upon exiting the physician's offices. Physician practices bill insurance companies for services provided. Any non-covered services are later billed to the patient.	Tuition is billed in advance of providing access to classes. Tuition is recorded as a receivable when billed and the revenue is recorded once the courses are delivered.
Processing and recording cash receipts	Cash is collected as order is placed and cash is entered in the cash register drawer. Subsequently, cash in drawer is reconciled to records generated by the cash register.	Cash is received electronically from customer bank accounts for debit card transactions and from credit card company electronic funds transfer (EFT) transactions.	A cashier at the physician's office collects any co-payments or other amounts as patient exits the physician's office. Payments from insurance companies are sent to the physician's offices for processing.	Tuition payments are typically received at the university's cashier's office or by mail via a bank lockbox.
Processing and recording sales returns and discounts	Returns or discounts are recorded using the cash register. Most likely, larger returns or discounts must be approved by the store manager.	Customers must ship merchandise for return back to specified Amazon distribution center for processing. Discounts are applied electronically by the Amazon online sales system at the point of customer ordering.	Generally, pre-negotiated discounts associated with health insurance are processed at the point of checkout. However, other discounts may be required by the insurance company, which would be processed later by the physician's billing office.	Any tuition waivers or scholarships provided by the university are processed as part of the billing process as approved by the registrar's office.

14-24 (continued)

Business Function	Starbucks	Amazon	Physician Practice	University
Writing off uncollectible accounts	The only uncollectible accounts relate to purchases made with an invalid credit card.	The only uncollectible accounts relate to purchases made with an invalid credit card.	Because of the complexities surrounding health insurance coverage and because of the number of individuals without health insurance, there is a high likelihood that patient receivables may not be fully collectible. Physician practices closely monitor uncollectible accounts and periodically write-off those deemed uncollectible. Many are turned over to collection agencies for processing.	If tuition is not paid in full, the student generally is unable to complete courses. Most universities require payment in full before a certain point in the semester. When tuition is unpaid, the student is no longer able to take the course. While some private universities may set up longer-term receivables, most universities require the student to obtain loans from non-university sources; thus, they often do not maintain large long-term receivable balances. Write-off of tuition receivables would be approved by the university's billing office.
Providing for bad debts	Because most sales are made with cash or debit card, the only provision for bad debts relates to sales paid by credit cards that are not valid.	Because most sales are made with debit or credit card, the only provision for bad debts relates to sales paid by invalid debit or credit cards.	Because of the high likelihood of uncollectible patient receivables, the provision for bad debts Is likely to be a material account.	The university's accounting function would be required to record an estimate of likely bad debts associated with unpaid tuition.

14-24 (continued)

b.

Transaction Objective	Starbucks	Amazon	Physician Practice	University
Occurrence of sales	The auditor would likely reconcile sales records generated by the cash register system to cash deposited at the bank to obtain evidence that recorded sales occurred. If sales are overstated, no cash would have been received from customers for those invalid sales. So, cash deposited would be less than sales in that situation. The auditor may perform substantive analytical procedures that examine the relationship between sales recorded and inventory usages.	The auditor could inspect documentation from the Amazon distribution centers that goods were shipped for a sample of sales transactions recorded. The auditor could also examine subsequent electronic fund transfers from banks and credit card companies for sales orders processed.	The auditor could select a sample of patient revenue transactions recorded and verify that there was documentation of medical procedures performed in the patient's medical records.	The auditor could select a sample of tuition revenue transactions and verify payment was received from the student for the amounts billed. The auditor could also verify records in the registrar's office that the student is enrolled and course grades were issued for the semester paid.

14-24 (continued)

c. Physician offices and universities would generally not have sales return activities. While Starbucks may receive returns for some merchandise in their stores (e.g., coffee mugs), they would likely not process a high volume of returns for drinks, which are usually consumed shortly after purchase.

d. Starbucks and Amazon most likely would not have a large volume of write-offs of uncollectible accounts given they generally accept payment in cash and debit or credit cards, which are processed daily by bank and credit companies.

14-25

1. a. Test of control
   b. (1) Cash received is recorded in the cash receipts journal. (Completeness)
      (2) Cash receipts are recorded on the correct dates. (Timing)
   c. Observation or inspection

2. a. Substantive test of transactions
   b. (1) Recorded receipts are for funds actually received by the company. (Occurrence)
      (2) Cash received is recorded in the cash receipts journal. (Completeness)
      (3) Cash receipts are deposited at the amount received. (Accuracy)
      (4) Cash receipts are recorded on the correct dates. (Timing)
   c. Inspection

3. a. Test of control
   b. Existing sales transactions are recorded. (Completeness)
   c. Inspection

4. a. Test of control
   b. Recorded sales are for shipments actually made to existing customers. (Occurrence)
   c. Inspection

5. a. Substantive test of transactions
   b. Recorded sales are for the amount of goods shipped. (Accuracy)
   c. Inspection

14-25 (continued)

6. a. Substantive test of transactions
   b. Sales transactions are properly included in the accounts receivable master file and are correctly summarized. (Posting and summarization)
   c. Reperformance

7. a. Test of control
   b. Recorded sales returns are for returns from existing customers. (Occurrence)
   c. Inspection

14-26

POSSIBLE ERROR OR FRAUD	CONTROL
1. Goods are removed from inventory for unauthorized orders.	f. Approved sales orders are required for goods to be released from warehouse.
2. Credit sales are made to customers with unsatisfactory credit ratings.	a. Customer orders are compared with an approved customer list.
3. Invoices are sent to co-participants in a fraudulent scheme, and sales are recorded for fictitious transactions.	i. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed.
4. Good shipped to customers do not agree with goods ordered by customers.	h. Shipping clerks compare goods received from warehouse with approved sales orders.
5. Invoices are sent for shipped goods, but are not recorded in the sales journal.	k. Daily sales summaries are compared with control total of invoices.
6. Invoices are sent for shipped goods, and are recorded in the sales journal, but are not posted to any customer accounts.	j. Control amounts posted to the accounts receivable ledger are compared with the control totals of invoices.
7. Invoices for goods sold are posted to incorrect customer accounts.	g. Monthly statements are mailed to customers with outstanding balances.
8. Invoices for goods sold are posted to incorrect customer accounts.	e. Goods returned for credit are approved by the supervisor of the sales department.

14-27 a. (2) b. (3) c. (4)

14-28

a. The COSO report identifies 347 fraud companies. Of these frauds, 61% involved improper revenue recognition.

b. The two categories of improper revenue recognition are recording of fictitious revenue, and recording revenues prematurely.

Fictitious revenue - For fraud involving fictitious revenue, an actual sale did not occur and revenue should not have been recognized, such as sham sales in which the goods were never shipped.

Premature revenue recognition – These frauds involve an actual sale, but the company recognized some or all of the revenue in a period before it was earned. For example, a company might recognize revenue for goods shipped in the subsequent period, or recognized revenue that was not yet earned because the company had ongoing commitments related to the sale, such as an equipment servicing commitment.

c. The COSO report describes several techniques to overstate revenue.

Conditional sales – In these transactions, the company recorded revenue although unresolved contingencies or side agreements gave the customer the right to return the merchandise.

Bill and hold sale - In a bill and hold sale, the company billed the customer for the goods, but they were held by the fraud company and shipped at a later date.

14-29

TEST OF CONTROL OR SUBSTANTIVE TEST OF TRANSACTIONS	TRANSACTION-RELATED AUDIT OBJECTIVE(S)	SUBSTANTIVE TEST
1. S T of T	Classification	Not applicable
2. S T of T	Completeness Accuracy Timing Posting and summarization	Not applicable
3. T of C	Accuracy	Compare unit selling prices on duplicate sales invoices to the approved price list.
4. T of C	Classification	Examine a sample of sales transactions to determine if each one is correctly classified in the sales journal.
5. S T of T	Accuracy	Not applicable
6. S T of T	Occurrence Completeness Accuracy Timing	Not applicable
7. T of C	Accuracy	Recalculate the cash discounts for a sample of remittances and determine whether each one was consistent with company policy.
8. T of C	Completeness	Trace from a sample of remittance advices to the cash receipts journal to determine if the related cash is recorded.
9. S T of T	Posting and summarization	Not applicable

14-30

POSSIBLE ERROR OR FRAUD	CONTROL
1. Customer checks are properly credited to customer accounts and are properly deposited, but errors are made in recording receipts in the cash receipts journal.	g. An employee, other than the bookkeeper, periodically prepares a bank reconciliation.
2. Customer checks are misappropriated before being forwarded to the cashier for deposit.	f. Monthly statements are mailed to customers with outstanding balances.
3. Customer checks are received for less than the customers' full account balances, but the customers' full account balances are credited.	e. Total amounts posted to the accounts receivable subsidiary records from remittance advices are compared to the validated deposit slip.
4. Customer checks are credited to incorrect customer accounts.	f. Monthly statements are mailed to customers with outstanding balances.
5. Different customer accounts are each credited for the same cash receipt.	e. Total amounts posted to the accounts receivable subsidiary records from remittance advices are compared to the validated bank deposit slip.

14-31

DEFICIENCY	RECOMMENDED IMPROVEMENT
1. Financial secretary exercises too much control over collections.	To extent possible, financial secretary's responsibilities should be confined to record keeping.
2. Finance committee is not exercising its assigned responsibility for collection.	Finance committee should assume a more active supervisory role.
3. The finance committee is responsible for the auditing function and administration of the cash function. Moreover, the finance committee has not performed the auditing functions.	An audit committee should be appointed to perform periodic auditing procedures or engage outside auditors.
4. The head usher has sole access to cash during the period of the count. One person should not be left alone with the cash until the amount has been recorded or control established in some other way.	The number of counters should be increased to at least two, and cash should remain under joint surveillance until counted and recorded so that any discrepancies will be brought to attention.
5. The collection is vulnerable to robbery while it is being counted and from the church safe prior to its deposit in the bank.	The collection should be deposited in the bank's night depository immediately after the count. Physical safeguards, such as locking and bolting the door during the period of the count, should be instituted. Vulnerability to robbery will also be reduced by increasing the number of counters.
6. The head usher's count lacks usefulness from a control standpoint because he surrenders custody of both the cash and the record of the count.	The financial secretary should receive a copy of the collection report for posting to the financial records. The head usher should maintain a copy of the report for use by the audit committee.
7. Contributions are not deposited intact. There is no assurance that amounts withheld by the financial secretary for expenditures will be properly accounted for.	Contributions should be deposited intact. If it is considered necessary for the financial secretary to make cash expenditures, he should be provided with a petty cash fund. The fund should be replenished by a check based upon a properly approved reimbursement request and satisfactory support.

14-31 (continued)

DEFICIENCY	RECOMMENDED IMPROVEMENT
8. Members are asked to enter "cash" on the payee line, thus making the checks completely negotiable and vulnerable to misappropriation.	Members should be asked to make checks payable to the church. At the time of the count, ushers should stamp the church's restrictive endorsement (For Deposit Only) on the back of the check.
9. No mention is made of bonding.	Key employees and members involved in receiving and disbursing cash should be bonded.
10. Written instructions for handling cash collections apparently have not been prepared.	Especially because much of the work involved in cash collections is performed by unpaid, untrained church members, often on a short-term basis, detailed written instructions should be prepared.
11. The envelope system has not been encouraged. Control features that it could provide have been ignored.	The envelope system should be encouraged. Ushers should indicate on the outside of each envelope the amount contributed. Envelope contributions should be reported separately and supported by the empty collection envelopes. Prenumbered envelopes will permit ready identification of the donor by authorized persons without general loss of confidentiality.
12. Records of contributions received that are supplied to members as a tax record of contributions made.	The church should only provide members documentation of actual contributions received versus contributions pledged for tax purposes.

14-32

INTERNAL CONTROL	a. STRENGTH OR DEFICIENCY	b. TRANSACTION RELATED AUDIT OBJECTIVE	c. NATURE OF DEFICIENCY
1. Credit is granted by a credit department.	Strength	Occurrence of sales.	
2. Once shipment occurs and is recorded in the sales journal, all shipping documents are marked "recorded" by the accounting staff.	Strength	Completeness of sales.	
3. Sales returns are presented to a sales department clerk who prepares a written, prenumbered receiving report.	Deficiency		Prenumbered receiving reports should be prepared by receiving department clerks immediately upon receipt of returned goods. A duplicate copy of the receiving report should be sent to the credit department for approval and preparation of a credit memorandum that is then forwarded to accounting to record the sales return.
4. Cash receipts received in the mail are received by a secretary with no recordkeeping responsibility.	Strength	Completeness of cash receipts.	
5. Cash receipts received in the mail are forwarded unopened with remittance advices to accounting.	Deficiency		This represents inadequate segregation of duties because it gives custody of the cash to those in accounting who are responsible for recordkeeping activities. Personnel in accounting could misappropriate cash receipts and alter accounting records to hide the fraud.

14-32 (continued)

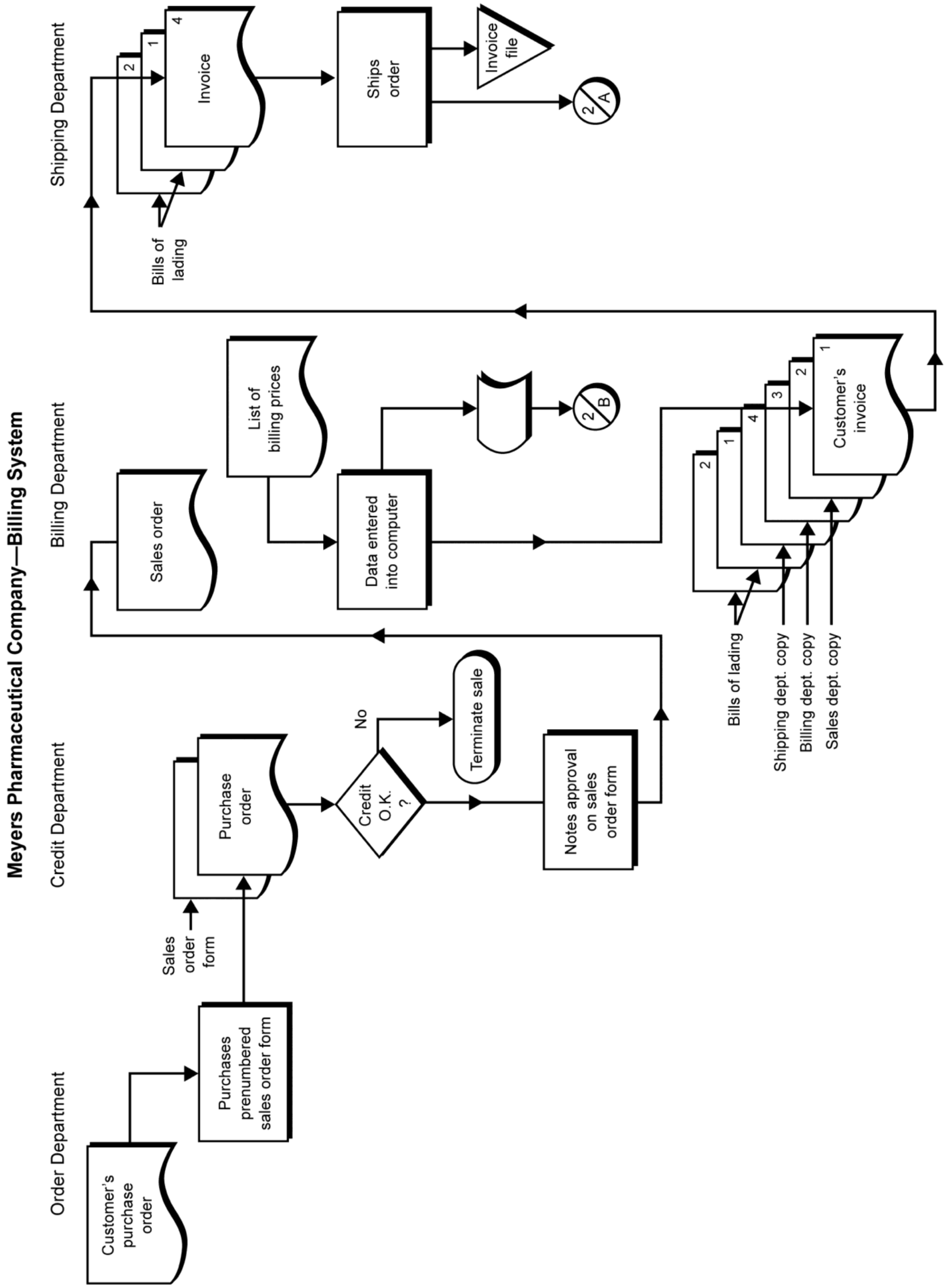
INTERNAL CONTROL	a. STRENGTH OR DEFICIENCY	b. TRANSACTION RELATED AUDIT OBJECTIVE	c. NATURE OF DEFICIENCY
6. The cash receipts journal is prepared by the treasurer's department	Deficiency		The cash receipts journal represents the primary accounting record for all cash received. It should be prepared by personnel within the accounting function, not the treasury function. The treasury function has primarily responsibilities surrounding the custody of cash. Thus, they should not have any recordkeeping responsibilities.
7. Cash is deposited weekly.	Deficiency		Cash should be deposited at least daily to prevent loss or theft of cash.
8. Statements are sent monthly to customers.	Strength	*Occurrence of sales* • Accuracy of sales • Posting and summarization of sales • Completeness of cash receipts • Accuracy of cash receipts • Posting and summarization of cash receipts	
9. Write-offs of accounts receivable are approved by the controller.	Deficiency		This is an inappropriate segregation of duties. The controller has recordkeeping responsibilities. The write-off of accounts involves authorization responsibilities. The write-offs should be approved by the credit department, not the controller.
10. The bank reconciliation is prepared by individuals independent of cash receipts recordkeeping.	Strength	• Occurrence of cash receipts • Completeness of cash receipts • Accuracy of cash receipts	

14-33

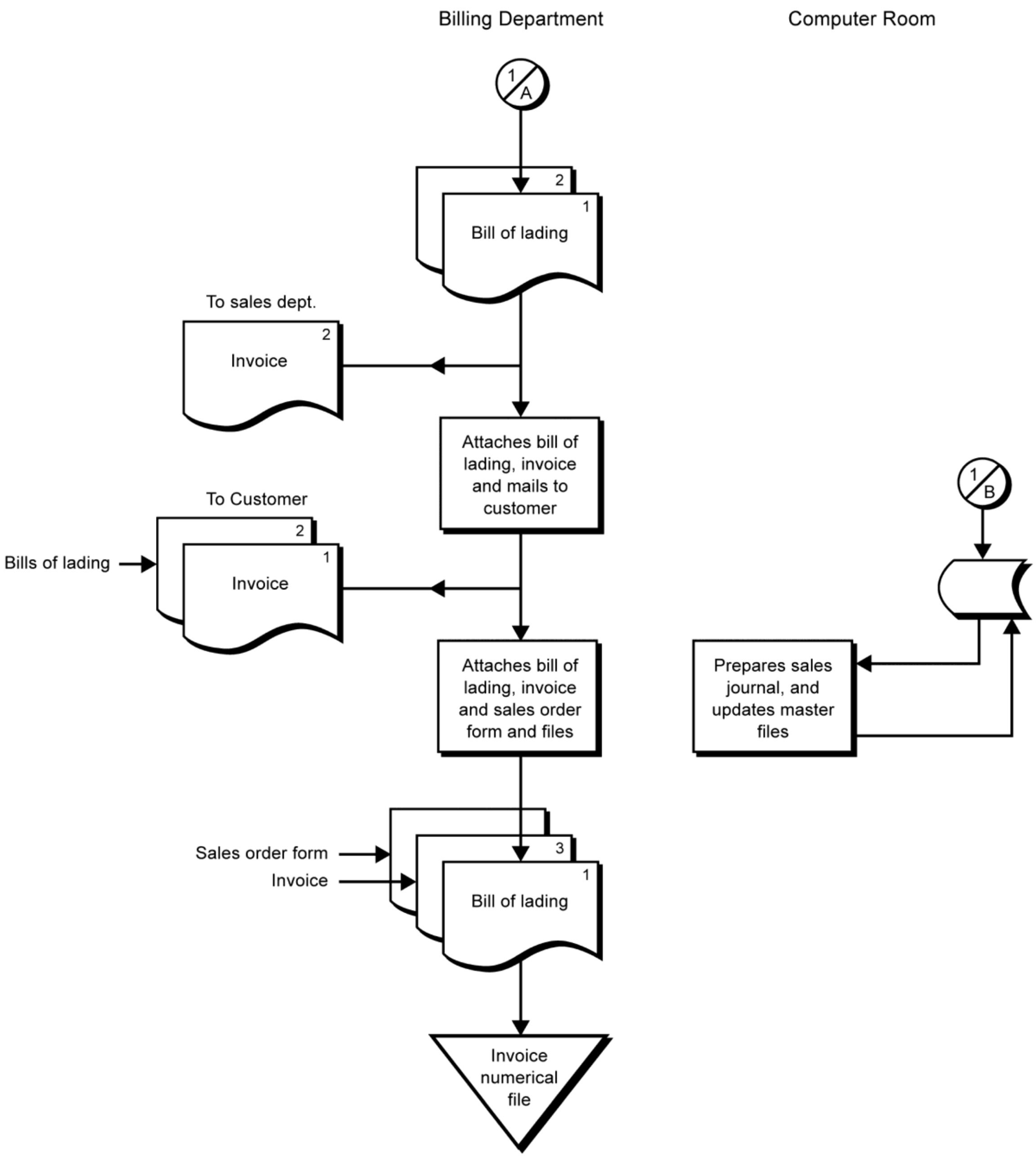
CONTROL	TRANSACTION-RELATED AUDIT OBJECTIVE	POTENTIAL FINANCIAL STATEMENT MISSTATEMENT IF CONTROL IS ABSENT
1.	Occurrence Accuracy	Sales may be recorded for invalid or non-existent products. Sales may be processed based on inaccurate price information.
2.	Occurrence Accuracy	Sales may be recorded for non-existent products. Sales may be processed for existing products using quantities ordered, even when ordered quantities are not on hand.
3.	Occurrence	Sales may be processed for customers who are unable to pay.
4.	Occurrence	Shipments may be made to persons making an unauthorized credit card purchase (e.g., with a stolen credit card).
5.	Accuracy	Sales may be processed inaccurately (e.g., wrong product, wrong price, wrong quantity).
6.	Occurrence Timing	Sales may be recorded even though shipment has not occurred. Sales may be recorded in the wrong time period.

■ Case

14-34 a.


Meyers Pharmaceutical Company—Billing System
Order Department
Credit Department
Billing Department
Shipping Department
Customer's purchase order
Purchases prenumbered sales order form
Sales order form
Purchase order
Credit O.K. ?
No
Terminate sale
Notes approval on sales order form
Sales order
List of billing prices
Data entered into computer
2 B
Customer's invoice
Bills of lading
Shipping dept. copy
Billing dept. copy
Sales dept. copy
Invoice
Bills of lading
Ships order
Invoice file
2 A

14-34 (continued)



14-34 (continued)

b.
and
c.

TRANSACTION-RELATED AUDIT OBJECTIVE	INTERNAL CONTROLS	TEST OF CONTROL
1. Recorded sales occurred.	Bill of lading and sales order form are attached to invoice. Sales are initiated by sales order form from customer. Credit department investigates customer credit and approves sales before shipment of merchandise is authorized.	Examine invoice package for presence of bill of lading and sales order form. Examine sales order form for indication of credit approval. Review client's credit approval system for effectiveness.
2. Existing sales transactions are recorded.	Bill of lading and invoices are prenumbered (numerical sequence is not accounted for) and must be prepared before merchandise is shipped.	Account for numerical sequences of bills of lading and sales invoices and determine that all have been recorded.
3. Recorded sales are at the correct amounts.	Control totals are prepared and checked by computer. (No verification of the sales price is performed.)	Examine computer edit reports for indication of errors and disposition thereof.
4. Sales transactions are properly included in the accounts receivable master file and are correctly summarized.	Sales transactions are simultaneously recorded in sales, accounts receivable, cost of sales, and relieved from the perpetual inventory.	Trace sales transactions to sales journal.
5. Recorded sales are properly classified.	None.	Not applicable.
6. Sales are recorded on the correct dates.	None.	Not applicable.

14-34 (continued)

d.

TRANSACTION-RELATED AUDIT OBJECTIVE	SUBSTANTIVE TEST OF TRANSACTIONS AUDIT PROCEDURES
1. Recorded sales occurred.	Select a sample of sales from sales journal and examine customer's purchase order, sales order form, and bill of lading to determine that the goods were ordered and shipped.
2. Existing sales transactions are recorded.	Perform analytical tests, including comparisons of operating statistics to prior years' and month to month at year-end.
3. Recorded sales transactions are stated at the correct amounts.	Compare sales prices to price lists. Examine customer correspondence indicating pricing disputes. Test clerical accuracy of a sample of sales invoices.
4. Sales transactions are properly included in the accounts receivable master file and are correctly summarized.	Foot the sales journal and trace the balance to the general ledger.
5. Recorded sales are properly classified.	Examine sales documents to determine that sales transactions are properly classified.
6. Sales are recorded on the correct dates.	Compare dates on bills of lading to the sales journal to determine that sales are recorded on a timely basis. Compare sales month to month and investigate any significant fluctuations, especially near year-end.

e. An audit program for conducting the audit of sales is as follows:

1. Obtain the sales journal for the year and perform the following procedures:
   - (a) Foot the journal for one month and reconcile to the general ledger balance.
   - (b) From the journal, select a sample of invoices and perform the following:

14-34 (continued)

(1) See that the customer's purchase order, sales order form, and bill of lading are available. Compare quantity, sales price, customer name, and date of shipment to sales journal. Obtain explanation of any differences.
(2) Examine sales order form for indication of credit approved.
(3) Compare sales price to price list.
(4) Test clerical accuracy of sales invoices.
(5) Determine propriety of classification of sales transactions.

2. Select a sample of bill of lading numbers. Locate the corresponding bills of lading and trace them to the sales journal to determine that the shipments were recorded. Compare the date per the bill of lading to the date per the sales journal to determine the promptness of recording.
3. Examine customer correspondence during the year for disputes on pricing of invoices.
4. Prepare a schedule of sales, cost of sales, and gross margin percentage, showing comparison between recent years and month to month. Obtain explanation of any significant fluctuations.

■ Integrated Case Application

14-35 a.,
b.,
c.,
and d.

PINNACLE MANUFACTURING—Part V

#	a. Key Internal Control	b. Transaction Related Audit Objectives	c. Test of Control	d. Substantive Test of Transaction
1.	Segregation of the purchasing, receiving, and cash disbursements functions.	Recorded acquisitions are for goods and services actually received (occurrence). Recorded cash disbursements are for goods and services actually received (occurrence).	Discuss segregation of duties with personnel and observe activities.	Trace entries in the acquisitions journal to related vendors' invoices, receiving reports, and purchase orders.
2.	Use of prenumbered voucher packages, properly accounted for.	Existing acquisition transactions are recorded (completeness).	Account for a sequence of voucher packages.	Trace from a file of vendors' invoices to the acquisitions journal.
3.	Use of prenumbered checks, properly accounted for.	Existing cash disbursement transactions are recorded (completeness).	Account for a sequence of checks.	Reconcile recorded cash disbursements with the cash disbursements on the bank statement (proof of cash disbursements).
4.	Use of prenumbered receiving reports, properly accounted for.	Existing acquisition transactions are recorded (completeness).	Account for a sequence of receiving reports.	Trace from a file of receiving reports to the acquisitions journal.
5.	Internal verification of document package before check preparation.	• Recorded acquisitions are for goods and services actually received (occurrence). • Recorded acquisitions are stated at the correct amounts (accuracy). • Acquisition transactions are properly included in the master files, and are properly summarized (posting and summarization). • Acquisitions are properly classified (classification). • Acquisitions are recorded on the correct dates (timing).	Examine document package for indication of internal verification.	Examine supporting documents for propriety and recompute information on the supporting documents.

14-35 (continued)

a.,
b.,
c.,
and d.

#	a. Key Internal Control	b. Transaction Related Audit Objectives	c. Test of Control	d. Substantive Test of Transaction
6.	Review of supporting documents and signing of checks by an independent, authorized person.	Recorded cash disbursements are for goods and services actually received (occurrence).	Examine checks for signature.	Trace the cancelled check to the related acquisitions journal entry and examine for payee name and amount.
7.	Cancellation of documents prior to signing of the check.	Recorded acquisitions are for goods and services actually received (occurrence).	Examine indication of cancellation.	Examine the acquisitions journal for duplicate entries to a vendor.
8.	Monthly reconciliation of the accounts payable master file with the general ledger.	• Acquisition transactions are properly included in the master files, and are properly summarized (posting and summarization). • Cash disbursement transactions are properly included in the master file, and are properly summarized (posting and summarization).	Inquire of client about monthly reconciliation procedures.	Foot acquisitions and cash disbursements journals and trace postings to the general ledger and accounts payable and inventory master files.
9.	Independent reconciliation of the monthly bank statements.	• Existing cash disbursement transactions are recorded (completeness). • Recorded cash disbursement transactions are stated at the correct amounts (accuracy).	Examine file of completed bank reconciliations.	Reconcile recorded cash disbursements with the cash disbursements on the bank statement (proof of cash disbursements).

14-35 (continued)

e.

Acquisitions Substantive Tests of Transactions

Note: More than one audit procedure is listed for certain objectives even though the requirement is for only one procedure.

TRANSACTION-RELATED AUDIT OBJECTIVES	SUBSTANTIVE AUDIT PROCEDURES
Occurrence	• Examine underlying documents for propriety. • Review the acquisitions journal, general ledger, and accounts payable master file for large or unusual amounts.
Completeness	• Trace a sample of receiving reports to the acquisitions journal. • Trace from a file of vendors' invoices to the acquisitions journal. • Trace from additions in perpetual inventory records to recorded acquisitions.
Accuracy	• Compare amounts for entries in acquisitions journal to related vendors' invoices, purchase orders and receiving reports. • Recompute information on vendor invoices. • Compare prices on vendor invoices with approved price limits established by management.
Posting and Summarization	• Trace individual entries in accounts payable master file to acquisitions journal.
Classification	• Examine vendors' invoices for proper classification. • Compare classification with chart of accounts by reference to vendors' invoices.
Timing	• Compare dates of receiving reports and vendors' invoices with dates in the acquisitions journal.

14-35 (continued)

f.

Cash Disbursements Substantive Tests of Transactions

Note: More than one audit procedure is listed for certain objectives even though the requirement is for only one procedure.

TRANSACTION-RELATED AUDIT OBJECTIVES	SUBSTANTIVE AUDIT PROCEDURES
Occurrence	• Trace cancelled check numbers in the cash disbursements journal to related cancelled checks and examine for payee, name, and amount. • Examine cancelled check for authorized signature, proper endorsement, and cancellation by the bank. • Review the cash disbursements journal, general ledger, and accounts payable master file for large or unusual amounts. • Trace cancelled check to the related acquisitions journal entry and examine for payee name and amount.
Completeness	• Trace entries in acquisitions journal to subsequent payment in cash disbursements journal.
Accuracy	• Compare cancelled checks with the related acquisitions journal and cash disbursements journal entries. • Recompute cash discounts.
Posting and Summarization	• Trace individual entries in accounts payable master file to cash disbursements journal.
Classification	• Compare classification with chart of accounts by reference to vendors' invoices and acquisitions journal.
Timing	• Compare dates on cancelled checks with cash disbursements journal. • Compare dates on cancelled checks with the bank cancellation date.

14-35 (continued)

g. *Note: Student answers will depend on answers in requirements b. through f.*

General

1. Discuss the following items with client personnel and observe activities:
   a. Segregation of duties
   b. Monthly reconciliation of accounts payable master file with the general ledger.
2. Test journal summarization and posting for a test month:
   a. Foot acquisition journal and trace postings to the general ledger and accounts payable and inventory master files.
   b. Foot cash disbursements journal and trace postings to general ledger and accounts payable master file.
3. Examine file of completed bank reconciliations.
4. Account for a sequence of cancelled checks.
5. Reconcile recorded cash disbursements with cash disbursements on the bank statement.
6. Review the acquisitions journal, cash disbursements journal, general ledger, and accounts payable master file for large or unusual amounts.
7. Examine underlying documents (vendors' invoices, receiving reports, purchase orders, and purchase requisitions) for indication of cancellation and reasonableness.

Acquisitions

8. Trace entries in the acquisitions journal to related vendors' invoices, receiving reports, and purchase orders.
   a. Examine indication of internal verification of dates, unit costs, prices, extensions and footings, account classification, recording in the journal, and posting and summarization.
   b. Examine supporting documents for propriety.
   c. Compare prices on vendors' invoices with approved price limits established by management.
   d. Recompute information on vendors' invoices.
   e. Examine vendors' invoices for proper classification.
   f. Compare dates on recorded acquisitions with dates on receiving reports and vendors' invoices.
   g. Examine document package for indication of internal verification.

14-35 (continued)

9. Account for a sequence of receiving reports and voucher packages.

10. Trace a sample of receiving reports and vendors' invoices to the acquisitions journal.

Cash Disbursements

11. Select a sample of cancelled checks and:
    a. Trace cancelled check to the related cash disbursements journal entry and acquisitions journal entry and examine for payee, name, amount, and date.
    b. Examine check for signature, proper endorsement, and cancellation by the bank.
    c. Compare date on cancelled check with bank cancellation date.
    d. Recompute cash discounts.

14-36 ACL Problem Solution

a. There are 4,082 shipments made in 2014. *(Look at the bottom of the worksheet on the screen).*

b. There are nine shipments with ship dates in 2013. *(Use Quick Sort command for the ship_date column).*

c. There are no duplicate shipping numbers. There are 24 gaps involving 46 missing shipping documents. A number of the gaps are close to each other, and several relate to the shipping documents with 2013 dates, and others occur near the end of 2014. Although the missing shipping documents could be due to voided items, the auditor would want to investigate these missing documents, especially those occurring near the beginning and end of the year, to determine whether they may represent cutoff misstatements. *(Use Gaps and Duplicates command under Analyze for the Shipping Number column).*

d. The greatest number of shipments was 11 to customer 0239212, which is a small percentage of the 4,082 shipments. The most items shipped was 1,636 items to customer 0245916, which is a small percentage of the 263,136 total items shipped. *(Use the Summarize command under Analyze to create a file of total shipments by customer number).*

14-36 ACL Problem Solution (continued)

e. There were five shipments involving 86 items without a customer number. There were also three shipments to customer 9898989 and one to customer 238314; these customer numbers appear to be outside the normal sequence of customer numbers. *(Use Quick Sort command to sort customer number in ascending and descending order).*

f. There are 1,042 shipments with 100 or more items. The output using 10 equal intervals is shown below. *(Use Filter to exclude all shipments with less than 100 items and then use Stratify command under Analyze for the items shipped column).*

<<< STRATIFY over 100-> 183 >>>
>>> Minimum encountered was 100
>>> Maximum encountered was 183

items_shipped	Count	<-- %	% -->	Items
		Shipped		
100 -> 108	141	13.53%	10.48%	14,685
109 -> 116	138	13.24%	11.08%	15,530
117 -> 124	144	13.82%	12.39%	17,376
125 -> 133	102	9.79%	9.39%	13,165
134 -> 141	86	8.25%	8.43%	11,823
142 -> 149	107	10.27%	11.12%	15,594
150 -> 158	144	13.82%	15.81%	22,168
159 -> 166	110	10.56%	12.73%	17,840
167 -> 174	55	5.28%	6.67%	9,345
175 -> 183	15	1.44%	1.90%	2,661
	1042	100.00%	100.00%	140,187