Audit of revenue and receivables

Receivables are usually audited using a combination of tests of details and analytical procedures.

Table 14.1: Assertions applicable to receivables

Assertions about classes of transactions	– All sales transactions recorded have occurred and relate to the entity **(occurrence)** – All sales transactions that should have been recorded have been recorded **(completeness)** – Amounts relating to transactions have been recorded appropriately **(accuracy)** – All transactions have been recorded in the correct period **(cut-off)** – All transactions are recorded properly **(classification)**
Assertions about account balances at the period-end	– Recorded receivables exist **(existence)** – The entity controls the rights to receivables and related accounts **(rights and obligations)** – All receivables that should have been recorded have been recorded **(completeness)** – Receivables are included in the accounts at the correct amounts **(valuation and allocation)**
Assertions about presentation and disclosure	– All disclosed events and transactions relating to receivables have occurred and pertain to the entity **(occurrence, rights and obligations)** – All disclosures required have been included **(completeness)** – Financial information is appropriately presented and described and disclosures clearly expressed **(classification and understandability)** – Financial and other information is disclosed fairly and at appropriate amounts **(accuracy and valuation)**

Internal control considerations

Segregating responsibilities in this area is a very important control. One person should not be responsible for taking orders, raising sales invoices and receiving and recording monies from customers. The failure to segregate these duties could lead to a fraud such as teeming and lading which would overstate receivables balances.

From the company's point of view, the reconciliation of the aged receivables accounts with the receivables control account on a regular basis is a key control to highlight anomalies. However, as with a bank reconciliation, the auditor will usually only focus on the year-end reconciliation and listings, as this is often the most efficient way to obtain audit evidence.

Procedures for receivables

Existence, completeness and valuation are key assertions relating to the audit of receivables.

Audit procedures for receivables are set out in the table below. This covers the audit of sales and prepayments as well as trade receivables. Receivables are often tested in conjunction with sales revenue. The key assertions for sales are occurrence, completeness and accuracy.

Table 14.2: Audit procedures - receivables

Audit procedures: receivables	
Completeness	• **Agree** the balance from the individual receivables ledger accounts to the aged receivables' listing and vice versa. • **Match** the total of the aged receivables' listing to the receivables ledger control account. • **Cast and cross-cast** the aged receivables listing before selecting any samples to test. • **Trace** a sample of shipping documentation to sales invoices and into the sales and receivables' ledger. • Complete the **disclosure checklist** to ensure that all the disclosures relevant to receivables have been made. • **Compare** the gross profit % by product line with the previous year and industry data. • **Compare** the level of prepayments to the previous year to ensure the figure is materially correct and complete. • **Review detailed statement of financial position** to ensure all likely prepayments have been included.

Audit procedures: receivables	
Existence	• Perform a **receivables' circularisation** on a sample of year-end trade receivables (see Section 3 for details of how to undertake the receivables' circularisation). • **Follow up** all balance disagreements and non-replies to the receivables' confirmation. • **Perform alternative procedures** for any exceptions and non-replies to the receivables' confirmation, such as: • **Review after-date cash receipts** by inspecting bank statements and cash receipts documentation. • Examine the **customer's account and customer correspondence** to assess whether the balance outstanding represents specific invoices and confirm their validity. • Examine the **underlying documentation** (purchase order, despatch documentation, duplicate sales invoice etc). • **Enquire from management** explanations for invoices remaining unpaid after subsequent ones have been paid. • **Observe** whether the balance on the account is growing and if so, find out why by discussing with management.
Rights and obligations	• Review **bank confirmation** for any liens on receivables. • Make **enquiries of management, review** loan agreements and review board minutes for any evidence of receivables being sold (eg to factors).

Audit procedures: receivables	
Valuation and allocation	• **Compare** receivables' turnover and receivables' days to the previous year and/or to industry data. • **Compare** the aged analysis of receivables from the aged receivables listing to the previous year. • **Review** the adequacy of the allowance for uncollectable accounts through discussion with management. • **Compare** the irrecoverable debt expense as a % of sales to the previous year and/or to industry data • **Compare** the allowance for uncollectable accounts as a % of receivables or credit sales to the previous year and/or to industry data. • Confirm adequacy of allowance by **reviewing correspondence** with customers and solicitors. • **Examine credit notes** issued after year-end for allowances that should be made against current period balances. • **Examine** large customer accounts individually and compare to the previous year's balances. • For a sample of old debts on the aged receivables listing, obtain further information regarding their recoverability by **discussions** with management and **review** of customer correspondence. • For a sample of prepayments from the prepayments' listing, **recalculate** the amount prepaid to ensure that it has been accurately calculated.

Cut-off	• For a sample of sales invoices around the year-end, **inspect the dates** and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off. • For **sales returns**, select a sample of returns documentation around the year-end and trace to the related credit entries. • Perform **analytical procedures** on sales returns, comparing the ratio of sales returns to sales. • **Review material** after-date invoices, credit notes and adjustments and ensure that they are recorded correctly in the relevant financial period.
Classification	• Take a sample of sales invoices and examine for proper **classification** into revenue accounts.

Audit procedures: receivables	
Accuracy	• For a sample of sales invoices, **compare** the prices and terms to the authorised price list and terms of trade documentation. • Test whether **discounts** have been properly applied by **recalculating** them for a sample of invoices. • Test the correct calculation of **tax** on a sample of invoices.
Occurrence	• For a sample of sales transactions recorded in the ledger, **vouch** the sales invoice back to customer orders and despatch documentation.
Occurrence and rights and obligations	• Determine, through **discussion** with management, whether any receivables have been pledged, assigned or discounted and whether such items require disclosure in the financial statements.
Classification and understandability	• **Review** the aged analysis of receivables for any large credits, non-trade receivables and long-term receivables and consider whether such items require separate disclosure. • **Read** the disclosure notes relevant to receivables in the draft financial statements and review for understandability.
Accuracy and valuation	• **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

SLAuS 505 - The receivables' confirmation

A confirmation of receivables is a major procedure, usually achieved by direct contact with customers. There are two methods of confirmation: positive and negative.

Objectives of confirmation

External confirmations are audit evidence obtained as a direct written response to the auditor from a third party in paper form or by electronic or other medium.

SLAuS 505 *External confirmations* covers the confirmation of amounts by third parties, including the confirmation of amounts by receivables.

Client's mandate

The SLAuS outlines what the auditors' response should be when management refuses permission for the auditors to contact third parties for evidence. If management asks the auditor not to seek the confirmation, the auditor shall enquire about management's reasons for the refusal and seek audit evidence regarding the validity and reasonableness of the reasons. They shall also evaluate the implications of the refusal on the assessment of the risk of material misstatement and on the nature, timing and extent of other audit procedures. The auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. If the auditor concludes that the refusal is unreasonable, or the auditor cannot obtain relevant and reliable audit evidence elsewhere, the auditor shall communicate with those charged with governance in accordance with SLAuS 260 and consider the implications for the auditor's report.

Positive v negative confirmation

A **positive confirmation request** is one in which the confirming party responds directly to the auditor indicating whether they agree or disagree with the information in the request or provides the requested information.

A **negative confirmation request** is one in which the confirming party responds directly to the auditor only if they disagree with the information in the request.
The positive method is generally preferable as it is designed to encourage definite replies from those contacted.
The negative method provides less persuasive audit evidence and shall not be used as the sole substantive procedure to audit receivables, unless all of the following are present:

- The **risk** of material misstatement has been assessed as **low**.
- The auditor has obtained sufficient appropriate audit evidence on the operating effectiveness of relevant **controls**.
- The population consists of a **large number of small, homogeneous account balances**.
- A **very low exception rate** is expected.
- The auditor is not aware of circumstances or conditions that would cause customers to **disregard the requests**.

A specimen 'positive' confirmation letter is shown below.

The statements will normally be prepared by the client's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, must maintain **strict control** over the preparation and despatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the auditors' own office for follow-up by them.

Figure 14.1: Specimen 'positive' confirmation letter

MANUFACTURING PLC
15 Harbour Side
Colombo
Date

Messrs (customer)

In accordance with the request of our auditors, ABC Co, we ask that you kindly confirm to them directly your indebtedness to us at [insert date] which, according to our records, amounted to Rs.......... as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter direct to our auditors in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors directly of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,
For Manufacturing PLC

Reference No: ....

....

(Tear-off slip)

The amount shown above is/is not * in agreement with our records as at

Account No .... Signature ....

Date .... Title or position ....

* The position according to our records is shown overleaf.

Notes
• The letter is on the client's paper, signed by the client.
• A copy of the statement is attached.
• The reply is sent directly to the auditor in a pre-paid envelope.

Sample selection

Auditors will normally only contact a **sample** of accounts receivable. If this sample is to yield a meaningful result it must be based upon a **complete list** of all accounts receivable. In addition, when constructing the sample, the following classes of account should receive special attention:

- **Old, unpaid** accounts
- Accounts **written-off** during the period under review
- Accounts with **credit balances**
- Accounts settled by **round sum payments**
- Accounts with **nil balances**
- Accounts which have been **paid** by the date of the examination

Follow-up procedures

SLAuS 505 states that the auditor may send an additional confirmation request when a reply to a previous request has not been received within a **reasonable time**. For example, the auditor may send an additional or follow-up request having rechecked the accuracy of the original address. Also, with the client's permission, the auditor can phone the customer to request a reply to the original request.

Exceptions and non-responses

An **exception** is a response that shows a difference between the information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.
A **non-response** is a failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Auditors will have to carry out further work in relation to those receivables who:

- **Disagree** with the **balance stated** (positive and negative confirmation), resulting in **exceptions**
- **Do not respond**, resulting in **non-responses**

In the case of disagreements, the customer response should have identified specific amounts which are disputed. These give rise to exceptions and may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor must evaluate whether this is indicative of fraud (in accordance with SLAuS 240). Exceptions might also indicate a deficiency in internal control. Some exceptions, of course, do not represent misstatements, as they may be due to timing, measurement or clerical errors in the confirmation procedures. The table below outlines some reasons for exceptions occurring.

Reasons for exceptions

There is a **dispute** between the client and the customer. The reasons for the dispute would have to be identified, and provision made, if appropriate, against the debt.

Cut-off problems exist, because the client records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended (see below).

The customer may have sent the **monies before** the year-end, but the monies were **not recorded** by the client as receipts until **after** the year-end. Detailed cutoff work may be required on receipts.
Monies received may have been posted to the **wrong account** or a cash-in-transit account. Auditors should check if there is evidence of other mis-posting. If the monies have been posted to a cash-in-transit account, auditors should ensure this account has been cleared promptly.

Customers who are also suppliers may **net-off balances** owed and owing. Auditors should check that this is allowed.

Reliability of responses

The SLAuS states that the auditor shall obtain further audit evidence to resolve any **doubts about the reliability** of a response to a confirmation request. This could include contacting the confirming party.
If the auditor concludes that a response to a request is **not reliable**, he shall evaluate the impact of this on the assessment of the risk of material misstatement (including the risk of fraud), and on the related nature, timing and extent of other audit procedures.

Auditing sales revenue

Completeness and occurrence of sales

Analytical procedures are important when testing completeness. A client is likely to have a great deal of information about company sales and should be able to explain any fluctuations and variances. Auditors should consider the following.

- The **level of sales** over the year, compared on a month-by-month basis with the previous year
- The effect on sales value of **changes in quantities** sold
- The effect on sales value of **changes in products** or **prices**
- The level of **goods returned, sales allowances** and **discounts**
- The **efficiency of labour** as expressed in sales or profit per tax per employee

In addition, auditors must record reasons for changes in the **gross profit margin**. Analysis of the gross profit margin should be as detailed as possible, ideally broken down by **product area** and **month or quarter**.
As well as analytical procedures, auditors may feel that they need to carry out a directional test on **completeness of recording** of individual sales in the accounting records. To do this, auditors should start with the documents that first record sales (**goods despatched notes** or **till rolls** for example), and trace sales recorded in these through intermediate documents, such as sales summaries, to the **receivables ledger**.

Auditing cash and bank balances
Audit objectives for cash
The following table demonstrates the audit objectives for cash balances and how these are related to the financial statement assertions relevant to this account area. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these financial statement assertions.

Table 15.1: Audit objectives for cash

Financial statement assertion	Audit objective
Existence	Recorded cash balances exist at the period-end
Completeness	Recorded cash balances include the effects of all transactions that have occurred
Rights and obligations	The entity has legal title to all cash balances shown at the period-end
Valuation	Recorded cash balances are realisable at the amounts stated

Audit procedures
Bank balances are usually **confirmed directly** with the bank in question.

Bank confirmation procedures
This type of audit evidence is valuable because it comes directly from an **independent source** and, therefore, provides greater assurance of reliability than that obtained solely from the client's own records. The bank letter is mentioned as a source of external third-party evidence in SLAuS 505 *External confirmations*.

Confirmation requests
The auditors should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from the bank:
- **Listing balances** and other information, and requesting confirmation of their accuracy and completeness, or
- **Requesting details of balances** and other information, which can then be compared with the requesting client's records

In determining which of the above approaches is the most appropriate, the auditors should weigh the **quality** of **audit evidence** they require in the particular circumstances against the **practicality** of obtaining a reply from the confirming bank.

Difficulty may be encountered in obtaining a satisfactory response, even where the client company submits information for confirmation to the confirming bank. It is important that a response is sought for **all** confirmation requests. Auditors should not usually request a response only if the information submitted is incorrect or incomplete.

Content of confirmation requests

The most commonly requested information is in respect of balances due to or from the client entity on **current, deposit, loan and other accounts**. The request letter should provide the account number and the type of currency for the account.

An example of a letter requesting confirmation of bank balances is as follows:

Figure 15.1: Sample letter requesting bank confirmations

20 November 20X4

The Manager
Big Bank plc
Mawatha
Colombo

Dear Sir/Madam

Subject: Confirmation of year-end Bank Balances as at 31 December 20X4 for Large Company plc (Previous year end 31 December 20X3).

In accordance with the agreed practice for provision of information to auditors, please forward information on our mutual client Large Company plc as detailed below on behalf of the bank, its branches and subsidiaries. This request and your response will not create any contractual or other duty with us.

(1) Details of year-end account balances

Please provide details of the year-end balances (as at 31 December 20X4) of the following accounts.

Company	Sort code	Account number	Currency
Large Company plc	40-51-99	21346767	LKR
Large Company plc	21-41-99	23109888	LKR

(2) Please provide details of any account balances not listed above as at the 31 December 20X4.

(3) Please provide details of any bank accounts opened or closed during the twelve months prior to 31 December 20X4.

Thank you for your help on this matter.

Yours Faithfully

ABC Chartered Accountants
Colombo
Tel: 0094775001222
e-mail: abc@123.com

Cut-off

Care must be taken to ensure that there is no **window dressing**, by auditing **cut-off** carefully. Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the company by:

(a) Keeping the cash book open to take credit for **remittances actually received** after the year-end, thus enhancing the balance at bank and reducing receivables

(b) Recording cheques paid in the period under review which are not actually despatched until after the year-end, thus decreasing the balance at bank and reducing liabilities A combination of (a) and (b) can contrive to present an artificially healthy-looking current ratio.

With the possibility of (a) above in mind, where lodgements have not been cleared by the bank until the new period, the auditors should **examine the paying-in slip** to ensure that the amounts were actually paid into the bank on or before the period-end date.

As regards (b) above, where there appears to be a particularly **large number of outstanding cheques** at the year-end, the auditors should check whether these were **cleared within a reasonable time** in the new period. If not, this may indicate that despatch occurred after the year-end.

Audit plan for auditing the bank balance

Audit procedures: bank balance
(to confirm completeness, valuation, existence, cut-off and assertions related to disclosure)

Obtain standard bank confirmations from each bank with which the client conducted business during the audit period.

Re-perform arithmetic of bank reconciliation to confirm its accuracy

Trace cheques shown as outstanding from the bank reconciliation to the cash book prior to the year-end and to the **after-date bank statements** and **obtain explanations** for any **large or unusual items** not cleared at the time of the audit.

Compare cash book(s) and **bank statements** in detail for the last month of the year, and **match items outstanding** at the reconciliation date to bank statements.

Review bank reconciliation previous to the year-end bank reconciliation and test whether **all items** are **cleared** in the last period or **taken forward** to the year-end bank reconciliation.

Obtain satisfactory explanations for **all items** in the **cash book** for which there are **no corresponding entries** in the **bank statement** and vice versa by **discussion** with finance staff.

Verify contra items appearing in the cash books or bank statements with original entry.

Verify, by **inspecting** paying-in slips, that **uncleared bankings** are **paid in** prior to the year-end.
Verify balances per the cash book according to the bank reconciliation by **inspecting** cash book, bank statements and general ledger.

Verify the **bank balances** with reply to **standard bank letter** and with the **bank statements**.

Inspect the cash book and bank statements before and after the year-end for **exceptional entries** or **transfers** which have a material effect on the balance shown to be in-hand.

Identify whether any **accounts** are **secured** on the **assets** of the company by **discussion** with management.

Cash

Cash balances should be verified if they are **material** or **irregularities** are suspected. Cash balances/floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak and because they may be material in total.
However, in enterprises such as hotels and retail organisations, the amount of cash-in-hand at the period-end could be considerable. Cash counts may be important for internal auditors, who have a role in fraud prevention.
Auditors will be concerned that the cash **exists**, is **complete**, and belongs to the company (**rights and obligations**) and is stated at the correct **value**.
Where the auditors determine that cash balances are potentially material they may conduct a **cash count**, ideally at the period-end. Rather like attendance at an inventory count, the conduct of the count falls into three phases: planning, the count itself, and follow-up procedures.

Planning the cash count

Planning is an essential element, as it is important that all cash balances are counted at the same time as far as possible. 'Cash' in this context may include unbanked cheques received, IOUs and credit card slips, in addition to notes and coins.
As part of their planning procedures the auditors will need to determine the **locations** where cash is held and which of these locations warrant a count.
Planning decisions will need to be recorded on the current audit file including:

- The **precise time** of the count(s) and location(s)
- The **names** of the **audit staff** conducting the counts
- The **names** of the **client staff** intending to be present at each location

Where a location is not visited it may be appropriate to obtain a letter from the client confirming the balance.

Cash count

The following matters apply to the count itself.

- All cash/petty cash **books** should be **written up** to date in **ink** (or other permanent form) at the time of the count.
- All **balances** must be **counted** at the **same time**.
- All **negotiable securities** must be **available** and **counted** at the time the cash balances are counted.
- At **no time** should the **auditors** be **left alone** with the cash and negotiable securities.
- **All cash** and securities **counted** must be **recorded** on working papers subsequently filed on the current audit file. **Reconciliations** should be prepared where applicable (for example, imprest petty cash float).

Table 15.3: Audit procedures - cash

Audit procedures: cash count **(to confirm completeness, valuation, existence and disclosure)**
Count cash balances held and agree to petty cash book or other record: – Count all balances simultaneously – All counting to be done in the presence of the individuals responsible – Enquire into any IOUs or cashed cheques outstanding for a long period of time
Obtain certificates of cash-in-hand from responsible officials.
Confirm that bank and cash **balances** as reconciled above are **correctly stated** in the financial statements.
Follow up Obtain **certificates of cash-in-hand** as appropriate.
Verify **unbanked cheques/cash receipts** have subsequently been **paid in** and agree to the bank reconciliation by **inspection** of the relevant documentation.
Ensure **IOUs** and cheques cashed for employees have been **reimbursed**.
Review whether **IOUs or cashed cheques outstanding** for **unreasonable periods** of time have been provided for.
Verify the **balances** as counted are reflected in the accounts (subject to any agreed amendments because of shortages and so on) by **inspection** of draft financial statements.