Accounts Receivable, Notes Receivable, and Revenue

CHAPTER 11

TESTING ACCOUNTS RECEIVABLE

When testing accounts receivable, we are also testing?

INCOME STMT:  SALES and bad debt expense
BALANCE SHEET:  Allowance for doubtful accounts

Therefore in MANY businesses, testing receivables is a critical test of the company’s operating activities.

Management Assertions

When auditors test accounts receivable, what management assertion/s are they MOST interested in?

- Valuation - did they record enough bad debt expense
- Existence/ Cutoff - are these valid (NOW/ timing/ revenue recogn.)

What about the others:

- Completeness
  Not as concerned, but there might be some cut-off issues to consider.

- Rights and Obligations
  Are these related to sham transactions, sale lease-back, etc.

- Presentation & Disclosure
  Have the receivables been pledged? Do they secure something?

Various Receivables

- Accounts or trade receivables
- Notes receivable
  - loans to officers, employees, subsidiaries
- Tax refunds
- Advances to suppliers
Internal Control Over the Revenue Cycle

- Controlling customers’ orders
- Credit approval
- Issuing merchandise
- Shipping
- Billing
- Adjustments to sales and receivables

Revenue Cycle Documents

- Customer purchase order
- Sales order
- Bill of lading
- Invoice
- Control listing
- Credit memo

Sale on Account

- Accounts receivable: 30,000
- Allowance for D.A.: (1,000)
- Sales: (30,000)
- Bad debts: 1,000
- Retained earnings: (29,000)

Made a sale for $30,000 on account. Estimated $1,000 would not be collectible.

Auditors’ Objectives

A. Consider inherent risks, including fraud.
Auditors’ Objectives

B. Consider internal control over receivables and revenue.
   1. Obtain an understanding of internal control.
   2. Assess control risk and design additional tests of controls and substantive tests.
   3. Perform additional tests of controls.
      a. Examine significant aspects of a sample of sales transactions.
      b. Compare a sample of shipping documents to related sales invoices.
      c. Review the use and authorization of credit memoranda.
      d. Reconcile cash register tapes and sales tickets with sales journals.
      e. Test computer application controls.
   4. Reassess control risk and modify substantive tests.

C. Perform substantive tests of receivables and revenue.
   1. Obtain an ARTB and reconcile to ledgers.
   2. Confirm receivables with debtors.
   3. Review the year-end cutoff of sales transactions.
   4. Perform analytical procedures for A/R and revenue.
   5. Review significant year-end sales contracts for unusual terms.
   6. Evaluate the propriety of the accounting methods for receivables and revenue.
   8. Determine adequacy of allowance for uncollectible accounts; obtain the aging to assist in this.
   9. Ascertain whether any receivables have been pledged.
   10. Investigate any transactions with related parties.
   11. Evaluate the business purpose of significant and unusual sales transactions.
   12. Evaluate presentation / disclosure of receivables and revenue.

LINK SUBSTANTIVE TEST TO THE OBJECTIVE

EXISTENCE/ Cutoff
- Confirmations
- Sales cut-off
- Vouching from AR aging to sale invoices
- Vouching to subsequent receipts
- UNDERSTAND TRANSACTIONS/ APPLY REV. RECOGN.
- COMPLETENESS/ Cut-off
- Sales cut-off
- Vouch from shipping documents to AR
- RIGHTS & OBLIGATIONS
- Confirmations; customer might tell you something
- Other testwork (debit for instance) may indicate pledges of receivables
VALUATION
- Analytics
- Turnover computations and comparisons
- Evaluation of aging
- Aging procedures (inquire all balances > 90 days)
- PRESENTATION & DISCLOSURE
- Factor what learned above into the financial statements.