Chapter 11

Accounts Receivable, Notes Receivable, and Revenue
Sources of Accounts Receivable

Sources

- Claims against customers from sale of goods
- Loans to officers or employees
- Loans to subsidiaries
- Claims against various other refunds
- Claims for tax refunds
- Advances to suppliers

Shown on balance sheet at net realizable value
Sources of Notes Receivable

- **Sources**
  - Written promises to pay certain amounts at future dates
  - Notes for substantial amounts
  - Installment note or contract can allow seller to hold lien on goods

- **Examples:**
  - Sale of industrial machinery, farm equipment
  - Issuance of capital stock
  - Loans to officers, employees
Audit Risk

- Audit risk significant because
  - Many incidences of fraud have involved overstatement of receivables and revenue
  - Revenue recognition may be based on complex accounting rules
  - Receivables and revenues are usually subject to valuation using significant accounting estimates
Objectives for the Audit of Receivables and Revenue

1. Use the understanding of the client and its environment to consider *inherent risk*, including fraud risks, related to receivables and revenues.

2. Obtain an understanding of *internal control* over receivables and revenues.

3. Assess the risks of material misstatement and design tests of controls and substantive procedures that:
   a. Substantiate the *existence* of receivables and the *occurrence* of revenue transactions
   b. Establish the *completeness* of receivables and revenue transactions
   c. Verify the *cutoff* of revenue transactions
   d. Determine that the client has *rights* to recorded receivables
   e. Establish the proper *valuation* of receivables and the *accuracy* of revenue transactions
   f. Determine that the *presentation and disclosure* of receivables and revenue are appropriate
Internal Control over A/R and Revenue

- Control Environment
  - Important because of risk of intentional misstatement of revenue
  - Independence of audit committee
  - Management establish tone at the top
  - Commitment to competence
  - Management’s philosophy and operating style
  - Human resource policies and practices

- Risk Assessment
  - Risk of misstatement of revenue
Internal Control over A/R and Revenue

- **Control Activities**
  - **Division of duties**
    - Prepare sales order
    - Approve credit
    - Issue merchandise from stock
    - Shipment
    - Billing
    - Invoice verification
    - Maintenance of control accounts
    - Maintenance of customers’ ledgers
    - Approval of sales returns and allowances
    - Authorization of write-offs of uncollectible accounts
Revenue Cycle--Documents

- Customer purchase order
- Sales order
- Bill of lading
- Invoice
- Control listing
- Credit memo
# Relating Controls to Assertions

## Figure 11.5

<table>
<thead>
<tr>
<th>Control</th>
<th>Typical Tests of the Control</th>
<th>Existence &amp; Occurrence</th>
<th>Completeness</th>
<th>Cutoff</th>
<th>Rights &amp; Obligations</th>
<th>Valuation &amp; Accuracy</th>
<th>Presentation &amp; Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Segregate duties over sales and collections of receivables.</td>
<td>Observe and make inquiries about the performance of various functions.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Match sales invoices with shipping documents, purchase orders, and sales orders.</td>
<td>Select a sample of sales invoices and compare details to shipping documents, purchase orders, and sales orders.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Review of the clerical accuracy of sales invoices by a second person.</td>
<td>Select a sample of sales invoices and examine them for evidence of second-person review.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Obtain credit approval of sales prior to shipment.</td>
<td>Make inquiries about credit policies; select a sample of sales transactions and examine evidence of credit approval.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Mail monthly statements to customers and follow up on errors reported.</td>
<td>Observe and make inquiries about the mailing of statements and review evidence of follow-up.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Reconcile bank (financial institution) accounts monthly.</td>
<td>Review a sample of bank reconciliations performed during the year.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Use control listing to control cash collections.</td>
<td>Observe, make inquiries about the process, and reconcile selected listings to the bank and accounting records.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Use budgets and analyze variances from actual amounts.</td>
<td>Examine budgets and evidence of follow-up on variances.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Use prenumbered shipping and billing documents and account for the sequence.</td>
<td>Observe and make inquiries about the use of prenumbered documents and inspect evidence of accounting for the sequence.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Use credit memoranda for authorization of adjustments to sales and receivables.</td>
<td>Select a sample of credits to customers’ accounts and inspect credit memoranda and other supporting documents.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Use a chart of accounts and an independent review of account classifications.</td>
<td>Inspect the chart of accounts and evidence of the review of account classifications.</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>
Revenue Cycle Controls
(1 of 2)

- Segregation of duties--sales and collections
- Matching of sales invoices and shipping documents
- Clerical accuracy checks on invoices
- Credit approval for sales transactions
- Mailing of monthly statements
Revenue Cycle Controls (2 of 2)

- Reconciliation of bank accounts
- Use of control listing of cash receipts
- Use of budgets and analysis of variances
- Control over shipping and billing documents
- Use of authorized credit memoranda
- Use of chart of accounts and review of account codings
Internal Control over Notes Receivable

Subdivision of duties

- The custodian of notes receivable should not have access to cash or to the general accounting records
- The acceptance and renewal of notes be authorized in writing by a responsible official who does not have custody of notes
- The write-off of defaulted notes be approved in writing by responsible officials and effective procedures adopted for subsequent follow-up of such defaulted notes
Audit Documentation

- Lead schedules for receivables and net revenue and
- Working papers
  - Aged trial balance of A/R
  - Analyses of other accounts receivable
  - Analysis of notes receivable and related interest
  - Analysis of allowance for doubtful accounts and notes
  - Comparative analyses of revenue
  - Documentation of internal control
  - Risk analyses and audit program
Receivables Audit Steps (1 of 4)

A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to receivables and revenue.

B. Obtain an understanding of internal control over receivables and revenue.

C. Assess the risks of material misstatement and design further audit procedures.
D. Perform further audit procedures—tests of controls.

1. Examples of tests of controls:
   a. Examine significant aspects of a sample of sales transactions.
   b. Compare a sample of shipping documents to related sales invoices.
   c. Review the use and authorization of credit memoranda.
   d. Reconcile selected cash register tapes and sales tickets with sales journals.
   e. Test IT application controls.
   f. Examine evidence of review and approval of revenue estimates.

2. If necessary, revise the risks of material misstatement based on the results of tests of controls.
E. Perform further audit procedures—substantive procedures for receivables and revenue.

1. Obtain an aged trial balance of trade accounts receivable and analyses of other accounts receivable and reconcile to ledgers.
2. Obtain analyses of notes receivable and related interest.
3. Inspect notes on hand and confirm those with holders.
4. Confirm receivables with debtors.
5. Review the year-end cutoff of sales transactions.
6. Perform analytical procedures for accounts receivable, notes receivable, and revenue.
7. Review significant year-end sales contracts for unusual terms.
8. Test the valuation of notes receivable, computation of interest income, interest receivable, and amortization of discount or premium.
E. Further audit procedures cont.

9. Evaluate the propriety of the client’s accounting methods for receivables and revenue.


11. Determine the adequacy of the client’s allowance for uncollectible accounts.

12. Ascertain whether any receivables have been pledged.

13. Investigate any transactions with or receivables from related parties.

14. Evaluate the business purpose of significant and unusual sales transactions.

15. Evaluate financial statement presentation and disclosure of receivables and revenue.
### FIGURE 11.2  Objectives of Major Substantive Procedures for Receivables and Revenue

<table>
<thead>
<tr>
<th>Substantive Procedures</th>
<th>Primary Audit Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain aged listing of receivables and reconcile to ledgers. Obtain analyses of notes receivable and related interest.</td>
<td>Valuation and accuracy</td>
</tr>
<tr>
<td>Inspect notes on hand and confirm those not on hand.</td>
<td>Existence, occurrence, and rights</td>
</tr>
<tr>
<td>Confirm receivables with debtors.</td>
<td>Existence, occurrence, and rights Valuation and accuracy</td>
</tr>
<tr>
<td>Review the year-end cutoff of sales transactions.</td>
<td>Existence, occurrence, and rights Completeness Cutoff</td>
</tr>
<tr>
<td>Perform analytical procedures. Review significant year-end sales contracts.</td>
<td>Existence, occurrence, and rights Completeness Valuation and accuracy</td>
</tr>
<tr>
<td>Verify interest earned on notes receivable.</td>
<td>Existence, occurrence, and rights Completeness</td>
</tr>
<tr>
<td>Evaluate the propriety of client’s accounting for transactions. Evaluate accounting estimates related to revenues.</td>
<td>Valuation and accuracy</td>
</tr>
<tr>
<td>Determine adequacy of allowance for uncollectible accounts.</td>
<td>Valuation</td>
</tr>
<tr>
<td>Ascertain the existence of pledged receivables. Investigate receivables from related parties.</td>
<td>Presentation and disclosure</td>
</tr>
<tr>
<td>Evaluate the business purpose of significant and unusual sales transactions.</td>
<td>Valuation and accuracy Presentation and disclosure</td>
</tr>
<tr>
<td>Evaluate financial statement presentation and disclosure.</td>
<td>Presentation and disclosure</td>
</tr>
<tr>
<td>Description of Misstatement</td>
<td>Examples</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>----------</td>
</tr>
</tbody>
</table>
| Recording unearned revenue  | Fraud:  | • Recording fictitious sales without receiving a customer order or shipping the goods.  
• Intentional overshipment of goods.  
• Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets.  
Errors:  | • Recording sales based on the receipt of orders from customers rather than the shipment of goods.  
• Inaccurate billing and recording of sales.  
• Ineffective billing process in which billing is not tied to shipping information.  
• Ineffective controls for testing invoices, or ineffective input validation checks and computer reconciliations to ensure the accuracy of databases.  
• Inadequate accounting manual; incompetent accounting personnel. |
| Early (late) recognition of revenue—“cutoff problems” | Fraud:  | • Holding the sales journal open to record next year’s sales as having occurred in the current year.  
• Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets. |
|                             | Error:   | • Recording sales in the wrong period based on incorrect shipping information.  
• Ineffective cutoff procedures in the shipping department. |
| Recording revenue when significant uncertainties exist | Fraud:  | • Recording sales when the customer is likely to return the goods.  
• Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets.  
Errors:  | • Recording sales when the customer’s payment is contingent upon the customer receiving financing or selling the goods to another party (e.g., consignment sales).  
• Aggressive attitude of management toward financial reporting: incompetent chief accounting officer. |
| Recording revenue when significant services still must be performed by seller | Fraud:  | • Recording franchise revenue when the franchises are sold even though an obligation to perform significant services still exists.  
• Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets.  
Errors:  | • Amount of revenue earned on franchises is miscalculated.  
• Aggressive attitude of management toward financial reporting: incompetent chief accounting officer. |
Details on Understanding the Client Business

- The types of products and services sold.
- The classes and categories of the client’s customers.
- Whether the business is affected by seasonal or cyclical demand.
- Typical marketing policies for the client and its industry.
- Policies regarding pricing, sales returns, discounts, extension of credit, and normal delivery and payment terms.
- Compensation arrangements that are based on recorded revenue.
- Typical revenue recognition principles used in the industry and their methods of application.
Fraud Risk related to Receivables and Revenue

- Understand controls established by management to control risk
- Determine controls have been implemented
- Respond to risk
  - Has overall effect on audit
  - Design of audit procedures
  - Performing procedures to address risk of material misstatement due to management override of internal control
Confirmation of Receivables

Receivables should be confirmed, unless:

- Accounts receivable are immaterial,
- The use of confirmations would be ineffective, or
- The auditors’ combined assessment of inherent and control risk is low, and audit risk can be reduced to acceptably low level with substantive tests
Confirmation of Receivables—Overall Process

**Figure 11.7** Accounts Receivable Confirmation Process

- **Accounts Receivable**
  - ABC Company
  - $220,000

  **Confirmation request**
  - to ABC Company prepared

  **CPA**
  - determines confirmation request is directed to appropriate confirming individual and address
  - Confirmation request delivered to ABC Company
  - ABC Company receives confirmation request

  **CPA receives response to confirmation request**

  **Response is delivered to the auditors**

  **ABC Company confirming party receives and responds to confirmation request**
Types of Confirmations

Two methods in which the client makes the formal request:

- Positive confirmations – request addressed to the debtor asking for a reply
  - Ordinarily sent with balances due on them
  - Blank forms – leave amount blank (used less frequently
- Negative confirmations – ask debtor to advise the auditors only if the balance shown is incorrect
  - Low level of assessed risk of material misstatement
  - Large number of small balances
Flowchart of the Confirmation Sequence

Develop Audit Objectives

Choose Appropriate Confirmation Form

- Determine the timing and extent
- Identify the information to be confirmed
- Select the accounts for confirmation

A

Prepare and Mail the Requests

- Send 2nd requests for positive confirmations
- Perform alternative procedures for non-respondents
- Resolve exceptions
- Document the procedures and results
Criteria for Recognition of Revenue

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- The seller’s price to the buyer is fixed or determinable
- Collectability is reasonably assured

Source: SEC Staff Accounting Bulletin No. 104.
Potential Revenue Recognition Problems

- Sales with unusual right to return
- Side agreements
- Franchise fees
- Bill and hold transactions
- Sales using notes with unusual interest rates
- Percentage-of-completion method of revenue recognition
- Multiple element agreements
Allowance for Doubtful Accounts (1 of 2)

- Significant estimate made by management
- Best evidence of collectability is subsequent payment
  - Analyze payments subsequent to balance sheet date
  - Document the subsequent payments inspected
Allowance for Doubtful Accounts (2 of 2)

Develop estimate and evaluate reasonableness of management estimate

1. Compare the details of the aging of accounts receivable to prior years’ aging.
2. Investigate the credit ratings for delinquent and unusually large accounts.
3. Review confirmation exceptions for an indication of amounts in dispute or other clues as to possible uncollectible accounts.
4. Summarize in a working paper those accounts whose collectability is doubtful based on the preceding procedures. List customer names, doubtful amounts, and reasons for considering these accounts doubtful.
5. Review with the credit manager the current status of significant doubtful accounts
6. Compute relationships, such as the number-of-days’-sales in accounts receivable and the relationship of the valuation allowance to (1) accounts receivable and (2) net credit sales.
Related Party

To identify related party transactions, auditors should review:

- Proxy and other filings with SEC or other regulatory agencies
- Conflict-of-interest statements by management
- Transactions with unusual terms
- Accounting records for unusual balances or transactions particularly near year-end