Auditing Sales and Receivables

Key Issues

• Sales are genuine and are neither overstated or understated
• Receivables do actually exist and are collectable, and adequate allowances have been made for receivables that are doubtful in terms of their collectability

The Revenue Cycle

Transaction Classes
– credit sales
– cash receipts
– sales adjustments

Account Balances
– sales
– sales discounts
– a/c’s receivable
– returns & allowances
– cost of sales
– inventory
– bad-debts expense
– provision bad debts
– cash
The Revenue Cycle

- Credit Sales Transactions
  - Accepting customer orders
  - Approving credit
  - Filling & dispatching orders
  - Invoicing customers
  - Recording the sales

The Revenue Cycle

- Cash Receipts Transactions
  - Receiving cash
    - Over the counter
    - Mail receipts
  - Depositing cash in bank
  - Recording receipts

The Revenue Cycle

- Sales Adjustments
  - Cash discounts
  - Sales returns & allowances
  - Bad debts
## Audit Objectives

### Transaction objectives

#### Occurrence (OE)
- Sales recorded in the accounts represent goods that were shipped to customers during the period (OE1)
- Cash receipts recorded in the accounts represent cash received from customers during the period (OE2)
- Sales adjustment transactions recorded in the accounts represent authorised discounts, returns and allowances, and bad debts applicable to the period (OE3)

#### Completeness
- All goods shipped to customers during the period are recorded in the accounts (C1)
- All cash received from customers during the period are recorded as cash receipts in the accounts (C2)
- All discounts, returns and allowances, and bad debts arising during the period are recorded as sales adjustments in the accounts (C3)

#### Accuracy
- All sales, cash receipts and sales adjustment transactions are properly (accurately) recorded (AV1)

#### Cut-off (CO)
- Particularly relevant to transactions around the year-end: all sales, cash receipts and sales adjustment transactions arising before the period end are recorded in the current period and those arising after the period end are included in the next accounting period (CO1)

#### Classification (PD)
- All sales (PD1), cash receipts (PD2), and sales adjustment transactions are recorded in the correct accounts (PD3)
Audit Objectives

Balances objectives

Existence (OE)  Accounts receivable included in the accounts represent amounts owed by customers at the end of the reporting period (OE4)

Rights and obligations (RO)  Accounts receivable at the end of the reporting period represent legal claims of the entity on customers for payment (RO1)

Completeness (C)  All amounts owed by customers at the end of the reporting period are included in accounts receivable in the accounts (C4)

Valuation and allocation (AV)  Accounts receivable represent gross claims on customers at the end of the reporting period and agree with the sum of the accounts receivable subsidiary ledger (AV2)

The allowance for bad debts represents a reasonable estimate of the difference between gross accounts receivable and their net realisable value (AV3)

Presentation and disclosure objectives (PD)

Occurrence and rights and obligations  Disclosed revenue events have occurred and pertain to the entity (PD4)

Completeness  All revenue cycle disclosures that should have been included in the financial report have been included (PD5)

Classification and understandability  Sales cycle information is appropriately presented and information disclosed is clearly expressed (PD6)

Accuracy and valuation  Sales cycle information is disclosed accurately and at appropriate amounts (PD7)
The Audit Plan

Strategy considerations
• Mix of tests of control & substantive tests to be applied; depends on inherent & control risk assessment & materiality
• Understanding the entity and its environment
  – To assist in assessing possibility of misstatements

Strategy considerations
• Analytical review
  – Identifying areas of potential misstatements
  – Highlights risk areas
• Materiality
  – Sales & cash transactions are always material
  – Accounts receivable balance is nearly always material

Strategy Considerations
• Inherent risk
  – Pressure on management to overstate revenue, cash & receivables and understate bad debts
  – High volume of transactions
  – Contentious revenue recognition issues
  – Cash is susceptible to misappropriation
  – Sales adjustments used to conceal theft
Strategy Considerations

- Variety & magnitude of potential misstatements usually lead management to adopt extensive internal controls
- High transaction volume means lower assessed level of CR approach is more efficient for sales & cash receipt transactions
- Where transaction volume is low &/or controls ineffective, predominately substantive approach should be used

Control Risk

- Control environment may reduce inherent risk
- Auditor must test the design effectiveness and operating effectiveness of the ICS over sales
- Based on results of tests, final assessment of CR is made and hence level of substantive testing planned
- See text Table 14.2
Substantive Testing

- Main focus is gross amount due from customers on credit sales, and related allowance for doubtful debts
- Acceptable level of detection risk must first be determined
- Table 14.5, page 603, shows a standard substantive testing program for accounts receivable assertions

Substantive Testing

1. Initial Procedures
   - Trace opening balances
   - Review activity
   - Agree accounts receivable trial balance

2. Analytical Procedures

3. Tests of Details of Transactions
   - Vouch accounts receivables
   - Test sales & cash receipts cut-offs
Substantive Testing

4. Tests of Details of Balances
   • Confirming accounts receivable
     – ASA 505 External Confirmations
     – Reliable external evidence on existence & rights assertions
   • Evaluate adequacy of bad debts provision
5. Presentation & Disclosure

Summary

• Sales and receipts from sales are the most important transaction classes for commercial entities
• A major focus of audit effort
• Major inherent risk for auditor is overstatement of revenues & assets; major risk for entity is misappropriation of cash