Chapter 10

Multiple Choice

10-1. c
10-2. a
10-3. b
10-4. d
10-5. a
10-6. b
10-7. b
10-8. c
10-9. b
10-10. d
10-11. b
10-12. d
10-13. a
10-14. a
10-15. c
10-16. d
10-17. b
10-18. c
10-19. a
10-20. b

Thought/Discussion Questions

10-21 [LO 3, 4, 5] Medco Hospital Buyers Group (MHBG) processes a significant number of intercompany transactions each month, mainly transferring cash between business units to meet the needs of operating cash flows. None of MHBG's intercompany transactions are material on an individual basis. The intercompany transactions only affect balance sheet accounts.

Company policy calls for intercompany accounts to be reconciled each month and for the balances between business units to be confirmed, however, the policy is not followed. The reconciliations are not performed regularly, and when they are performed it is not in a timely manner.

Management reviews the financial reports of the various business units and follows up on any large amounts in the intercompany accounts. Management also reviews operating expenses of each of the business units each month, using variances as an indicator of reasonableness. Management consistently investigates any large intercompany account balances and unusual or large variances that are identified in this monthly review. *(Adapted from AS 2, D1, Scenario A)*

Do you believe the lack of monthly intercompany account reconciliation and confirmation at MHBG is an ICFR deficiency? If you think it is, is a significant deficiency or a material weakness and why? (AS 2, D1, Scenario B, *Retrievable online at http://pcaobus.org/Rules/Rulemaking/Docket008/2004-03-09_Release_2004-001_Appendix_D.pdf*)

Solution:

This is a significant deficiency. Assuming the company uses a standard sales contract for most transactions, individual sales transactions are not material to the entity. The lack of reconciliations could allow sales personnel to modify sales contract terms. While the company's accounting function reviews significant or unusual modifications to the sales contract terms, it does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. Although the entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, the amounts do not appear to have been material. Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons:

- The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected.
- Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition.
- However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded.
- Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

10-22 [LO 1, 5] Scrubs Unlimited sells surgical scrub apparel and surgical drape materials to hospitals. Typically the entire package is sold as an individual transaction. Consequently, individual transactions are often material to Scrubs Unlimited. The company has a standard sales contract, but it is often changed by the sales agent negotiating the sale and consequently, gross margin often varies significantly on different transactions. Sales agents modify payment and delivery terms also, which can affect the appropriate timing and amount of revenue that should be recognized. Management does not approve modifications to the sales contract in advance and the accounting function does not have a process in place to regularly review sales contracts to identify changes made by the sales staff. *(Adapted from AS 2, D2, Scenario B, Retrievable online at http://pcaobus.org/Rules/Rulemaking/Docket008/2004-03-09_Release_2004-001_Appendix_D.pdf*

The auditor believes the lack of controls over modifying sales contracts and accounting for them constitutes a material weakness. Why?

Solution:
The auditor is correct in believing that this is a material weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity, and the gross margin can vary significantly for each transaction. The company does not have procedures in place for the accounting function to regularly review modifications to sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margins on individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material. Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

10-23 [LO 2] FlexBandage Inc. manufactures surgical wraps which it distributes to hospitals and clinics around the country. FlexBandage uses primarily trade accounts when dealing with its customers and bases its accounts receivable valuation at year end on an aging schedule and prior history of overall collections.

a. When should recognize revenue from its sales transactions?

Solution: FlexBandage should recognize revenue from sales when it is determined that sales are the result of real transactions that meet the criteria for revenue recognition. Here the focus is on when the hospitals and clinics take possession and is billed for the surgical wraps and what the policy is regarding returns.

b. If FlexBandage is a publicly owned company what is a potential problem auditors need to consider for revenue recognition?

Solution: For public companies the primary concern is that revenue may be overstated. Sometimes the misstatement is the result of an error, and sometimes it results from intentional
actions by management of the company. Auditors need to consider:

- Whether cash is appropriately collected and that proper billing occurs.
- All sales that occurred are properly recorded.
- That recognizing and recording revenue appropriately is in the proper period.
- Sales must be recorded at the proper amounts and that current price lists are
- used for pricing, recording, and billing sales transactions.
- Accurate posting of accounts receivable subsidiary ledgers is completed
- Invoices were correctly prepared and credit for cash received was given to the right customer.

c. How would your answer to part b. change if FlexBandage were a privately owned company?

Solution: In a privately owned company, the concern about improper revenue recognition also extends to understatement. For example, in an attempt to pay less income tax or not pay a minority investor the full fair share of profits, an owner-manager may intentionally not record cash sales. Auditors pay special attention to revenue recognition because of its vulnerability to error and fraud.

10-24 [LO 3] For each of the following situations decide whether proper controls relating to the segregation of duties have been implemented. If not, recommend any improvements that could be made.

a. A catering company prices each job separately based on the size, kind of food, and other variables. Currently, the event planner for each account prices the job, places all the necessary orders, and collects payment at the time of the event.

Solution: The event planner is the weak link in the control for this company. Without segregation of duties, he or she could place orders and steal merchandise or receive cash and pocket it. Likewise since this individual sets the price on each job and collects cash, he or she could work out a kickback scheme with suppliers.

b. A department store has implemented an electronic system to process and authorize credit card transactions.

Solution: While the electronic authorization system is good, there needs to be some kind of reconciliation with the receivables department on the revenue recording and collection, as well as contractual compliance procedures to investigate swipe fees and contractual agreements regarding credit decisions.

c. A mail order company accepts both checks and credit cards as payment on sales. The checks received through the mail are collected on a weekly basis, restrictively endorsed, and a remittance list is created.

Solution: A weekly basis is too long to have checks lying around, despite the endorsement. In fact, it is surprising that the mail order company accepts checks. Exclusive payment with credit cards or PayPal would ensure that the company more efficiently recognizes revenue, when goods are shipped.

d. The same mail order company from part c. does not release any inventory for shipping until employees have matched the inventory items to be shipped with an approved sales invoice.

Solution: While this is a good control, it can be improved by sending a shipping notice to the accounts receivable department, so that billing can be initiated and the sales transaction posted.

e. The accounting department at Carly Corporation reconciles their books to their bank statements every six months.

Solution: Every six months is too long. This should be done monthly to better account for cash. Also, most banks only allow corrections of their mistakes to be made if caught within 90 days.

10-25 [LO 1, 3, 4] Sarah works in a clothing boutique whose return policy requires a manager to authorize any returns or exchanges. While auditing the boutique you interview Sarah and learn that the weekend manager has given Sarah and several other employees the authorization code to process returns and exchanges so the register does not get backed up when the store gets busy. As the auditor, would you continue to test this control during your audit? What recommendations would you make to improve this control?

Solution:

If a control cannot achieve its objective because of design that is being overridden or the design is poor, the auditor will not test how well it operates. Since the control in not working as designed, the auditor might suggest a cost-effective and different technology for the processing of returns and exchanges, such as fingerprint recognition or voice recognition for exchange agents, assignment of separate key codes for each employee that has been trained to do exchanges, or a dual control of an online authorization through a partnership of the store's employee plus a third party vendor.

10-26 [LO 4] For each of the following (a-c) determine which audit objective is being met by the following control. In addition, list a test that an auditor would do to provide assurance that the control was effective.

a. All sales orders are matched to shipping to documents on a weekly basis to determine whether the orders are being filled in a timely manner and all items that are shipped are billed.

Solution:

For timeliness – **Cutoff objective -** Select transactions from the sales journal and agree the date of posting to the sales date on the sales invoice and shipping document; agree amounts
For billing **- Existence or occurrence, rights and obligations, valuation or allocation, presentation and disclosure objectives -** Select transactions that have been recorded from the sales journal; trace sales journal entries to supporting documents and records such as sales invoice, bill of lading, sales order, customer order; verify appropriateness of underlying documents and agree amounts; select a sample of sales invoices and examine supporting documents for evidence of service provided or evidence that the items listed in the invoice are what was shipped

b. The person who prepares the daily cash deposit is different from the person who reconciles the cash account with the deposit ticket.

Solution:

Segregation of duties **– Completeness, valuation or allocation, and presentation and disclosure objectives -** Trace items listed on a sample of daily cash receipts records to the cash receipts journal, agreeing amounts and details such as dates and names; trace amounts and details on a sample of daily cash receipts records to deposit records; reconcile items on the cutoff bank statement with other client-prepared bank reconciliations, cash receipts journal, and cash disbursements journal

c. Any sale made for a price other than the specified selling price is approved by management.

Solution:

Prices **– valuation or allocation objective -** Examine the approved price list or other supporting evidence for accuracy and proper authorization and agreement to the price used on the sales invoice

10-27 [LO 2, 4, 5] Your client, Cars Unlimited, Inc., is currently the largest client for the local office of the audit firm. Cars Unlimited, Inc. is a large car dealership that sells over 15,000 cars a year. You have been on this engagement for 3 years already but this is your first time as the senior associate. Over the past 3 years, you have developed a strong friendship with many of the car salesmen that work at the dealership.

During the audit planning process, the engagement manager identifies the sales at year-end to be of high risk. The manager assigns you to perform the audit work for this high risk area. After comparing the VINs from the sales forms to the VINs included in the year-end inventory counts, you noticed that 10 vehicles that were reported as been sold at year-end but the vehicles were still in the lot for the year-end inventory count. The total revenue for these 10 vehicles is not above the materiality threshold for this client.

After looking over additional backup, you notice that the salesman was the same for all 10 vehicles. The salesman was Josh, one of the guys that you became friends with over the years. Before alerting anyone on your engagement team, you decide to talk to Josh about the situation and listen to his explanation. During the discussion with Josh, he tells you the following information:

- He backdated the retail date for the vehicles to include them in his previous month's sales figure, without the knowledge of the dealership.
- The reason was so that he could reach the required sales figure in order for him to receive a bonus.
- He only did it because his son was sick and need the money to provide his son to with medical care. Lastly, he ended the conversation by saying, "Please don't inform the company of this issue because I will lose my job and have to pay back the bonus that I don't have. My son is still very ill and I need this job to pay for the medical bills."

Identify the ethical issues in the above situation. How would you handle your dilemma?

Solution: This case presents a classic fraud triangle. Pressure – Josh's need to reach a sales figure to achieve a bonus. Opportunity – He was a long-time trusted employee. Rationalization – he only did it to help his sick son. The ethical breaches include Josh's backdating, without dealership knowledge; Josh's intent to take advantage of his long-term job with the dealership (regardless of his rationalization) in order to deceive and obtain a bonus through his unethical deed.

You cannot turn a blind eye to Josh's fraud, even though he is your friend. To do that would put you into collusion with him and violate both the trust of your client and firm. As hard as it may seem, the only course of action is to let the engagement manager know about what you have uncovered in this high risk audit area and work with him to take it to the audit committee of the company. You must retain your independence and integrity.

Problems

10-28 For each of the following errors identify an audit procedure the auditor could have used to detect it. [LO 5]

a. The allowance for doubtful accounts estimated by management is too small.
    - **Solution:** Compare sales returns and allowances as a percentage of gross sales, by product line, with previous years

b. Cash in payment of an account receivable is deposited in the bank in the current period but is not posted to the accounts receivable record, trial balance or general ledger until the subsequent period.
   - **Solution:** Compare large individual customer balances that are over a threshold amount with the same customers' balances in previous years

c. For a month, sales are transacted using an outdated price list with amounts that are too low. The transactions are recorded accurately based on the price list used. Management does not know the incidents occurred.
   - **Solution:**
     - Compare gross margin percentage, by product line, with previous years
     - Compare sales, by product line, month-to-month over time

d. Cash for the exact amounts of sales are regularly pocketed by employees and not recorded on the sales terminal. Customers do not ask for receipts.
   - **Solution:**
     - Have a policy of giving receipts or your order is "free"
     - Assign sales terminal numbers to each employee and obtain computerized printouts and reconcile with receipts by employee, possibly tied to a bonus or sales incentive

e. Management records false sales close to year end and posts them as accounts receivable.
   - **Solution:** Compare number of days that accounts receivable are outstanding with previous years and related turnover of accounts receivable
   - Compare totals of various categories on the aged accounts receivable schedule as a percentage of accounts receivable with what existed in prior years
   - Compare the balance in the allowance for uncollectible accounts as a percentage of accounts receivable with the percentage that existed in prior years
   - Compare the accounts receivable written off in the current year as a percentage of accounts receivable with the percentage amount that was written off in prior years

f. Sales on account *for services* that take place in the first two days of the subsequent year are posted in the current year.
   - **Solution:** Compare the balance in the allowance for uncollectible accounts as a percentage of accounts receivable with the percentage that existed in prior years
   - Have the auditor physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.

10-29 [LO 4, 5] You are responsible for performing substantive analytical procedures on services revenue for MDCosmetics, a company that employees and provides administrative services (billing, collections, supplies purchasing, etc.) for a group of plastic surgeons in the Orange County area of California. MDCosmetics is a public company and this is the third year your audit firm has performed the audit. You have recorded information on sales revenue, sales discounts (mostly for special promotions), cash, and accounts receivable. Others on your audit team have finished the audit of cash, accounts receivable, and payroll and have not found any major problems with either ICFR or accounts and disclosures. The results of the other audit work are available to you. You also have schedules related to operating room use time both in the doctor's private offices and at hospitals, as well as information on the number and pay grades of support staff who participated in the scheduled surgeries. Although your firm has conducted the audit previously, in prior years sales have been audited only as the result of the accounts receivable and cash collections audit.

Draft the analytical procedures that you would include in the audit program for sales.

Solution:

To identify possible over- or understatement of sales and account receivable, the auditor should:

- Compare gross margin percentage, by product line, with previous years
- Compare sales, by product line, month-to-month over time

To identify possible over- or understatement of sales returns and allowances and accounts receivable, the auditor should:

- Compare sales returns and allowances as a percentage of gross sales, by product line, with previous years

To identify possible misstated accounts receivable and related income statement accounts, the auditor should:

- Compare large individual customer balances that are over a threshold amount with the same customers' balances in previous years

To identify possible uncollectible accounts receivable that have not been provided for, the auditor should:

- Compare bad debt expense as a percentage of gross sales with previous years

To identify possible over- or understatement of the allowance for uncollectible accounts, and bad debt expense or to identify possible fictitious accounts receivable, the auditor should:

- Compare number of days that accounts receivable are outstanding with previous years and related turnover of accounts receivable

- Compare totals of various categories on the aged accounts receivable schedule as a percentage of accounts receivable with what existed in prior years
- Compare the balance in the allowance for uncollectible accounts as a percentage of accounts receivable with the percentage that existed in prior years
- Compare the accounts receivable written off in the current year as a percentage of accounts receivable with the percentage amount that was written off in prior years

10-30 [LO 2, 5] Your client, General Hospital, provides a wide range of healthcare services to "qualified" patients. In order to be a "qualified" patient, an individual must provide the hospital with a valid form of identification and a current insurance card. Before a patient can receive services, the hospital must verify that the insurance is current and the individual is covered on the plan.

On New Year's Eve, an individual arrives at General Hospital with major burns from a firework accident. In need of immediate attention, the patient convinces the receptionist that he will fill out all the paperwork later and that he has valid insurance. The receptionist decides that the individual seems believable and admits the patient without checking the insurance to be valid but does receive a valid form of identification. After the patient received medical services related to the firework accident, the receptionist asked him to complete all the necessary forms and provide a current insurance card. At that time, the individual informs the receptionist that he does not have his insurance card with him but he will bring it to the hospital the next day. On January 2, the patient brings a copy of his current insurance card and the hospital verifies that the services he received are covered on his plan.

Use the criteria in FASB Statement of Financial Accounting Concepts No.5 and indicate when and/or how the client should recognize the revenue. Assume the company has a calendar year-end. Explain your answer. Additionally, what controls are in place and how would you audit these controls?

Solution:

Revenue recognition should show this as of the date of service, since all insurance companies key their explanation of benefits on this date. The answer is January 1.

Students should include controls appropriate to the hospital setting, such as:

- Process for prior authorization of treatment by Medicare or private insurance companies.
    - To test this, the auditor would select a sample of patient invoices and examine authorization approval, including authorization by appropriate agency, and date preceding service.
    - The hospital example is a bit different than most business services due to the fact that the service is a matter of life or death.

   - Therefore, many hospitals typically have a free care fund or allowances or financial assistance programs available to them for charges not paid. In fact, hospitals get certain accounting and public-relations benefits even when they don't collect from the uninsured. For-profit hospitals get a tax write-off on uncollected debts. Non-profit hospitals (85 percent of U.S. hospitals are non-profit) cite their uncollected debts in fund-raising efforts and to the government in arguing for higher Medicare and Medicaid reimbursement payments.
- Only real and appropriately documented services are charged. Within the hospital, bar coding is key to make sure a device or service has been provided and charted.
   - To test this, the auditor would observe personnel as procedures are completed for patients
- Patient services should be accounted for chronologically and used to post to patient accounts
   - To test this, the auditor would account for a continuous date sequence while the patient was in a facility and procedures have been recorded by tracing to patient accounts journal and accounts receivable subsidiary ledger
- Patient admission forms are used to collect information prior to treatment
   - To test this, the auditor would examine the patient admission forms for all documentation of evidence regarding patient information and responsible parties and payment plan arrangements

10-31 [LO 2, 5] Nile.com is an online retailer of electronics, music, books, DVDs, and a variety of other consumer goods. All sales are made on the basis of FOB Destination Prepaid, the shipping costs are paid by the customer. During the last week of the year, Nile.com had a large year-end sale of all merchandise on the site. The company provided a guarantee that all orders would be shipped by the end of the year. During that week Nile.com had sales orders totaling $5.8 million, which was equal to 23% of total sales for the year before the sale. As the company promised, all the orders were shipped on December 31. At this time, all the money was collected and no products for these orders were in the control of the company. The customers received their orders within 5 days of shipment.

Use the criteria in FASB Statement of Financial Accounting Concepts No.5 and indicate when and/or how the client should recognize the revenue. Assume the company has a calendar year-end. Explain your answer. Additionally, what controls are in place and how would you audit these controls?

Solution:

The revenue should be recognized on January 4, since the goods were sent were sent F.O.B. destination, which means that title to the goods transfers to the consumer after they reach them (five day delivery)

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Controls should be put in place to make sure that :

- Process for granting/approving credit and setting credit limit for new customers, or approving credit for each transaction for continuing customers is completed by authorized company employee and documented prior to completion of transaction.
    - To test this, the auditor would select a sample of sales invoices and examine for evidence of credit approval, including authorization by appropriate individual, and date preceding service or shipment.
- Goods are only shipped for real and appropriately documented sales. This requires that the system requests a sales order number to be entered before a shipping document can be generated. If an invalid sales order number is entered the system will not allow the user to proceed to generate the shipping document
    - To test this, the auditor would observe personnel as they create shipping documents; attempt to create a shipping document without a sales order number and with an invalid sales order number
- Shipping documents are accounted for numerically and used to post sales transactions
    - To test this, the auditor would account for a continuous numerical sequence of shipping documents and examine evidence that the shipping transactions have been recorded by tracing to sales journal and accounts receivable subsidiary ledger
- Customer order document is used to collect information prior to sale and initiate the transaction
    - To test this, the auditor would examine the customer order document for evidence of customer information
- Bills to customers are based on documents which support that a sale has occurred
    - To test this, the auditor would select a sample of sales invoices and examine supporting bill of lading and customer order.
- Reconciliations verify that transactions are properly posted to company records
    - To test this, the auditor would examine evidence of reconciliation of computer files for sales journal, accounts receivable subsidiary ledger and general ledger, and ledger of shipments, if appropriate
- Transactions are only recorded as sales when supported by appropriate records
    - To test this, the auditor would select a sample of sales document packages (invoice and all supporting documents) and examine for consistency with sales policies and any other internal verification
- When sales invoices are created, amounts are based on service provided or items included in shipments
    - To test this the auditor would select a sample of sales invoices and examine supporting documents for evidence of service provided or evidence that the items listed in the invoice are what was shipped
- Sales invoice amounts are determined using approved price lists or other authorization

- To test this, the auditor would examine the approved price list or other supporting evidence for accuracy and proper authorization and agreement to the price used on the sales invoice

- Customer invoices or statements are sent based on company records
  - To test this, the auditor would observe whether customer statements (or invoices) are sent
- Transactions are recorded to customer accounts receivable records based on supporting documentation
  - To test this, the auditor would select a sample of document packages and trace to the accounts receivable subsidiary ledger agreeing specific transaction; or select a sample of transactions from the accounts receivable subsidiary ledger and examine supporting document packages agreeing specific transaction details and amounts
- Sales are posted consistent with year-end cutoff procedures
  - To test this, the auditor would account for a continuous numerical sequence of shipping document that occur before and after year end, trace to sales journal and verify for posting in correct year; for service transactions, trace underlying documents such as project completion, work-in-process calculation or human resources records to sales journal to verify correct date of posting
- Accounts receivable subsidiary ledger and general ledger are reconciled
  - To test this, the auditor would examine evidence that the accounts receivable subsidiary ledger is reconciled to the general ledger

10-32 [LO 1, 3, 5] You are on an engagement to provide an integrated audit on the financial statements of Carson's Orthopedic Shoes. This company is a small-size online retailer that sells custom shoes to the public. All orders are processed, packaged, and shipped by company employees at a small warehouse.

At the beginning of the audit engagement, the company provided your senior with the process diagram related to the shipping process. After reviewing the diagram, you have identified two "holes" in the diagram. First, the diagram doesn't identify how the shipping department receives the signal to ship the product. Second, the diagram indicates that no invoice is included with the shipped shoes.

You are assigned by your senior to conduct an inquiry of the shipping process. Prepare a list of questions which will provide you with an understanding of the controls that are in place. Additionally, what documentation would you ask management for?

Solution:

The invoice processing and billing function should be independent of the shipping function to provide adequate segregation of duties. Lack of segregation of duties for these functions can permit theft. The shipping process requires that the seller fill the order, typically removing the goods from storage or warehousing, before shipping. While credit sales requiring shipping may not seem like a major category of sales for traditional "brick-and-mortar" retail establishments, it is a very important category of sales for retailers who sell only or primarily online. Questions should focus on a better understanding of the process, including:

(1) When a product is shipped to the purchaser,
(2) the seller's shipping department documentation of the shipment,
(3) documentation used to notify the billing department about the shipment,
(4) How the information about the shipment triggers the process of billing the purchaser,
(5) What documentation is used to authorize the retrieval from the warehouse or storage. (i.e., approved copy of the customer order or sales order, pick ticket, or bills of lading).

10-33 [LO 4] Understanding the management assertions related to a specific control is an important factor in preparing the tests of controls. Using the assertions provided below, select the management assertion(s) that relates to the purpose of the controls in table. (A management assertion may be selected once, more than once, or never at all.)

<u>Management Assertions:</u>

a. Existence and occurrence
b. Completeness
c. Rights and obligations
d. Valuation and allocation
e. Presentation and disclosure
f. Authorization
g. Cutoff

SOLUTION:

Purpose of Control	**Management Assertion**
To ensure that credit is approved before a sale is executed and service is provided or goods are shipped	Authorization
To ensure that transactions shown as sales are properly classified	Presentation and disclosure
To ensure that when cash receipts are recorded they show cash that was actually received by the company, and deposited	Valuation and allocation Presentation and disclosure
To ensure that cash receipts transactions are properly posted to the accounts receivable subsidiary ledger and general ledger	Valuation and allocation Rights and obligations
To ensure that all cash received by the company is deposited and recorded in the cash receipts journal and that amounts and details, including the date, are shown correctly	Completeness Existence and occurrence Valuation and allocation Presentation and disclosure Cutoff
To ensure that sales transactions are recorded based on the correct dates	Cutoff

10-34 [LO 5] Over the year, the Jackson Sports Supplies Company received multiple complaints from customers that there payments were incorrectly posted. While the total amount of payments received equaled the customers' total payments, the amounts were broken up in multiple entries at different dates. Additionally, the company was experiencing cash-flow problems at the end of the year. Management concluded that they had a problem in the billing and collection process. The Jackson Sports Supplies Company hired you to perform an examination of the billing and collection process to determine any deficiencies that exist in the process.

After studying the billing and collection process, you came up with following conclusions:

1. There is a lack of segregation of duties in the accounts receivable department. There are only two bookkeepers to perform all of the duties in the billing and collection process.
2. The receptionist is assigned to open the incoming mail but regularly just gives the mail to the bookkeepers unopened.
3. The main responsibilities of bookkeeper A are:
    - Receive payments received by mail
    - Create a daily remittance list of all payments received
    - Depositing receipts
4. The main responsibilities of bookkeeper B are:
    - Recording receipts in the cash receipts journal
    - Posting the payment in the individual customer's accounts and the general ledger accounts
5. Additionally, you were told that bookkeeper A is regularly out of the office for business and personal reasons. On these days, bookkeeper B is responsible for performing bookkeeper A's duties.
6. Since there is a lack of segregation of duties and the company received complaints from customers of errors in their statements, you suspect that the bookkeeper may performing an embezzlement scheme called lapping. Lapping occurs when the bookkeeper conceals the cash shortage by delaying the posting of cash remittances.

Required:
Create a list of audit procedures that you should perform in order to decide if lapping exists in Jackson Sports Supply Company.

Solution:

- Mail positive accounts receivable confirmation requests directly to all customers with old balances.
- Investigate all exceptions noted on confirmations.
- Obtain authenticated deposit slips directly from the bank.
- Compare individual customers' names, dates, and amounts shown on the customer's remittance advices with the names, dates, and amounts recorded in the

cash receipts journal, individual customer ledger accounts and deposit slips (if practicable).

- Verify the propriety of noncash credits to accounts receivable (for example, sales discounts, sales returns, bad debt write-offs).
- Perform a surprise inspection of deposits.
- Foot the cash receipts journal, the customers' ledger accounts, and the accounts receivable control account.
- Reconcile the total of the individual customers' accounts with the accounts receivable control.
- Compare information in copies of monthly customers' statements with information in customers' ledger accounts.

10-35 [LO 4, 5] Denice Williams, CPA is the in-charge auditor for Midwest Health Solutions, Inc. She requested an aging analysis of accounts receivable as of 12/31/11, the company's year-end. Below is the information she received:

Categories	Amount	Estimated Uncollectible
Current	$3,000,000	1%
1-30 days past due	2,000,000	2%
31-60 days past due	1,000,000	5%
61-90 days past due	500,000	10%
Over 90 days past due	1,750,000	25%

The controller for Midwest said that the percentage have been used throughout his tenure with the organization (approximately 10 years). He also indicates that the current balance in the allowance for uncollectible accounts is $190,000, which is adequate in light of successful collection efforts for the 61-90 day and the over-90-day categories.

Required:
1. Explain why is it important for the auditor to address the adequacy of the allowance for uncollectible accounts.
2. What procedures should Denice apply to determine whether this allowance is adequate?
3. Show an example of an analysis estimate that she might prepare and discuss how you would use this to convince the controller that an adjustment is necessary.

Solution:

1. The auditor needs to address the adequacy of accounts receivable to provide reasonable assurance about management's valuation assertions. In other words, are the customer accounts reflected in the balance sheet the best estimate of the net realizable value? Therefore, both the aging schedule and the allowance balance are important evidence.
2. Denice should obtain an understanding of how the estimates were developed. This includes a review of the process, developing independent estimates or tests of

reasonableness through discussions with the credit manager, and reviewing subsequent events prior to the completion of field work.
Not only should she obtain an aging schedule, but she should review it by tracing balances to the accounts receivable subsidiary ledger on a test basis, check for cutoff (making sure remittances apply to year-end receivables), and draft a proposed audit adjustment based on her estimate.
3.

	$3,000,000	X	1%	=	$ 30,000
	2,000,000	X	2%	=	40,000
	1,000,000	X	5%	=	50,000
	500,000	X	10%	=	50,000
	1,750,000	X	25%	=	437,500
Total	$8,250,000				$ 607,500

The auditor should suggest a downward adjustment of receivables through a substantial increase in the allowance for uncollectible accounts of $417,500 (or $607,500 – 190,000). Denice needs to convince the controller by presenting her results and a proposed audit adjustment and inform him that the absence of this adjustment would result in a qualified opinion.

10-36 [LO3] You are the auditor for Johnson Products, a medical supply company. They ship wholesale products to clinics and hospitals and some retail products to drug stores.

When flowcharting the revenue cycle, you discover the following information:

- All sales are made on open account via 1/10, net/30 credit terms, unless arrangements are OK'd by credit manager approval. Credit terms were last evaluated 10 years ago.
- Inventory is maintained in real-time via computer.
- Official prices can be updated as needed by product managers or the sales vice president.
- Regional managers can override official prices if the computer queries deviations.
- New customers require credit approval by the regional sales manager.
- Once a line of credit is established, a monthly credit report is generated to compare customer credit lines with instances where credit has been exceeded. In those cases, a halt is placed on further sales.

Required:

What are the internal control weaknesses you identify? What problems could this create and what suggestions would you make to correct them?

Solution:

Weakness	Correction
In this company it appears that many	These situations could lead to fraud and

individuals can override the policies in place, indicating a lack of segregation of duties. • Credit manager can alter credit terms • Official prices can be updated by a number of people – product managers and sales vice president • Regional managers can override prices and extend credit approval for new customers.	abuse. Suggestions would include more oversight and more segregation of duties. • Credit manager can alter credit terms with separate approval from controller. • Limit price updates to one or two individuals. • Have price overrides signed off by two individuals and reserve credit decisions for the credit manager.
"As needed" price increases may not be sufficient.	This could result in inventory valuation problems. Update price increases on a regular basis depending on the product – daily, bi-weekly, and based on new inventory received or manufactured.
Monthly credit line checking is not sufficient.	This could result in many bad debts or slow payments. Build a sub-routine in the revenue cycle program that compares credit line to each order to prevent excess purchases above credit limit available.
Credit terms have not been evaluated regularly.	If the credit manager has been altering credit terms for many customers, then there may be issues of fraud or abuse, or perhaps ineffective operations within the health care environment or industry. Credit terms need to be evaluated at least annually and/or in light of cash flow implications for Johnson and also consideration of how customers receive medical reimbursement payments from insurance companies, Medicare, Medicaid, etc.

10-37 [LO 7] Daniel Martin, CPA is the auditor for HMO Health Systems. He requests that the client's bank cutoff statement be sent directly to him at his CPA office. In tracing reconciling items to the cutoff statement, he lists the following:

1. A deposit in transit (dated 12/31/10) cleared the bank on 01/10/11.
2. Checks 1812, 1813, 1814, and 1815 recorded as of 12/31/10 did not clear the bank until 01/19/11, 01/20/11, 01/21/11, and 01/22/11, respectively.
3. An outstanding check payable to T. Simpson was endorsed by HMO's controller.

Required:

What possible errors or fraudulent activity is associated with each of these items? Explain whether any audit adjustments are necessary.

Solution:

When examining the statements, auditors pay particular attention to payees and endorsements and clearing dates for paid checks and deposits in transit.
1. A year-end deposit in transit that does not clear until January 10th of the following year, is indicative of 2011 cash receipts recorded in 2010. In this case the auditor should examine the underlying documentation for the deposit, such as customer remittance advices. An adjustment crediting Cash and debiting Accounts Receivable may be in order if this is traced to 2011.
2. An unexplained endorsement by the Controller of the company suggests fraud and needs to be discussed with senior management or the audit committee, if collusion is suspected. An audit adjustment may be in order, pending a fraud investigation and management's disposition of the matter. In any case, there is an error in the debit side of the company's books. If the original entry had been made as a debit to Purchases, the adjustment for the fraud would include a debit to Loss from defalcation or Receivable from Controller and a credit to the misstated Purchases account.
3. These checks suggest an improper cash disbursement cutoff. Unless the checks were all drawn payable to the same payee, it is probably unlikely that they were held prior to deposit. The auditor should examine any underlying documentation and if a cutoff misstatement is likely, the audit adjustment should reverse the disbursement and debit cash for the year of audit.

10-38 [LO 5] You are conducting an audit of the financial statements of Medical Complex Rentals, Inc. for the year ending March 31, 2010. You are assigned to examine the annual rent reconciliation (below) prepared by the controller of the company.

Medical Complex Rentals, Inc.
Rent Reconciliation
For the Year Ended March 31, 2010

Gross Office Rentals (Schedule 1)	$2,300,000	(a)
Less Vacancies (Schedule 2)	100,000	(b)
Net Office Rentals	$2,200,000	
Less Unpaid Rents (Schedule 3)	25,000	(c)
Subtotal	$2,175,000	
Add prepaid rent collected (Schedule 4)	15,000	(d)
Total cash collected	$2,190,000	(e)

Required:

The controller has provided you with Schedules 1 – 4 (not shown). You find that the internal controls can be relied upon and that the cash receipts for rentals are deposited in a special bank account. Based on this, what audit procedures would you use to substantiate each of the balances labeled (a through e)?

Solution:

(a)
1. Physically examine the rental property and number of units. Note occupied versus vacant offices.
2. Compare the total units to total rents on Schedule 1 by examining lease agreements.
3. Prepare a gross rent schedule (if not given in Schedule 1) and foot, ascertaining the reasonableness of occupied and vacant rentals per individual lease agreements and comparing the total with the rent reconciliation.

(b)
1. Physically examine the rental property vacant during the month.
2. Compare vacant rental charge for each vacant unit with Schedule 2.
3. Prepare a schedule of vacancies (if not given in Schedule 2) and compare total with rent reconciliation.

(c)
1. Trace unpaid rents from ledger to Schedule 3.
2. Prepare an unpaid rent schedule (if not given in Schedule 3) and compare with reconciliation total.
3. Examine collection file for attempts to collect.
4. Request confirmations from tenants with unpaid rents.

(d)
1. Trace the receipt of prepaids to ledger.

2. Compare amounts collected with lease terms.

(e)
1. Foot the reconciliation.
2. Reconcile and confirm the special bank account
3. Reconcile cash receipts with ledger and financial statements.

10-39. [LO 2] You are auditing Riverview Medical Center for its fiscal year ending December 31, 2010. During your tests of account balances you noted the following:

1. The November revenue journal indicates that patients were billed $150,000 and this amount was posted as a debit to Accounts Receivable and a credit to Revenues. In fact, the footing of the journal shows that the correct amount of patient billings was $155,500.
2. You prepared a bank reconciliation at year-end and found that an $8,000 check had been omitted from the list of outstanding checks. The check had been issued and recorded during October but had not yet cleared the bank.

Required:

Based on your brainstorming about possible frauds, what could these indicate about an attempted concealment?

Solution:

1. The revenue journal was under-footed by $5,500. Because the understatement is posted as a debit to Accounts Receivable, future collections were also understated. This would allow someone to intercept patient remittances without a shortage resulting.
2. A misappropriation of cash may have occurred. The fraud perpetrator would have to manipulate the bank reconciliation, by understating the amount subtracted for outstanding checks. Alternatively, the shortage could be covered by overstating deposits in transit. An unrecorded check would reduce the bank balance but not the book balance.

10 – 40. [LO 1, 3, 4,5] You are auditing Seaside Hospital and Medical Complex. You complete a walkthrough with the help of Seaside's controller. The following comments relative to cash receipts are outlined in your memo describing Seaside's accounting procedures.

1. Cash receipts are sent directly to the accounts receivable clerk, with no processing by the mail department. The accounts receivable clerk keeps a cash receipts journal, prepares the bank deposit slip in duplicate, posts from the deposit slip to the subsidiary accounts receivable ledger and mails the deposit to the bank within 2 days.

2. The controller validates the deposit slips directly (unopened) from the bank, also receives the monthly bank statements directly, and promptly reconciles the account.
3. At the end of the month the accounts receivable clerk notifies the general ledger clerk of the monthly totals of cash receipts for posting.
4. Each month, the general ledger clerk makes debit entries to record Cash from sources other than cash receipts from patients (i.e., borrowed funds).

Required:

List at least three problems indicated. For each, identify one audit procedure to investigate the problem, the reason for the audit procedure, and a recommendation that Seaside should implement. Use the following table to organize your answers.

	Problem	Audit Procedure	Reason for the Procedure	Recommendation
1.				
2.				
3.				

Solution:

Students may have many different answers, since this memo details significant problems with segregation of duties and weak internal controls. Below is an example:

	Problem	Audit Procedure	Reason for the Procedure	Recommendation
1.	There are no initial controls over cash receipts from the mailroom, prior to the accounts receivable.	Surprise examination of cash receipts.	Without the accounts receivable clerk's knowledge, the auditor should make list of cash receipts in the mailroom. The undeposited mail receipts should be controlled after completion of their preparation for deposit and postings. The deposit slip should be compared to remittances. The auditor should supervised deposit mailing to the bank. The bank statement containing this deposit should be mailed directly to the auditor.	Implement a control listing of cash receipts in the mailroom and segregate collection, recording, and deposit functions.
2.	No segregation of duties on the issue	Send patient account	The accounts receivable clerk may be careless in	Segregate the receipt of cash from the posting.

	of controlling the cash and posting to and from deposit slips.	confirmations.	performing her duties or commit fraud by lapping the accounts. Also, collusion between the general ledger clerk and the account receivable clerk could lead to a fraud by posting misstatements.	
3.	Possible overstatement of assets by general ledger clerk	Investigate and examine supporting documents.	Need to substantiate source of debit entries in the general ledger cash account. Recording of major lines of credit through loans seems to be beyond the authority of a general ledger clerk and must have additional verification.	Suggest other adjustments of cash be verified by at least one other individual, like controller or CFO

10-41. Go to the Web site for Mednax, Inc. at www.mednax.com. Click through the menu tabs for investors, SEC filings, and 10K.

(a) Explain what Mednax does. Who works for Mednax?

(b) Explain its billing collection, and reimbursement activities as described by Mednax.

(c) Who are the third-party payers for Mednax?

(d) Read Item 1A, Risk Factors. Identify risks that you believe are directly related to ICFR. How could a material weakness in ICFR cause any of these risks to affect the financial statements?

(e) Search the 10K document for disclosures on revenue recognition and contractual allowances. How does the company determine what to record? What will the auditor need to investigate or test? Propose appropriate audit procedures.

Solution:

(a) MEDNAX, Inc., is a national medical group that comprises the nation's leading provider of neonatal, maternal-fetal and pediatric physician subspecialty services as well as anesthesia services. MEDNAX employs more than 1,450 physicians in 33 states and Puerto Rico.

(b) The company assumes responsibility for contracting with third-party payors for all of our affiliated physicians. As such, they are responsible for billing, collection and reimbursement for services rendered by their affiliated neonatal, maternal-fetal, pediatric subspecialty and anesthesia physicians. In all instances, however, they do not assume responsibility for charges relating to services provided by hospitals or other physicians with whom they collaborate.

Such charges are separately billed and collected by the hospitals or other physicians. Mednax provides their affiliated physicians with a training curriculum that emphasizes detailed documentation of and proper coding protocol for all procedures performed and services provided, and they provide comprehensive internal auditing processes, all of which are designed to achieve appropriate coding, billing and collection of revenue for physician services. Generally, Menax's billing and collection operations are conducted from their business offices located across the United States and in Puerto Rico as well as their corporate offices.

(c) Third-party payers for Mednax include: government-sponsored plans, including Medicaid and Medicare, managed care organizations, and commercial health insurance payors.

(d) Compliance with newly enacted healthcare legislation needs to be monitored as well as credit line compliance and contractual reserves. The note also mentions discretionary uses of cash and alternative credit arrangements which may impact investors. Reasonableness tests and investigation of timeliness of Medicare collections will also important foci for the auditor and their affects on financial statements.

(e) Mednax recognizes patient service revenue at the time services are provided by their affiliated physicians. It will be particularly important for the auditor to examine contractual adjustments, professional liability coverage, and uncollectibles, cash controls and timeliness of cash collections, as well as reimbursement terms, proper coding of services, and whether services were actually provided.

10-42. Go to the Web site for Best Buy at www.bestbuy.com. Scroll to the bottom and select "For our Investors." Select SEC filings and the most recent 10K. Find Note 1 to the (c) below, explain in your own words:

- The company's revenue recognition policies.
- How the company determines what to record.
- What the auditor will need to investigate or test.
- Steps the auditor might use to perform the investigation of
    a. Sales returns
    b. Gift cards
    c. Sales incentives

Solution: Student answers may vary depending on the filing.

Essentially, however, the 2010 10K for Best Buy indicates that the company recognizes revenue, net of estimated returns, at the time the customer takes possession of the merchandise or receives services. The company also estimates the liability for sale returns, based on historical return levels. They also record an allowance for doubtful accounts receivable for amounts due from third parties, based on estimates of historical write-offs and chargebacks, as well as aging trends.

Best Buy, goes on to admit that their recording of revenue contains uncertainties due to assumptions and estimates of the timing of future sales returns, uncollectible accounts and the redemptions of gift cards and certificates. With respect to gift cards, a liability is initially established for the cash value of the gift card and the revenue from gift cards is recognized when: (1) the card is redeemed by the customer or (2) the likelihood of the card being redeemed is remote. Based on historical redemption patterns, if the card is not redeemed within 24 months, the liability is remote.

The auditor will need to investigate the reasonableness of Best Buy's assumptions regarding sales returns, allowance for doubtful accounts, gift cards and customer loyalty programs. Sales returns and allowances vary in their magnitude and may need differing levels of control and approval in different environments. For example in the retail sales environment of Best Buy, a credit memo is typically used. The credit memo is prepared, typically on an automated basis using a sales terminal, and then approved by someone with authority before cash is returned to the customer or a credit is recorded to the customer's account balance. Some retail environments have a separate returns department to handle return of goods. Others require authorization by a supervisor, who inspects the returned goods before signing the authorization. The auditor should also inspect required documented approvals of write-offs of accounts receivable before transactions are recorded. Write-offs are often authorized by the credit department manager or a designated employee. Policies for recording transactions, reconciling the various control totals, and comparing subsidiary ledgers and other reports to the general ledger are all part of the control process. Documentation, policies, reconciliation, and recording of gift cards and sales incentives should also be traced and vouched through the revenue recognition process.

10-43.

Access the SEC case of Serologicals Corporation, Inc. at http://www.sec.gov/litigation/admin/34-45852.htm.

Required:

(a) Briefly describe the way that Serologicals Corporation improperly recognized revenue with its largest clients.
(b) While the practice of bill and hold is not fraudulent, what are some of the criteria that Serologicals violated using this method?

(c) Search for a footnote from another company that lists its policy for bill and hold transactions that comply with GAAP and summarize its criteria (typically found under revenue recognition).

Solution:

(a) & (b) Below is a summary of the Serological's bill and hold scenario and violations.

On December 29, 1998 Serologicals Corporation a subsidiary known as Pentex, which supplied a broad line of purified animal and human blood proteins to biopharmaceutical companies. During 1999, Serologicals continued a bill-and-hold relationship with one of its largest customers that had originated at Pentex in 1997. As a result, Serologicals improperly recognized revenue when it invoiced the customer and prior to actually shipping the product. Serological periodically sent pre-purchase product samples to the customer for testing. If the customer did not reject a sample within ten to twelve weeks after receipt, Serologicals automatically sent an invoice to the customer for the bulk product from which that sample came--referred to as a "Lot"--and recognized a sale of the Lot.

The SEC decided that when Serologicals sent an invoice to the customer, it failed to comply with GAAP because the risks and rewards of ownership of the Lots had not yet passed to the customer. The customer never specified a fixed delivery schedule for the Lots, did not make a fixed commitment to purchase any Lot, and Lots were stored at Serologicals' warehouse. Finally, the customer's purchase orders specified "F.O.B. Shipping," suggesting that the risk of loss did not shift to the customer until the goods were delivered to the shipper. The SEC concluded that Serologicals' bill-and-hold sales caused overstatement of net income by $316,000 in the second quarter of 1999 and understatement of net loss by $401,000 in the third quarter of 1999.

(c) Student answers may vary.