

Figure 14-11 ■ Confirmation Request Forms

**BATES COMPANY**  
P.O. Box 1922 Sandusky, Ohio 44870

Ace Engineering Service  
Box 131  
Indiana, Pennsylvania 15701

This request is being sent to you to enable our independent auditors to confirm the correctness of our records. It is not a request for payment.

Our records on December 31, 20X1 showed an amount of \$16,421.08 receivable from you. Please confirm whether this agrees with your records on that date by signing and returning this form directly to our auditors. An addressed envelope is enclosed for this purpose. If you find any difference please report details direct to our auditors in the space provided below.

\_\_\_\_\_

Controller \_\_\_\_\_

The above amount is correct  .

The above amount is incorrect for the following reasons:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

(Individual or Company Name) \_\_\_\_\_

By: \_\_\_\_\_

Please examine this monthly statement carefully and advise our auditors

Reddy & Abel  
Certified Public Accountants  
465 City Center Bldg.  
Marian, New York 11748

as to any exceptions.  
A self-addressed envelope is enclosed for your convenience.

THIS IS NOT A REQUEST FOR PAYMENT

- A large number of small balances is involved.
- The auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

Frequently, a combination of the two forms is used in a single engagement. For example, in the audit of a public utility, the auditor may elect to use the negative form for residential customers and the positive form for commercial customers. When the positive form is used, the auditor should generally follow up with a second and sometimes an additional request to those debtors that fail to reply.

### Timing and Extent of Requests

When the applicable level of detection risk is low, the auditor ordinarily requests confirmation of receivables as of the balance sheet date. If the auditor follows a lower assessed level of control risk approach and is able to support a low control risk assessment, the confirmation date may be one or two months earlier. In such a case, the auditor is expected to vouch material changes between the confirmation date and balance sheet date and may elect to reconfirm accounts with unusual changes.

The extent of request, or sample size, is related to the factors discussed in Chapter 12 (see Figure 12-6). Negative confirmation requests require larger sample sizes than positive requests. Stratification may also affect sample size. For example, auditors frequently seek confirmation of all accounts in excess of a certain dollar (less than or equal to tolerable misstatement) balance or in excess of a certain age, and select a random sample of all other accounts. Sample size may be determined judgmentally or with the aid of a statistical sampling plan as explained in Chapter 13.

### Controlling the Requests

The auditor must control every step in the confirmation process.

This means:

- Ascertaining that the amount, name, and address on the confirmation agree with the corresponding data in the customer's account.
- Maintaining custody of the confirmations until they are mailed.
- Using the firm's own return address envelopes for the confirmations.
- Personally depositing the requests in the mail.
- Insisting that the returns be sent directly to the auditor.

Client assistance can be used in the preparation of the requests, provided the foregoing controls are observed.

A working paper should indicate each account selected for confirmation, the results obtained from each request, and cross-references to the actual confirmation responses. A confirmation control working paper is illustrated in Figure 14-12. The actual confirmation responses should also be retained in the working papers.

### Disposition of Exceptions

Confirmation responses will inevitably contain some exceptions. Exceptions may be attributed to goods in transit from the client to the customers, returned goods, or payments in transit from the customer to the client, items in dispute, errors, and irregularities. All exceptions should be investigated by the auditor and their reso-



Figure 14-12 ■ Confirmation Control Working Paper

| Bates Company                                      |                    | W/P Ref: <u>B-2</u>        |                          |                      |                        |  |
|--|--------------------|----------------------------|--------------------------|----------------------|------------------------|--|
| Accounts Receivable Confirmation Control—Acct. 120 |                    | Prepared By: <u>A.C.E.</u> |                          | Date: <u>1/28/12</u> |                        |  |
| December 31, 20X1                                  |                    | Reviewed By: <u>P.A.R.</u> |                          | Date: <u>1/31/12</u> |                        |  |
| Conf. No.  | Customer           | Book Value                 | Confirmed Value <i>⊗</i> | Audited Value        | (Over) Under Statement | Subsequent Collections Examined Thru 1-28-X2 |
| 1  | Applied Devices    | 43,840.00                  | 43,480.00                | 43,480.00            |                        |  |
| 2  | Barry Mfg.         | 14,001.27                  | <i>NR</i>                | 14,001.27            |                        | 14,001.27 ✓                                  |
| 3  | Brandt Electronics | 63,199.96                  | 63,199.96                | 63,199.96            |                        |  |
| 4  | Groton Electric    | 116,823.14                 | 116,823.14               | 116,823.14           |                        |  |
| 5  | Jed Inc.           | 86,685.21                  | 77,268.25                | 77,268.25            | (9,416.96) <i>(X1)</i> |  |
| 60   | W & M Mfg. Corp.   | 32,461.12                  | <i>NR</i>                | 32,461.12 ✓          |                        | 4,071.43 ✓                                   |
| Totals   |                    | 470,847.92                 | 414,968.57               | 461,430.96           | (9,416.96)             |  |

| <u>Response Recap:</u> | <u># Items</u> | <u>\$ Value</u> |
|------------------------|----------------|-----------------|
| Confirmations mailed   | 60             | 470,847.92      |
| Confirmations received | 58             | 414,968.57      |
| Response %             | 97             | 88              |

| <u>Summary of Results:</u>               | <u># Items</u> | <u>\$ Value</u> |
|--|----------------|-----------------|
| Account total                            | 300            | 619,536.74      |
| Book value of confirmation sample        | 60             | 470,847.92      |
| % Coverage of book value                 |                | 76              |
| Audited value of sample                  | 60             | 461,430.96      |
| Ratio of audited to book value of sample |                | 98              |

*⊗* Signed confirmation response attached for confirmed values.  
*NR* Nonresponse—alternative procedures performed  
 ✓ Examined entries in cash receipts journal and related remittance advices for total collections indicated.  
 ✓ Examined supporting documentation for portion of book value remaining uncollected as of 1/28/12.  
*(X1)* Credit memo issued 1/12/12 for merchandise returned 12/28/11. Adjusting entry:  
     Dr. Sales Returns                   9,416.96  
     Cr. Accounts Receivable           9,416.96 } See W/P B-1 and AE-1

lution indicated in the working papers as illustrated in Figure 14-12. For example, an auditor might vouch payments in transit to subsequent cash receipts.

### Alternative Procedures for Dealing with Nonresponses

When no response has been received after the second or third positive confirmation request to a customer, alternative procedures should ordinarily be performed. AU 330.31 acknowledges that the omission of such procedures may be acceptable when both of the following conditions apply:

- There are no unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions.

- The nonresponses, projected as 100 percent misstatements to the populations and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially correct.

The two main alternative procedures are examining subsequent collections and vouching open invoices comprising customer balances.

The best evidence of existence and collectability is the receipt of payment from the customer. Before the conclusion of the audit fieldwork, the client will receive payments from many customers on amounts owed at the confirmation date. The matching of such collections back to open (unpaid) invoices comprising the customers' balances at the confirmation date establishes the existence and collectability of the accounts.

In performing this test, the auditor should recognize the possible adverse implications of collections that cannot be matched to specific transactions or balances. For example, a round sum amount may, on investigation, reveal items in dispute, and token payments on large balances may indicate financial instability on the part of the customer.

If the customer has not paid the receivable, the auditor can vouch the receivable to underlying customer orders and shipping documentation.

### Summarizing and Evaluating Results

The auditor's working papers should contain a summary of the results from confirming accounts receivable. The summary should provide, as a minimum, statistical data on:

- The number and dollar value of confirmations sent and responses received
- The proportion of the population total covered by the sample
- The relationship between the audited and book values of items included in the sample

The lower portion of Figure 14-12 illustrates how such data might be presented. Statistical and nonstatistical procedures may be used to project misstatements found in the sample to the population as explained in Chapter 13.

The combined evidence from the confirmations, alternative procedures performed on nonresponses, and other tests of details and analytical procedures is evaluated to determine whether sufficient evidence has been obtained to support management's assertions about gross accounts receivable. When numerous exceptions are found, or insufficient responses are received from confirmation requests and the auditor is unable to obtain sufficient competent evidence from other substantive tests, he or she will be unable to issue a standard auditor's report.

### Applicability to Assertions

The confirmation of accounts receivable is the primary source of evidence in meeting the existence or occurrence assertion. Acknowledgment of the debt by the customer in the response confirms that the client has a legal claim on the customer. Thus, this test also provides evidence concerning the rights and obligations assertion. The confirmation of accounts receivable is not a request for payment. Thus, it does not provide evidence as to the collectability of the balance due. However, the responses may reveal previously paid items or disputed items that affect the proper valuation of the amount due. In this sense, confirmation of accounts receiv-



able relates only to the valuation or allocation assertion for gross accounts receivable. When a customer's response indicates agreement with the book balance, there is evidence that the balance is complete. However, the evidence about the completeness assertion is limited because (1) unrecorded receivables cannot be confirmed and (2) customers are more likely to report errors of overstatement than errors of understatement.

### Tests of Details of Accounting Estimates

The key accounting estimate involved in the revenue cycle is the allowance for doubtful accounts. Audit tests of this accounting estimate include:

- Using generalized audit software to foot and crossfoot the **aged trial balance** of accounts receivable and agreeing the total to the general ledger balance.
- Testing the aging of the amounts shown in the aging categories on the aged trial balance.
- Considering evidence concerning the collectability of past-due amounts by, for example, reading correspondence from customers.
- Identifying customers with past-due balances, and calculating credit histories for customers with past-due balances.
- Evaluating prior estimates of uncollectable accounts with subsequent experience and the benefit of hindsight.
- Using the evidence obtained above to assess the reasonableness of the percentages used to compute the allowance component required for each aging category and the adequacy of the overall allowance.

Refer to the example of an aged trial balance presented in Figure 14-10. The auditor can use generalized audit software to generate an aging of the client's master file. Alternatively, the aging of a customer's balance can be tested by vouching the amounts shown in each aging category to the subsidiary ledger or master file and determining the length of time between the dates the unpaid sales invoices were recorded and the trial balance date.

In considering the collectability of past-due amounts, the auditor will pay particular attention to customers that demonstrate deteriorating payment history as the year progresses. They may examine correspondence with customers and outside collection agencies, review customers' credit reports and financial statements, and discuss the collectability of specific accounts with appropriate management personnel.

The allowance for uncollectable accounts is an accounting estimate made by management that involves both objective and subjective considerations. In essence, it is a prospective estimate of receivables that will not be collected in the future. The auditor's responsibility is to judge the reasonableness of the allowance and related provision for uncollectable accounts expense. From the aging data, information about collectability, and analysis of the client's prior experience with uncollectable accounts, the auditor can assess the reasonableness of the percentages used to compute the allowance component required for each aging category and the adequacy of the overall allowance. An important aspect of evaluating prior experience with the entity involves using hindsight to evaluate prior estimates of the allowance and subsequent experience in collecting receivables outstanding at the date of the estimate. When the client's controls over (1) granting credit and (2) writing off uncollectable accounts are strong, less evidence will be required in making this assessment than when controls are weak.

### Tests of Details of Disclosures

Figure 14-9 describes a number of tests of disclosures for the revenue cycle. The auditor must be knowledgeable about the statement presentation and disclosure requirements for accounts receivable and sales under GAAP. The requirements include proper identification and classification for receivables. A review of the accounts receivable trial balance may indicate receivables from employees, officers, affiliated companies, and other related parties that should be reclassified or separately disclosed, if material. The same source may reveal receivables with credit balances that, if significant in the aggregate, should be reclassified as current liabilities. GAAP also requires proper classification of receivables as current and noncurrent, and disclosures concerning the pledging, assigning, or factoring of receivables. Disclosures may be required regarding significant customers, or sales by significant lines of business. Evidence relevant to these matters should be obtainable by inquiring of management and reviewing minutes of board of directors' meetings and loan agreements. Evidence is also obtained through the audit procedures performed to test other assertions. Management's representations on these matters should be obtained in writing in a client representation letter as one of the final steps in the audit, as explained in Chapter 19.

### LEARNING CHECK

- 14-18** a. Identify the transaction classes that should be considered in assessing control risk for accounts receivable assertions.  
 b. Which transaction class control risk assessments should be considered in assessing control risk for the existence of accounts receivable?  
 c. When is it necessary to determine a revised acceptable level of detection risk and a revised level of tests of details risk?
- 14-19** Develop preliminary audit strategies for each financial statement assertion.
- 14-20** What is involved in vouching recorded receivables transactions to supporting documentation, and to what specific account balance audit objectives does the evidence pertain?
- 14-21** What cutoff tests are performed for accounts receivable, how are they performed, and to what account audit objectives does the evidence pertain?
- 14-22** a. Under what circumstance might it not be necessary to confirm accounts receivable?  
 b. What factors should be considered in determining the form of the confirmation request?  
 c. When positive confirmation requests are used, how does the auditor deal with nonresponses?
- 14-23** a. What roles does an aged trial balance play in an audit?  
 b. What procedures should be applied to the aged trial balance?  
 c. What steps should the auditor perform when auditing the accounting estimate associated with the allowance for doubtful accounts?  
 d. If the auditor is auditing the allowance for doubtful accounts at year-end, why is it useful to evaluate prior accounting estimates using hindsight?
- 14-24** What disclosures for accounts receivable are required by GAAP?



[ **KEY TERMS** ]

Accounts receivable trail balance,  
p. 661  
Aged trial balance, p. 670  
Cash receipts cutoff tests, p. 664

Negative confirmation, p. 665  
Positive confirmation, p. 665  
Sales cutoff test, p. 663  
Sales return cutoff test, p. 664

[ **OTHER ASSURANCE SERVICES** ]**Audit Decision 13**

■ How does the auditor use the knowledge obtained during the audit of the revenue cycle to support other assurance services?

Generally accepted auditing standards do not require that the auditor perform other assurance services. However, many auditors develop industry specializations so that they can understand industry trends and better identify risks associated with financial statements not presenting fairly financial position, results of operations, or cash flows. The client and its board of directors usually want to take full advantage of the auditor's knowledge. In the process of performing the audit, the auditor may benchmark company performance against others in the industry. The auditor might address, for example, whether:

- The company is effectively utilizing assets to generate sales based on a ratio of sales to total assets.
- Receivables are growing faster than sales, thereby consuming valuable cash flows.
- The company has appropriately addressed risks associated with a changing or maturing marketplace.
- The company is bringing successful new product innovations to market and is enjoying a high percentage of revenues from new products, relative to the competition.

As an auditor completes the audit of the sales cycle, he or she should summarize key issues that might support other assurance service and client recommendations.

To illustrate further, consider the information contained in Figure 8-7 regarding Net Technology, Inc. The collection period of 87 days (4.2 turns) is substantially longer than the industry median of 49 days (7.4 turns), and the ratio of sales to total assets of 1.34 is substantially below the industry median of 2.0. The auditor might recommend that the client consider encouraging a faster turn with cash discounts, possibly implement a policy of charging interest on past-due receivables, or revise its credit policy to speed up cash collections. The auditor might use knowledge obtained in other aspects of the audit to determine whether the poor utilization of total assets is due to receivable problems, inventory problems, or poor utilization of fixed assets. In this way the CPA uses the knowledge obtained during the audit to assist the client in identifying opportunities for improved business performance.

[ **FOCUS ON AUDIT DECISIONS** ]

This chapter focuses on the practical aspects of auditing the revenue cycle. The chapter pays particular attention to audit planning concerns related to the revenue cycle, specific internal controls that are tailored to the revenue cycle, and substantive tests for the revenue cycle. Figure 14-13 summarizes the audit decisions discussed in Chapter 14 and provides page references indicating where these decisions are discussed in more detail.

**Figure 14-13** ■ Summary of Audit Decisions Discussed in Chapter 14

| Audit Decision  | Factors that Influence the Audit Decision  | Chapter References |
|---|--|--------------------|
| D1. What is the nature of the revenue cycle, and how are specific audit objectives developed for the revenue cycle?                           | The revenue cycle includes three major classes of transactions: (1) credit sales, (2) cash receipts, and (3) sales adjustments. The primary balance in the revenue cycle is accounts receivable, net of the allowance for doubtful accounts. Figure 14-2 develops specific audit objectives for the audit of the revenue cycle.  | pp. 629–630        |
| D2. How does understanding the entity and its environment affect audit planning decisions in the revenue cycle?                               | Different companies in different industries experience various risks associated with the revenue cycle. Revenue recognition is more problematic in some industries, and some industries have significant transactions that result in cash collection in advance of earning revenues. Figure 14-3 provides examples of five different industries and how knowledge of the entity and its environment can be used to develop expectations of the financial statements and to assess the risk of material misstatement. The chapter also discusses common inherent risks associated with the revenue cycle. | pp. 630–632        |
| D3. What are the important inherent risks in the revenue cycle?   | Auditors commonly encounter three significant inherent risks in the revenue cycle. First, revenue recognition issues are the most significant cause of financial statement restatements. Second, cash receipts present an opportunity for misappropriation of assets. Third, the allowance for doubtful accounts represents a significant accounting estimate associated with the revenue cycle. Additional inherent risk factors are also discussed in this chapter section.  | pp. 633–634        |
| D4. How does the auditor determine analytical procedures that would be effective in identifying potential misstatements in the revenue cycle? | Analytical procedures are cost effective, and they often identify assertions that need audit attention. Figure 14-4 explains a number of analytical procedures that are helpful in identifying potential misstatements in the revenue cycle. Additional analytical procedures that use nonfinancial data are also explained in the chapter discussion.   | pp. 634–636        |
| D5. What are the relevant aspects of internal control components for the revenue cycle?   | This section of the chapter reviews important aspects of the control environment, risk assessment, information and communication, and monitoring that are relevant to the revenue cycle.   | pp. 636–638        |
| D6. What should be considered in evaluating control activities for credit sales transactions?   | Making credit sales involves authorizing the sale, delivering goods or services, and recording the sale. It is essential for the auditor to understand the audit trail and common documents and records used in recording credit sales. These are discussed in detail in the chapter. Figure 14-5 provides a series of example control activities that are commonly used to control assertions related to credit sales.  | pp. 639–646        |
| D7. What should be considered in evaluating control activities for cash receipts?   | Cash receipt functions include receiving cash, depositing cash, and recording cash receipts. This section explains the documents and records involved in recording cash receipts, and Figure 14-7 provides a series of examples of commonly used control activities that control assertions related to cash receipts.  | pp. 647–651        |

*(continues)*



Figure 14-13 ■ (Continued)

| Audit Decision  | Factors that Influence the Audit Decision   | Chapter References |
|---|---|--------------------|
| <p>D8. What should be considered in evaluating control activities for sales adjustment transactions?</p>  | <p>Sales adjustments functions include granting cash discounts, granting sales returns and allowance, and determining uncollectable accounts. This section explains the documents and records involved in recording sale adjustments and provides a series of example control activities that control assertions related to each sales adjustment function.</p>   | <p>pp. 651–653</p> |
| <p>D9. What are the relevant aspects of tests of controls when the auditor plans to assess control risk below the maximum for the revenue cycle?</p>            | <p>Many of the control activities in the revenue cycle involve programmed controls. In order for the auditor to assess control risk as low, the auditor needs to (1) test computer general controls, (2) test the computer application itself, and (3) test the effectiveness of manual followup activities. Examples of tests of computer application controls are provided in this chapter discussion.</p>  | <p>p. 654</p>      |
| <p>D10. What are the factors involved in determining an acceptable level of tests of details risk for accounts receivable assertions?</p>                       | <p>Once the auditor has completed risk assessment procedures, the auditor can develop a preliminary audit strategy for each assertion. In determining the appropriate level of test of details risk, the auditor should consider inherent risk, control risk, and analytical procedures risk. This section examines common issues involved in assessing these risks, and example preliminary audit strategies are developed for each of the five basic financial statement assertions.</p>  | <p>pp. 655–658</p> |
| <p>D11. How does the auditor determine the elements of an audit program for substantive tests to achieve specific audit objectives for accounts receivable?</p> | <p>This section of the chapter uses the framework developed in Chapter 12 to design substantive tests for the revenue cycle. Figure 14-9 focuses on the nature of substantive tests for the revenue cycle. It summarizes the initial procedures, analytical procedures, tests of details of transactions, tests of details of balances, tests of details of accounting estimates, and tests of details of disclosures relevant to the revenue cycle. The chapter discussion explores these tests in more detail.</p>                                    | <p>pp. 658–664</p> |
| <p>D12: How are confirmation procedures used in auditing accounts receivable?</p>   | <p>Confirmations are an important procedure for testing the existence and valuation of receivables at historic cost. The chapter discussion explains the use of positive and negative confirmations. In addition, it discusses important audit evidence that is needed when customers do not respond to confirmations.</p>  | <p>pp. 664–671</p> |
| <p>D13: How does the auditor use the knowledge obtained during the audit of the revenue cycle to support other assurance services?</p>                          | <p>Once the auditor has completed an audit of the revenue cycle, the auditor should have information that supports an audit opinion as well as recommendations related to improvements in internal controls. In addition, the auditor probably has obtained knowledge that may be relevant to other assurance services such as risk assessment or performance measurement services. This final section of the chapter provides examples of how knowledge obtained while auditing the revenue cycle can be used to support other assurance services.</p> | <p>p. 672</p>      |

**objective questions**

Objective questions are available for the student at [www.wiley.com/college/boynton](http://www.wiley.com/college/boynton)

**comprehensive questions**

- 14-25 **(Knowledge of the entity and its environment)** Your client is a regional motel chain. It owns 27 properties in your region and manages another 40 properties for absentee owners. All the motels located are on interstate freeways and achieve at least 60 percent of capacity on a regular basis. Many motels are fully booked during the summer travel season; however, during the balance of the year price competition is significant.

**Required**

Explain how your knowledge of the business and industry would impact your audit of total revenues and accounts receivable for the client.

- 14-26 **(Analytical procedures)** The following data was taken from the production and accounting records for Casuccio Manufacturing, Inc.

|                                 | UNAUDITED 20x9 | AUDITED 20x8 | AUDITED 20x7 |
|---------------------------------|----------------|--------------|--------------|
| <i>Operating Data</i>           |                |              |              |
| Capacity in Units               | 450,000        | 450,000      | 450,000      |
| Production in Units             | 450,000        | 400,000      | 300,000      |
| Inventory in Units              | 32,000         | 28,000       | 21,000       |
| <i>Financial Data (\$000)</i>   |                |              |              |
| Total Revenues                  | \$ 35,200      | \$ 27,500    | \$ 21,200    |
| Total Assets                    | \$ 23,000      | \$ 19,500    | \$ 15,700    |
| Accounts Receivable, Net        | \$ 5,900       | \$ 4,300     | \$ 3,900     |
| Bad Debt Expense                | \$ 175         | \$ 135       | \$ 105       |
| Accounts Receivable Written Off | \$ 165         | \$ 125       | \$ 100       |

**Required**

- Calculate the following ratios for 20x9, 20x8 and 20x7:
    - Sales to total assets
    - Sales to production
    - Revenue per unit sold
    - Accounts receivable growth to sales growth
    - Uncollectable accounts expense to net credit sales
    - Uncollectable accounts expense to accounts receivable written off
    - Accounts receivable turn days
  - Describe the implications of the resulting ratios for the auditor's audit strategy for year 20x9.
    - What specific audit objectives are likely to be misstated?
    - How should the auditor respond in terms of potential audit tests?
- 14-27 **(Internal control questionnaire—cash receipts)** Harris, CPA, has been engaged to audit the financial statements of the Spartan Drug Store, Inc. Spartan is a medium-sized retail outlet that sells a wide variety of consumer goods. All sales are for cash or check. Cashiers utilize cash registers to process these transactions. There are no receipts by mail, and there are no credit card or charge sales.



**Required**

Construct the “Processing Cash Collections” segment of the internal control questionnaire on “Cash Receipts” to be used in the evaluation of the internal control structure for the Spartan Drug Store, Inc. Each question should elicit either a *Yes* or *No* response.

AICPA (adapted)

14-28 **(Controls over cash receipts processing at a church)** You have been asked by the board of trustees of a local church to review its accounting procedures. As a part of this review, you have prepared the following comments relating to the collections made at weekly services and recordkeeping for members’ contributions:

1. The church’s board of trustees has delegated responsibility for financial management and audit of the financial records to the finance committee. This group prepares the annual budget and approves major disbursements but is not involved in collections or recordkeeping. No audit has been considered necessary in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years.
2. The collection at the weekly service is taken by a team of ushers. The head usher counts the collection in the church following each service. He then places the collection and a notation of the amount counted in the church safe. Next morning the financial secretary opens the safe and counts the collection again. She withholds about \$100 to meet cash expenditures during the coming week and deposits the remainder of the collection intact. To facilitate the deposit, members who contribute by check are asked to draw their checks to “cash.”

**Required**

Describe the weaknesses and recommend improvements in procedures for collections made at weekly services. Organize your answer using the following format:

| WEAKNESS | RECOMMENDED IMPROVEMENT(S) |
|----------|----------------------------|
|          |                            |

AICPA (adapted)

14-29 **(Flowcharting and evaluating on-line computer processing of cash receipts)** Until recently, Consolidated Electricity Company employed a batch processing system for recording the receipt of customer payments. The following narrative describes the procedures involved in this system.

The customer’s payment and the remittance advice (a punch card) are received in the treasurer’s office. An accounts receivable clerk in the treasurer’s office keypunches the cash receipt into the remittance advice and forwards the card to the EDP department. The cash receipt is added to a control tape listing and then filed for deposit later in the day. When the deposit slips are received from EDP later in the day (approximately 2:30 P.M. each day), the cash receipts are removed from the file and deposited with the original deposit slip. The second copy of the deposit slip and the control tape are compared for accuracy before the deposit is made and then filed together.

In the EDP department, the remittance advices received from the treasurer’s office are held until 2:00 P.M. daily. At that time, the customer payments are processed to update the records on magnetic tape and prepare a deposit slip in triplicate. During the update process, data are read, nondestructively, from the master accounts receivable tape, processed, and then recorded on a new master tape. The original and second copy of the deposit slip are forwarded to the treasurer’s office. The old master tape (former accounts receivable file), the remittance advices (in customer number order), and the third copy of

the deposit slip are filed and stored in a secure place. The updated accounts receivable master tape is maintained in the system for processing the next day.

Consolidated Electricity Company has revised and redesigned its computer system so that it has on-line capabilities. The new cash receipts procedures, described below, are designed to take advantage of the new system.

The customer's payment and remittance advice are received in the treasurer's office as before. A cathode ray tube terminal is located in the treasurer's office to enter the cash receipts. An operator keys in the customer's number and payment from the remittance advice and checks. The cash receipt is entered into the system once the operator has confirmed that the proper account and amount are displayed on the screen. The payment is then processed on-line against the accounts receivable file maintained on magnetic disk. The cash receipts are filed for deposit later in the day. The remittance advices are filed in the order they are processed; these cards will be kept until the next working day and then destroyed. The computer prints out a deposit slip in duplicate at 2:00 P.M. for all cash receipts since the last deposit. The deposit slips are forwarded to the treasurer's office. The cash receipts are removed from the file and deposited with the original deposit slip; the duplicate deposit slip is filed for further reference. At the close of business hours (5:00 P.M.) each day, the EDP department prepares a record of the current day's cash receipts activity on a magnetic tape. This tape is then stored in a secure place in the event of a systems malfunction; after 10 working days, the tape is released for further use.

### Required

- a. Prepare a systems flowchart for the company's new on-line cash receipts procedures.
- b. Have the new cash receipts procedures as designed and implemented by Consolidated Electricity Company created any internal control structure problems for the company? Explain your answer.

ICMA (adapted)

14-30 **(Substantive tests of accounts receivable)** The following situations were not discovered by an inexperienced staff auditor in the audit of the Parson Company.

1. Several accounts were incorrectly aged in the client's aging schedule.
2. The accounts receivable turnover ratio was far below expected results.
3. Goods billed were not shipped.
4. Some year-end sales were recorded in the wrong accounting period.
5. Several sales were posted for the correct amount but to the wrong customers in the accounts receivable ledger.
6. The allowance for uncollectable accounts was understated.
7. Several sales were entered and posted at incorrect amounts.
8. Mathematical errors were made in totaling the accounts receivable ledger.
9. An unrecorded sale at the balance sheet date was collected in the next month.
10. Several fictitious sales were recorded.
11. The pledging of some customer accounts as security for a loan was not reported in the balance sheet.
12. Some year-end cash receipts were recorded in the wrong accounting period.

### Required

- a. Identify the substantive test that should have detected each error.
- b. For each substantive test identified in (a), indicate the account balance audit objective to which it pertains.



c. Indicate the type of evidence obtained (i.e., physical, confirmations, documentary, written representations, mathematical, oral, or analytical) from each substantive test.

(Use a tabular format for your answers with one column for each part.)

14-31 **(Sales cutoff test)** You are engaged to perform an audit for the Wilcox Corporation for the year ended December 31, 20X0. Only merchandise shipped by the Wilcox Corporation to customers up to and including December 31, 20X0, has been eliminated from inventory. The inventory, as determined by physical inventory count, has been recorded on the books by the company's controller. No perpetual inventory records are maintained. All sales are made on an FOB shipping point basis. You are to assume that all purchase invoices have been correctly recorded.

The following lists of sales invoices are entered in the sales journal for the months of December 20X0 and January 20X1, respectively.

|          | SALES<br>INVOICE<br>AMOUNT | SALES<br>INVOICE<br>DATE | COST OF<br>MERCHANDISE<br>SOLD | DATE SHIPPED                   |
|----------|----------------------------|--------------------------|--------------------------------|--------------------------------|
| December |                            |                          |                                |                                |
| a.       | \$3,000                    | Dec. 21                  | \$2,000                        | Dec. 31                        |
| b.       | 2,000                      | Dec. 31                  | 800                            | Nov. 3                         |
| c.       | 1,000                      | Dec. 29                  | 600                            | Dec. 30                        |
| d.       | 4,000                      | Dec. 31                  | 2,400                          | Jan. 3                         |
| e.       | 10,000                     | Dec. 30                  | 5,600                          | Dec. 29 (shipped to consignee) |
| January  |                            |                          |                                |                                |
| f.       | \$6,000                    | Dec. 31                  | \$4,000                        | Dec. 30                        |
| g.       | 4,000                      | Jan. 2                   | 2,300                          | Jan. 2                         |
| h.       | 8,000                      | Jan. 3                   | 5,500                          | Dec. 31                        |

**Required**

Based on a sales cutoff analysis, record necessary adjusting journal entries at December 31, in connection with the foregoing data.

AICPA

14-32 **(Confirmation procedures)** King, CPA, is auditing the financial statements of Cycle Co., an entity that has receivables from customers, which have arisen from the sale of goods in the normal course of business. King is aware that the confirmation of accounts receivable is a generally accepted auditing procedure.

**Required**

- Under what circumstances could King justify omitting the confirmation of Cycle's accounts receivable?
- In designing confirmation requests, what factors are likely to affect King's assessment of the reliability of confirmations that King sends?
- What alternative procedures would King consider performing when replies to positive confirmation requests are not received?

## cases

14-33 The following information was taken from the accounting records for Aurora Manufacturing, Inc.

|   | YEAR 5<br>UNAUDITED | YEAR 4<br>AUDITED | YEAR 3<br>AUDITED | YEAR 2<br>AUDITED | YEAR 1<br>AUDITED |
|---|---------------------|-------------------|-------------------|-------------------|-------------------|
| Accounts Receivable Gross                         | \$535,000           | \$295,000         | \$265,000         | \$207,500         | \$175,000         |
| Allowance for Uncollectible Accounts              | (\$14,150)          | (\$6,400)         | (\$5,275)         | (\$5,900)         | (\$5,400)         |
| Total Assets                                      | \$2,200,000         | \$1,800,000       | \$1,500,000       | \$1,200,000       | \$1,000,000       |
| Total Revenues                                    | \$2,700,000         | \$2,050,000       | \$1,750,000       | \$1,400,000       | \$1,200,000       |
| Uncollectable Account Expense                     | \$33,750            | \$25,625          | \$21,875          | \$17,500          | \$15,000          |
| Write-off of Accounts Receivable                  | \$26,000            | \$24,500          | \$22,500          | \$17,000          | \$14,000          |
| <b>Industry Median</b>                            |                     |                   |                   |                   |                   |
| Sales to Total Assets                             | 1.25                | 1.23              | 1.29              | 1.26              |                   |
| Accounts Receivable Collection Period             | 47                  | 48                | 47                | 47                |                   |
| Uncollectable Account Expense to Net Credit Sales | 1.50%               | 1.30%             | 1.25%             | 1.25%             |                   |

**Required**

- Calculate the following ratios for years 2, 3, 4, and 5:
  - Sales to total assets
  - AR growth to sales growth
  - AR collection period
  - Uncollectable account expense to net credit sales
  - Uncollectable account expense to bad debt write-offs
- Describe the implications of the resulting ratios for the auditor's audit strategy for year 5. What specific audit objectives are likely to be misstated? How should the auditor respond in terms of potential audit tests?

## comprehensive case

The following information is designed to be used with cases 14-34 and 14-36. These cases continue audit tests related to the audit of the Mt. Hood Furniture, Inc., which is coordinated with a number of chapters in this book.

**Mt. Hood Furniture Sales Cycle Information****Computer Aspects of Accounting System**

Mt. Hood Furniture, Inc. owns its own computer and computer software for sales, inventory management, purchases, payroll, general ledger, and other accounting applications. None of the accounting processing is outsourced. Mt. Hood's computer operations are headed by Jay Harris, the IT manager, who is relatively new to Mt. Hood. Jay also has taken on the responsibility for security administration. Mr. Harris recently hired Julie Macbeth as head of Systems Development. Ms. Macbeth has focused most of her attention on the development of a new system which will be implemented next year, and has kept changes to existing systems to a minimum. John Rufner is head of computer operations and is responsible for the day-to-day operations of existing computer systems, as well as installing hardware and operating system software associated with the new system which will come on-line in 20x4. Keith Brown serves as an assistant to the CFO and also is respon-



sible for the data control function. Keith reconciles computer output every morning and is responsible for following-up on exception reports generated by the computer system.

Mt. Hood's accounting and inventory management are supported by a network of personal computers (PCs) with units at locations in the offices and warehouse and a central server to handle all accounting and inventory files. Printers are located in areas in which printed documents or records are routinely needed. The computer is used to control and process most transactions, to print documents, prepare accounting records, and prepare periodic financial statements. The company uses a network housed on a HP 9000 server. Access is controlled by passwords. However, passwords are not changed regularly and are controlled informally. Only employees with jobs requiring computer data entry or access to file information and reports are given passwords. Passwords are required to enter the system and specific applications within the system. Once logged on to the application, employees have access to most programs and can enter relevant data. All entered data are processed by batch processing at the end of the day. Data is stored on transaction files in a traditional file system of organization. Normal data entry takes place via the software, which subjects any input to various logical and numerical tests. Most input is backed up by paper trails of source documents and other business papers. The client has strong backup capabilities, and no hardware malfunctions have resulted in the loss of data.

### **Initiating Sales and Delivering Goods**

The company sells its office furniture products to independent dealers in major U.S. cities, several national chains, and warehouse-club chains. The office cabinetry line offers custom orders for on-site installation. Customers include major hotels, professional, and corporate offices. The company also produces a catalogue and has an information web site with an order link. Most sales orders are taken by company sales staff that visits the dealers and buyers for national chains (with the exception of orders that are taken from the order link on the company's web site).

Approved prices are modified quarterly based on quantities in inventory, recent production costs, and competitive forces in the marketplace. Prices are determined at a meeting involving Conrad Saws, James Doyle, and Julia Anderson. Julia Anderson is responsible for updating the master price file, which is reviewed by the entire team once new prices have been entered into the computer.

Finished products are shipped FOB from the warehouse or picked up by the customer. Sales terms on all office furniture and custom cabinetry are FOB net 30, and interest is charged on all receivables over 30 days at a rate of prime plus 1 percent. The company does not ship any inventory on consignment, but office furniture inventory has been shipped to new dealers with terms on an initial shipment of net 120 days, before interest is charged.

When orders are received, they are routed directly to the warehouse, where prospective customers are compared with an approved customer list. If the customer is not on the approved customer list, the order is routed to Keith Brown, assistant to the CFO, who reviews the prospective customer's credit background and prepares a report for Julia Anderson. Julia puts her written approval or disapproval on the credit report. If credit is not approved, Mr. Brown contacts the company directly and asks if the company is prepared to accept goods shipped C.O.D. If they will accept goods shipped C.O.D., the customer is put on the approved customer list with notation to ship only on a C.O.D. basis. If credit is approved, the customer is added to the approved customer list and the warehouse is notified so that it can ship goods. Julia Anderson and Keith Brown are the only individuals with authority to update the approved customer master file, which includes information on whether goods can be shipped on credit or C.O.D.

The warehouse prepares a shipment for customers that are on the approved order list, and goods are shipped the same day or the next day for goods that are in stock. Goods not in stock are put on a back-order list that is shared with production. Using the computer, a warehouse clerk prepares printed copies of both packing slips and bills of lading. The computer does not allow the preparation of a packing slip or a bill of lading for companies not

on the approved customer list. At the end of every day, packages of packing slips and bills of lading, signed by the freight carrier or customer, are sent to accounting.

### Recording Sales

Sales invoices are prepared every night based on the information entered in shipping. The computer calculates an invoice based on the customer information, the information on goods shipped, and the pricing information from the master price file. The company also grants a 1 percent discount to dealers for orders over \$50,000. Once the transaction file is updated, it is merged with the accounts receivable master file. The computer performs the following control procedures:

- The computer program checks internal file labels to ascertain that it is processing the current sales transaction file.
- The computer checks to see that the following fields have appropriate alpha or numeric information before the invoice is processed:
  - Customer information
  - Quantities ordered for each stock number
  - Quantities shipped for each stock number
  - Prices checked against the master price list
  - Bill of lading number
- The computer performs a reasonableness test on the amount of the sale invoice based on the customer number and customer sales history. A transaction is not processed without further approval if the calculated sales invoice is greater than 120 percent of the largest sale to the customer in the last two years.

Transactions that result in an error report are not processed and are printed on an error report. Keith Brown is responsible for clearing all exceptions the next day, including approving sales that exceed the reasonableness test.

When the transaction file is merged with the accounts receivable master file, the following computer controls are performed:

- A total of customer numbers is checked to ascertain that the complete master file is about to be processed.
- Run-to-run totals are calculated for total receivables comparing beginning receivables, plus sales, with the new receivable balance.

If these controls surface errors, the routine is not processed and Keith Brown needs to follow up and determine the errors and ensure that the run is correctly processed the next day. A report is also run comparing the number of items shipped with the number of items billed. This report also goes to Keith Brown for review and followup if necessary.

### Cash Collections

All cash receipts are routed to the cashier, Megan Rogers, who prepares a prelisting of cash receipts and the bank deposit. She is also responsible for depositing cash and returning the validated deposit slip to Julia Anderson, the CFO. The prelisting of cash receipts is forwarded to Erin Riley in accounts receivable. She is responsible for entering cash receipts in the computer.

The cash receipts program is run every evening. When the transaction file is processed, the computer checks for appropriate alpha or numeric information in customer number and cash receipt fields before the cash receipt is processed. If these controls find errors, the routine is not processed. Keith Brown needs to follow up and make a determination on the errors and needs to ensure that the run is correctly processed the next day. A report is also



run preparing a listing of cash received, which is forwarded to Julia Anderson for comparison with the bank deposit. When the transaction file is merged with the accounts receivable master file, the following computer controls are performed:

- A hash total of customer numbers is checked to ascertain that the complete master file is about to be processed.
- Run-to-run totals are calculated for total receivables comparing beginning receivables, less cash receipts, with the new receivable balance.

If these controls find errors, the routine is not processed. Keith Brown needs to follow up and determine the errors and ensure that the run is correctly processed the next day. In addition, a reasonableness test compares the cash receipts with the balance due. A separate report is printed of all customers whose balance results in a credit balance in accounts receivable. This report also goes to Keith Brown for review and followup if necessary.

**Other Procedures**

Keith Brown prepares a monthly bank reconciliation which is reviewed by Julia Anderson by the 10th of every month. Julia Anderson reviews an aging of accounts receivable weekly. She and Keith Brown follow up on past-due accounts. Julia Anderson prepares any journal entries to write off accounts receivable. These reports are reviewed and approved by Conrad Saws.

14-34 (Mt. Hood Furniture, Inc., Review of Internal Controls in the Sales Cycle) Complete the following requirements based on the information on Mt. Hood Manufacturing provided above.

**Required**

- a. Prepare a flowchart for sales and cash receipt transactions for Mt. Hood Furniture, Inc.
- b. Evaluate the strengths and weaknesses in the sales cycle for Mt. Hood Furniture, Inc. using the following format. Organize your evaluation by audit objective. For each audit objective, describe the relevant internal control strength or weakness, and cross-reference to the flowchart. For each strength, describe how you would test the control and then discuss the audit implications for other tests if the tests of controls show that the control is strong. For each weakness, discuss the implications of the weakness and recommend an appropriate improvement in internal controls. Use the following format.

| AUDIT OBJECTIVE    | DESCRIBE STRENGTH OR WEAKNESS | FLOWCHART REFERENCE | DESCRIBE TESTS OF CONTROL FOR STRENGTHS OR DESCRIBE IMPLICATIONS OF WEAKNESSES | DESCRIBE INFLUENCE OF STRENGTH ON AUDIT STRATEGY OR DESCRIBE RECOMMENDED IMPROVEMENT FOR WEAKNESSES |
|--------------------|-------------------------------|---------------------|--|---|
| Occurrence<br>Etc. |                               |                     |  |   |

14-35 (Mt. Hood Furniture, Inc., Accounts Receivable Confirmations) Complete the following requirements related to the confirmation of receivables for Mt. Hood Manufacturing based on previous work and the following information.

**Required**

- a. Determine the sample size using PPS sampling that you want to use for sending accounts receivable confirmations. Use the materiality level that you allocated to

accounts receivable in Chapter 8. Use an audit risk of 5 percent. You may assume that control risk for the relevant assertions is low. Make your own judgments about inherent risk and analytical procedures risk based on the evaluations you made in Chapters 7 and 8. You confirmed receivables at November 30, 20X3 when the book value of accounts receivable was \$6,741,725.

- b. You may assume that except for the following, you received confirmations from customers that showed no exceptions. Mt. Hood ships goods FOB shipping point. Determine whether the following conditions represent errors for purposes of your evaluation. Based on your evaluation of the following information and the parameters of the sample you designed above, evaluate the result of confirming accounts receivable.
1. Dealer No. 129 disputed receivables in the amount of \$30,500, as they were not received until December 2, 20x3. Further investigation showed that the dealer ordered the goods on November 30, 20x3, and they were not counted in inventory when the inventory was taken on that date. The freight carrier came by late in the day and picked up the goods, even though the warehouse was normally shut down for inventory on November 30, 20x3. Cash in the amount of \$30,500 was received on December 29, 20x3. The book value of the receivable for dealer No. 129 at November 30, 20x3 was \$30,500.
  2. Dealer No. 65 disputed receivables in the amount of \$25,750, as it had been paid on November 30, 20x3. A check from dealer No. 65 was received and deposited on December 1, 20x3. The book value of the receivable for dealer No. 65 at November 30, 20x3 was \$25,750.
  3. No response was received from dealer No. 41. Goods amounting to \$44,000 were shipped on November 29, 20x3. A review of the cash receipts journal showed that a check for \$44,000 was deposited on December 24, 20x3. The book value of the receivable for dealer No. 41 at November 30, 20x3 was \$44,000.
  4. Dealer No. 78 disputed receivables in the amount of \$755 claiming that they did not receive an appropriate volume discount on purchases over \$50,000. The book value of the receivables for dealer No. 78 at November 30, 20x3 was \$75,500.
  5. Dealer No. 130 disputed the price on stock number 11205, which was priced at \$1,500 per unit and should have been priced at \$1,200 per unit on three units. Mt. Hood furniture issued a credit memo for \$900 on December 7, 20x3. The book value of the receivable for dealer No. 130 at November 30, 20x3 was \$30,500.
  6. No response was received from custom cabinet customer No. 29. A review of the cash receipts journal showed that a check for \$30,250 was deposited on December 16, 20x3. The book value of the receivable for dealer No. 29 at November 30, 20x3 was \$30,250.
  7. Discount Chain No. 501 disputed the price on stock number 10609, which was priced at \$1,485 per unit and should have been priced at \$1,188 per unit on 10 units. Mt. Hood Furniture issued a credit memo for \$2,970 on December 10, 20x3. The book value of the receivable for Discount Chain No. 501 at November 30, 20x3 was \$457,800.
  8. Dealer No. 85 disputed the balance on the confirmation of \$35,700 in its entirety. Further investigation showed that the balance was charged to the wrong customer. Goods were shipped to dealer No. 58. On December 3, 20x3 the error was discovered. A credit memo was issued to dealer No. 85 and an invoice was sent to dealer No. 58, which was paid in full on December 27, 20x3.

14-36 (Mt. Hood Furniture, Inc., Allowance for Doubtful Accounts)

### Required

Evaluate the fair presentation of the allowance for doubtful accounts based on the following information.

Following is a summary of the activity in accounts receivable and in the allowance for doubtful accounts for the last two years. Also included below is the aging of accounts



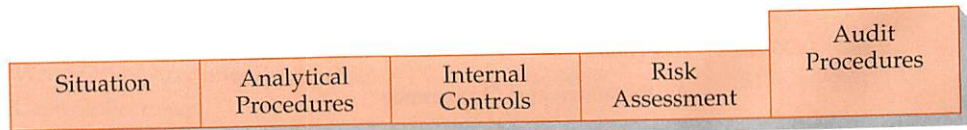


Following is a brief summary of the results of tests of controls.

| CONTROL   | CONTROL RISK ASSESSMENT |
|---|-------------------------|
| The computer matches sales invoice information with underlying shipping information.  | Low                     |
| The computer matches sales prices with the authorized price list.   | Low                     |
| A prelist is prepared for cash receipts and compared with deposit slips.  | Moderate                |
| The computer prepares a daily report of authorized sales returns that have not resulted in a receiving report or a credit memo. | Low                     |

Prepare a brief memo explaining how you would assess control risk in preparation for accounts receivable confirmations.

To: Audit File  
 Re: Control Risk Assessment  
 From: CPA Candidate



*Audit procedure*

- A. Select a sample of recorded sales transactions from several days before and after year-end and examine supporting sale invoices and shipping documents to determine that sales were recorded in the proper period.
- B. Trace beginning balance for accounts receivable to the prior year's working papers.
- C. Send positive confirmations for accounts receivable and follow-up on disputed confirmations.
- D. Trace a sample of revenue transactions from shipments to recorded sales invoices in the sale journal.
- E. Determine whether there are credit balances that are significant in the aggregate that should be reclassified as liabilities.
- F. Send confirmations to entities that have purchased accounts receivable.
- G. Compare uncollectable accounts expense to net credit sales.
- H. Review activity in the general ledger account for accounts receivable and investigate entries that appear unusual in amount or source.
- I. Use generalized audit software to recompute the aging of accounts receivable and investigate the credit history of accounts that are over 60 days past due.
- J. Observe that all cash received through the close of business on the last day of the fiscal year is included in cash on hand or deposits in transit and that no receipts of the subsequent period are included.

