Chapter 14 – Auditing the Revenue Cycle
Chapter Overview

Auditing the Revenue Cycle

Risk Assessment Procedures in the Revenue Cycle
- Developing Audit Objectives
- Understanding the Entity and its Environment
- Inherent Risk, Including the Risk of Fraud
- Analytical Procedures
- Consideration of Internal Control Components

Control Activities for Credit Sales Transactions
- Common Documents and Records
- Functions and Control Activities
- Illustrative System for Credit Sales

Control Activities for Cash Receipts Transactions
- Common Documents and Records
- Functions and Control Activities
- Illustrative System for Cash Receipts

Control Activities for Sales Adjustment Transactions and Other Controls
- Common Documents and Records
- Functions and Control Activities
- Other Controls in the Revenue Cycle

Substantive Tests of Accounts Receivable
- Determining Detectives Risk
- Designing Substantive Tests

Other Assurance Services
## The Revenue Cycle

**Figure 14-1** The Revenue Cycle

<table>
<thead>
<tr>
<th>Revenue Transaction</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Sale</td>
<td>Accounts Receivable</td>
<td>Sales</td>
</tr>
<tr>
<td></td>
<td>Cost of Goods Sold</td>
<td>Inventory</td>
</tr>
<tr>
<td>Cash Receipt</td>
<td>Cash</td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td></td>
<td>Sales Discounts</td>
<td></td>
</tr>
<tr>
<td>Sales Returns and Allowances</td>
<td>Sales Returns and Allowances</td>
<td>Accounts Receivable</td>
</tr>
<tr>
<td>Provision for Bad Debts</td>
<td>Bad Debt Expense</td>
<td>Allowance for Doubtful Accounts</td>
</tr>
<tr>
<td>Write-off of Bad Debts</td>
<td>Allowance for Doubtful Accounts</td>
<td>Accounts Receivable</td>
</tr>
</tbody>
</table>
## Develop Audit Objectives

### Figure 14-2  ■ Specific Audit Objectives for the Revenue Cycle

<table>
<thead>
<tr>
<th>Specific Audit Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transaction Objectives</strong></td>
</tr>
<tr>
<td><strong>Occurrence.</strong> Recorded sales transactions represent goods shipped or services provided during the period (EO1).</td>
</tr>
<tr>
<td>Recorded cash receipt transactions represent cash received during the period (EO2).</td>
</tr>
<tr>
<td>Recorded sales adjustment transactions during the period represent authorized discounts, returns and allowances, and uncollectable accounts (EO3).</td>
</tr>
<tr>
<td><strong>Completeness.</strong> All sales (C1), cash receipts (C2), and sales adjustments (C3) made during the period were recorded.</td>
</tr>
<tr>
<td><strong>Accuracy.</strong> All sales (VA1) and cash receipts (VA2) and sales adjustments (VA3) are accurately valued using GAAP and correctly journalized, summarized and posted.</td>
</tr>
<tr>
<td><strong>Cutoff.</strong> All sales (EO1 or C1), cash receipts (EO2 or C2), and sales adjustments (EO3 or C3) have been recorded in the correct accounting period.</td>
</tr>
<tr>
<td><strong>Classification.</strong> All sales (PD1), cash receipts (PD2), and sales adjustments (PD3) have been recorded in the proper accounts.</td>
</tr>
</tbody>
</table>
Inherent Risk, Including the Risk of Fraud

• Management Misstatement of Revenue
  – Overstate revenues
  – Overstate cash and gross receivables
  – Understate allowance for doubtful accounts

• Other Misstatement Factors
  – Opportunities for error
  – Timing
  – Misclassification
  – Adjustment transactions
## Analytical Procedures

### Figure 14-4  Analytical Procedures Commonly Used to Audit the Revenue Cycle

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Audit Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to Capacity</td>
<td>Net Sales ÷ Nonfinancial Measure of Capacity</td>
<td>Helpful in assessing the reasonableness of total revenues.</td>
</tr>
<tr>
<td>Market Share</td>
<td>Client’s Net Sales ÷ Net Sales of Industry</td>
<td>Helpful in assessing the reasonableness of both total revenues and gross margins. Larger market share is often associated with larger gross margins.</td>
</tr>
<tr>
<td>Sales to Total Assets</td>
<td>Sales ÷ Average Total Assets</td>
<td>This ratio is useful for manufacturing and other asset-based companies. Describes the relationship between assets and sales revenues.</td>
</tr>
</tbody>
</table>
Consideration of Internal Control Components

• Control Environment

• Risk Assessment

• Information and Communication

• Monitoring

• Initial Assessments of Control Risk
Control Activities for Credit Sales Transactions

• Credit Sales Orders
  – Over-the-Counter
  – Mail Order
  – Internet

• Computerized Accounting System
  – General Controls
  – Application Controls
Common Documents and Records

• Customer Order

• Sales Order

• Shipping Document
  – Bill of Lading
  – Packing Slip

• Sales Invoice

• Authorized Price List
Common Documents and Records

- Sales Transactions File
- Sales Journal
- Customer Master File
- Accounts Receivable Master File
  - Accounts receivable subsidiary ledger
- Customer Monthly Statement
Function and Control Activities

- Authorizing Sales
  - Accepting Customer Orders
  - Approving Credit

- Delivery of Goods and Services
  - Filling Sales Orders
  - Shipping Sales Orders

- Recording Sales
ORDER PROGRAM: Perform edit and credit checks; print sales orders

Initiate Sales
- Sales Order

Enter Sales Orders
- Documentary Audit Trail

Key Reports

Computer Program and Files
- Customer master file
- Perpetual Inventory
- Transaction master file
- Open Orders
**System Flowchart – Credit Sales**

**Actions**: 
- **Enter Data on Goods Shipped**
- **Unfilled Orders and Back Orders**
- **Shipping Document**
- **Authorization to Pick Goods**
- **Shipment of Items**
- **Perpetual Inventory**
- **Shipping File**

**Shipping Program**:
- Retrieve open orders:
- Add shipping data:
- Transfer to shipping file:
- Print shipping documents
System Flowchart – Credit Sales

BILLING PROGRAM:
Retrieve shipped order data; prepare invoices; perform edit checks; enter data in sales transaction

Sales Invoice

Exception Reports

Sales Transaction File

Sales Journal

General Ledger

Exception Reports

General Ledger Master File

Monthly Statements

Exception Reports

Accounts Receivable Master File

Daily Sales Report

MASTER FILE UPDATE PROGRAM:
Update master files; print sales journal, G/L, monthly statements, and reports
Cash Receipts Transactions –
Common Documents and Records

• Remittance Advice

• Prelist

• Cash Count Sheets

• Daily Cash Summary

• Validated Deposit Slip

• Cash Receipts Transactions File

• Cash Receipts Journal
Cash Receipts Transactions - Functions

• Receiving Cash Receipts
  – Over-the-Counter Receipts
  – Mail Receipts

• Depositing Cash in Bank
  – Deposited intact daily

• Recording the Receipts
Sales Adjustment Transactions – Common Documents and Records

- Sales return authorization
- Authorization for accounts receivable write-off
- Receiving report
- Credit memo
- Journal entry
- Cash Receipts journal
Sales Adjustment Functions and Controls

- Granting Cash Discounts
- Granting Sales Returns and Allowances
- Determining Uncollectible Accounts
- Other Controls
- Tests of Controls
Substantive Tests of Accounts Receivable

- Determining Detection Risk for Tests of Details
  - Existence and Occurrence
  - Completeness
  - Rights and Obligations
  - Valuation and Allocation
  - Presentation and Disclosure
Designing Substantive Tests

• Initial Procedures

• Analytical Procedures
Designing Substantive Tests

• Tests of Details of Transactions
  – Vouch Revenue Transactions
  – Trace Revenue Transactions
  – Perform Cutoff Tests
    • Sales Cutoff Tests
    • Sales Return Cutoff Tests
  – Perform Cash Receipts Cutoff Test
Designing Substantive Tests

- Tests of Details of Balances
  - Confirm Receivables

- Forms of Confirmation
  - Positive Confirmation
  - Negative Confirmation

- Timing and Extent of Requests

- Controlling the Requests
Designing Substantive Tests

- Tests of Details of Balances
  - Disposition of Exceptions
  - Alternative Procedures for Dealing with Nonresponses
  - Summarizing and Evaluating Results
  - Applicability to Assertions
Designing Substantive Tests

• Tests of Details of Accounting Estimates
  – Allowance for Doubtful Accounts
  – Aged Trial Balance

• Tests of Details of Disclosures