

AUDIT PROCEDURES – RECEIVABLE AND SALES

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Abstract

The overall objective of the audit of accounts receivable and sales is to determine if they are fairly presented in the context of the financial statements as a whole. The sales account is closely tied to accounts receivable; therefore, evidence supporting accounts receivable tends to support sales. For example, having determined that an account receivable is valid, the auditor has thereby supported the validity of the sale.

Analytical procedures can often be used to test the sales account. An unusual relationship detected in the audit of receivables and inventory may reflect a problem for the reported sales figure as well

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An effective and efficient audit approach for sales usually is to limit the testing in this area to analytical procedures. See the discussion titled "Analytical Review Procedures" later in this chapter.

The table below summarizes specific audit objectives related to financial statement assertions for accounts receivable and identifies common, but not all inclusive, substantive audit procedures that accomplish these objectives.

Specific Audit Objectives	Common Substantive Audit Procedures	Financial Assertions	Statement
Accounts receivable reflected in the balance sheet exist, are for valid transactions, and include all authentic obligations of third parties to the entity.	Test the reconciliation of the aged subsidiary ledger of individual accounts to the general ledger.	Existence Completeness Existence	Occurrence Rights and Occurrence
Billings are for the correct amount and uncollectible accounts are promptly identified and provided for; the allowance for uncollectible accounts	Mail confirmation requests to customers and reconcile confirmation exceptions. Mail confirmation requests to customers and reconcile confirmation exceptions. Review analysis of doubtful accounts and bad debt expense	Accuracy Cutoff Classification Valuation and allocation Presentation and disclosure: Occurrence and rights and obligations Presentation and disclosure ¹ . Completeness	

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<p>is adequate. Receivables are properly classified in the balance sheet between current and noncurrent assets and disclosures are adequate with respect to assigned, pledged, unbilled, discounted, and related-party receivables, and transfers of receivables. Disclosures are clearly expressed.</p>	<p>and related documents. Review bank confirmations for indications of liens on receivables. Inquire about receivables that have been assigned, pledged, unbilled, or discounted or are with related parties. Review aged subsidiary ledger of individual accounts for amounts due from employees, credit balances, or unusual items.</p>	<p>Presentation and disclosure: Understandability and classification Presentation and disclosure: Accuracy and valuation</p>
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Reconciling the Aged Subsidiary Ledger of Individual Accounts to the General Ledger

The first step in auditing accounts receivable is to reconcile the aged subsidiary ledger of individual accounts to the general ledger control account. This is ordinarily done before any other tests to assure the auditor that the population being tested agrees with the general ledger. In addition, the auditor traces a sample of individual balances to supporting documents, such as duplicate sales invoices, to verify the customer name, balance, and proper aging.

Confirmation of Accounts Receivable

The Confirmation Process states that the confirmation of accounts receivable is a generally accepted auditing procedure and should be performed in all audit engagements, except under one or more of the following circumstances:

1. The accounts receivable balance is immaterial to the financial statements.
2. It is expected that the use of confirmations would be ineffective.
3. The auditor's combined assessed level of inherent risk and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

Although the confirmation of accounts receivable is not necessary when audit risk can otherwise be reduced to an "acceptably low level, Statements of Auditing Standards points out that such a situation is unusual by stating that "in many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions."

From a practical standpoint, it is rare that a sample of receivables is not circularized for confirmation where receivables are material, as third-party verification of an entity's records provides greater audit assurance than evidence from within the entity. When the auditor concludes that it is not necessary to confirm accounts receivable, that position must be documented in the workpapers, along with

the way the auditor overcame the Statements of Auditing Standards general requirement to do so. Thus, the workpapers must include a full explanation based on one or more of the three circumstances listed above.

When performing confirmation procedures, the auditor must use judgment to determine the following:

- Design of confirmation request
- Confirmation date
- Number of accounts to be confirmed

Design of confirmation request The Confirmation Process states that, when designing the confirmation request, the auditor should consider the following factors:

- Form of confirmation request
- Auditor's prior experience with the client
- Nature of information being confirmed
- Characteristics of respondents

Form of confirmation request Two common types of confirmations are used for confirming accounts receivable: positive and negative.

A *positive* confirmation request is addressed to the customer requesting that it send directly to the auditor confirmation of whether the balance stated on the confirmation request is correct or incorrect. A *negative* confirmation request is addressed to the customer and requests a response only if the customer disagrees with the stated amount on the confirmation request. A positive confirmation request is considered more reliable because it requires affirmative action on the part of the debtor.

The determination of which type of confirmation to use is an auditor's decision and is based on (1) the strength of the client's internal controls, (2) the nature of the accounts receivable population, and (3) the facts and circumstances of the individual audit. A more detailed explanation of positive and negative confirmations follows:

1 *Positive confirmation request*—A positive confirmation may be designed in two ways. The information to be confirmed may be indicated in the confirmation request, or the request may be blank, requiring the respondent to fill in the missing information. There is a trade-off in the selection of the complete or incomplete request. When an incomplete form is completed and returned by a respondent, more competent evidence is created than when the respondent is simply asked to sign a completed confirmation form. However, when the incomplete form is used, the response rate generally will be lower and it may be necessary to perform alternative audit procedures to supplement the confirmation process. When a positive confirmation is used and the request is not returned, no audit evidence is created.

2 *Negative confirmation request*—A negative confirmation form requires the respondent to return the confirmation only if there is disagreement with the amount owed. When negative confirmations are not returned, the evidence generated is different from that generated when positive confirmations are used. That is, the lack of returned negative confirmations provides only implicit evidence that the information is correct. The Confirmation Process describes this limitation as follows:

Unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct.

Because of this limitation, the negative confirmation form should be used only under the following conditions:

- The combined assessed level of inherent and control risk is low.
- The audit population contains a large number of relatively small individual balances.
- There is no reason to believe that respondents will not give adequate attention to confirmation requests.

Even under the conditions described above, Statements of Auditing Standards expresses a concern that the use of negative confirmations will not generate sufficient competent evidential matter and concludes that "the auditor should consider performing other substantive procedures to supplement the use of negative confirmations." For example, if the auditor uses negative confirmations to test the existence of accounts receivable, it may also be advisable to use additional tests, such as reviewing subsequent cash collections and vouching, to determine with reasonable assurance that accounts receivable do exist.

When a response is received from a negative confirmation indicating disagreement with the amount owed, the auditor should investigate the reason for the disagreement. If there are a number of disagreements or the disagreements appear to be significant, the auditor should reconsider the original assessment of the level of inherent and control risk. This reassessment may lead to the conclusion that the combined assessed level of inherent and control risk is not low, in which case the auditor should modify the originally planned audit approach appropriately.

Auditor's prior experience with the client When designing confirmation requests, the auditor should consider information from prior experience with the client and with similar clients. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. Prior experience may suggest, for example, that a confirmation form was improperly designed or previous response rates were so low that audit procedures other than confirmation should be considered.

Nature of information being confirmed The auditor should consider the capabilities of the respondents when determining what to include in the confirmation request. Respondents can confirm only

what they are capable of confirming, and there is a tendency to confirm only what is relatively easy to confirm. For example, when designing an accounts receivable confirmation, the auditor should consider whether respondents are more capable of verifying an individual account balance or transactions that make up a single account receivable balance.

Information to be confirmed with respondents should not be limited to dollar amounts. For example, in complex transactions it may be appropriate to confirm

terms of contracts or other documentation that supports such transactions. In addition, it may be appropriate to confirm information that is based on oral modifications and, therefore, not part of the formal documentation. Statements of Auditing Standards provides the following guidance with respect to oral modifications:

When the auditor believes there is a moderate or high degree of risk that there may be significant oral modifications, he or she should inquire about the existence and details of any such modifications to written agreements.

If the client responds to the auditor's inquiry by stating that there are no oral modifications to an agreement, the auditor should consider confirming with the other party to the agreement that no oral modifications exist.

Characteristics of respondents Confirmation requests should be addressed to respondents who will generate meaningful and competent evidential matter. Factors to be considered in this regard include the following:

- *Competence of the recipient*—*Recipients may be apathetic about the confirmation process, and management may have assigned responsibility to an individual who will sign and return the confirmation without adequate concern for its accuracy.*
- *Knowledge of the respondent*—*Confirmations may be signed by persons who have no knowledge of the account and no authority to respond.*
- *Objectivity of the respondent*—*For example, the reliability of confirmations from related parties may be questionable.*

If information concerning the above factors, as well as other relevant factors, comes to the auditor's attention, and that information suggests that meaningful and competent evidential matter will not result from the confirmation process, the auditor should consider using other audit procedures to test financial statement assertions.

Statements of Auditing Standards specifically warns that under some circumstances the level of professional skepticism should be increased, resulting in a closer scrutiny of the respondent. Two examples presented in *The Confirmation Process* are: (1) significant, unusual year- end transactions that are material or (2) where the respondent is the custodian of a material amount of the client's assets.

Confirmation date

The confirmation date relates to the timing of the confirmation procedures. Whether confirmations are requested as of year end or as of some other date will depend on the overall design of the audit approach, with the aim of making the examination more efficient or meeting client deadlines. A confirmation date other than year end can be justified when internal controls are sufficiently reliable to produce reasonably accurate revenue and collection data between the confirmation date and year end. Otherwise, confirmation must be performed at or very near to the balance-sheet date. Other factors the auditor should consider when deciding on a

confirmation date include (1) the materiality of the accounts receivable balance and (2) the auditor's exposure to lawsuits because of the possibility of client bankruptcy and similar risks.

If the auditor makes the decision to confirm accounts receivable prior to year end, the auditor may find it necessary to test the transactions occurring between the confirmation date and the balance-sheet date by examining such internal documents as duplicate sales invoices, shipping documents, and evidence of cash receipts in addition to performing analytical procedures of the intervening period.

Number of accounts to be confirmed

The auditor also must decide how many confirmations to send and to which customers. The auditor may determine the extent of confirmations to send by using statistical analyses or by judgmentally determining the sample size. The primary considerations affecting the decision on the number of confirmations to send are:

- The materiality of total accounts receivable (i.e., if the accounts receivable balance is highly material relative to the other asset balances, a larger number of accounts would be necessary than when the balance is immaterial)
- The number of accounts receivable
- The distribution in the size of the accounts
- The results of obtaining an understanding of the client's internal control and tests of transactions
- The results of the confirmation tests in previous years
- The type of confirmation being used (more confirmations usually are required for negative than for positive confirmations)
- The results of related analytical procedures

In most audits, the auditor's emphasis should be on confirming accounts with the following characteristics:

- Accounts with larger balances
- Accounts with older balances
- Accounts in dispute
- Accounts with credit balances
- Accounts with related parties

Usually, the auditor selects all accounts above a certain dollar amount and selects a sample from the remainder. During selection of the accounts for confirmation, it is important that the auditor have complete discretion and independence in choosing the accounts to be confirmed. However, clients sometimes request that certain accounts not be confirmed. In these cases, the auditor should determine (1) the client's reasons for the request and whether they are valid, (2) whether the amounts involved are material, and (3) whether it is possible to verify the balances in the accounts by other means (e.g., testing subsequent collections).

If the client dictates which accounts to select or refuses to grant permission to confirm certain accounts and the auditor cannot confirm the validity of the accounts by other means, the auditor should evaluate the effect of this scope limitation on the overall audit and whether an unqualified opinion can still be issued on the financial statements.

Occasionally, the client may ask the auditor to perform procedures that go beyond the minimum scope requirements of the audit. For example, the client may ask the auditor to confirm certain customer accounts receivable that are below the cutoff amount determined by the auditor or to confirm all customer accounts receivable. While it is permissible for the auditor to accommodate the client's wishes, the auditor should indicate clearly in the workpapers which tests are being performed to be responsive to the client's expectations.

Performance of confirmation procedures

For confirmation procedures to be effective, the auditor must maintain control of the confirmations from the time they are prepared and mailed until they are returned by the customer. The confirmation process should be executed so that the client does not have an opportunity to intercept requests when they are mailed or when they are returned from respondents.

The confirmation process ideally involves the auditor mailing a confirmation request directly to a respondent and receiving the returned confirmation directly from the respondent. When positive confirmations are used and there is no response, the auditor should consider sending second and, possibly, third requests.

Statements of Auditing Standards recognizes that other means of confirmation may be used but notes that the auditor must consider using additional audit procedures to reasonably ensure that a response is authentic and relevant. Specifically, The Confirmation Process discusses the use of facsimile and oral responses.

When a fax is received from a respondent as part of the confirmation process, some degree of uncertainty arises concerning the source of the information. Problems may arise if auditors rely on faxes as audit evidence without performing corroborating audit procedures. For example, it is possible to preprogram a fax machine with an incorrect transmitting number and name, which leaves the recipient with no other information about the source of the document. Another problem is that information contained in the faxed document itself can be easily manipulated. If a fax can be intercepted, a dishonest party can remove and replace key information.

While Standards of Auditing Standards recognizes that fax confirmations may be used, it notes that the auditor must consider using additional procedures to reasonably ensure that a response is authentic and relevant. When a fax is received from a respondent as part of the confirmation process, some degree of uncertainty arises concerning the source of the information. To reduce that risk, procedures such as the following may be used:

- Verify the source and content of the fax by telephoning the respondent.
- Request that the respondent mail the original confirmation directly to the auditor.

When information is confirmed orally, the content of, and circumstances surrounding, the confirmation should be documented in the workpapers. If the information confirmed orally is significant, The Confirmation Process requires that the auditor request the respondent to confirm the information in writing.

Auditors sometimes are able to directly access online information held by a third party concerning a client's account balance or other information.

Alternative procedures—nonresponses

For negative confirmations, no problem exists for nonresponses because the customer was not requested to respond if the balance or information was correct. Once an account is selected for positive confirmation, on the other hand, the account usually must be supported. Nevertheless, the auditor often is unable to obtain a 100% response rate when positive confirmations are used. When information has not been confirmed, alternative audit procedures must frequently be employed.

Statements of Auditing Standards concludes that it may be acceptable to omit the use of alternative procedures when the auditor has not received replies to positive confirmation requests if both of the following conditions are met:

- The auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions.
- When testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100% misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated.

When information has not been confirmed for positive requests and the auditor has decided to use alternative audit procedures, the specific nature of the alternative procedures depends on the account balance and the client's internal control. Common alternative procedures include examining subsequent cash collections and reviewing documentation.

- *Examining subsequent cash collections*—The auditor may examine cash receipts subsequent to the confirmation date to determine if the receivable has, in fact, been collected. Evidence of the receipt of cash subsequent to the confirmation date includes examining remittance advices and related bank deposit tickets, entries in the cash receipts records, and subsequent credits in the accounts receivable subsidiary records. This verification, along with shipping documents that indicate that the goods were shipped prior to the confirmation date (or documentation that services were delivered), provides good evidence that the receivable was owed as of the confirmation date. Additional care should be taken to match subsequent payments with specific invoices outstanding as of the confirmation date. One particular fraud

scheme called "lapping" involves applying funds subsequently paid by another customer to the wrong account to conceal a misappropriation. Careful examination of subsequent remittances to determine if they were applied to the correct account would uncover this scheme.

Because review of subsequent cash collections involves an examination of evidence outside the entity, it is usually considered to provide more reliable audit evidence than a review of internal documentation.

- *Reviewing documentation*—The auditor may review the documentation that gave rise to the receivable. For example, a sales invoice should be issued on the date the receivable was created and there should be shipping documents related to the sale. By examining the sales invoices and shipping documents, the auditor can verify the actual date of the billing and the shipping date.

Alternative procedures—responses with differences

Confirmation responses sometimes contain differences noted by the customer. The auditor must determine the reasons for the differences and clear them satisfactorily. In many cases, differences are caused by timing differences between the client's and the customer's records. It is important to distinguish between these differences and *exceptions*, which represent misstatements of the accounts receivable balance. The most commonly reported types of differences in confirmations are as follows:

- *Payment has already been made*—Reported differences typically arise when the customer has made a payment prior to the confirmation date, but the client has not received the payment in time to record it before the confirmation date. The auditor should carefully investigate these instances to determine the possibility of a cash receipts cutoff error, lapping, or cash theft.
- *Merchandise has not been received*—Differences typically arise because the client records the sale at the date of shipment and the customer records the purchase when the goods are received. The time the goods are in transit is frequently the cause of differences reported on confirmations. These should be investigated to determine the possibility that the customer did not receive the goods at all or that a cutoff error in the client's records exists.
- *The goods have been returned*—The client's failure to record a credit memo could result from timing differences or from the improper recording of sales returns and allowances. Again, these differences should be investigated.
- *Clerical errors and disputed amounts exist*—Differences typically arise because the customer states that there is an error in the price charged for the goods, the goods are damaged, the proper quantity of goods was not received, or there is other customer dissatisfaction. These differences should be investigated to determine whether the client is in error and, if so, the amount of the error.

The auditor should investigate all differences between the client's records and the information provided by respondents. If such differences cannot be resolved or if the auditor determines that they represent misstatements, the auditor should:

- Determine the cause of the misstatement.
- Extrapolate the misstatement (together with other misstatements included in the same sampling application, if applicable) over the population to determine whether additional audit evidence is required to reduce the risk of material misstatement to an appropriately low level.
- Consider the possibility that fraud may have occurred.
- Determine whether additional audit procedures are necessary to achieve the desired confirmation audit objectives.
- Report all unreconciled misstatements to a client personnel not directly involved in the area subject to confirmation.
- Consider whether responses indicate matters that should be reported to the audit committee.

Errors noted while performing additional tests of accounts receivable balances at the client's request may receive different consideration.

Evaluating the results of confirmation procedures

When all differences have been resolved, including those discovered when performing alternative procedures, the auditor should determine whether the related assertions have been sufficiently tested. Statements of Auditing Standards concludes that the following factors should be considered:

- The reliability of evidence obtained through the confirmation process and alternative procedures
- The nature and implications of exceptions discovered
- The evidence obtained by the auditor through the use of procedures other than confirmation and alternative procedures
- Whether additional evidence is needed

If the auditor concludes that evidential matter obtained through the confirmation process, alternative audit procedures, and other audit procedures is not sufficient to substantiate relevant assertions in the financial statements, additional evidence must be obtained. The additional evidence may be acquired by applying whatever procedures the auditor deems appropriate, including additional confirmations, tests of details, and analytical procedures.

It will be necessary for the auditor to generalize from the sample to the entire population of accounts receivable. Even though the sum of the errors in the sample may not significantly affect the financial statements, the auditor must consider whether the population is likely to be materially misstated.

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